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GEORGIA

Country Diagnostic

October 2021



Georgia

Country Diagnostic

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Georgia Country Diagnostic

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About this publication

This joint publication between the EBRD and the EIB aims to identify the key challenges and opportunities for promoting private sector development as well as public and private sector investment in Georgia.

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The mission of the EIB Economics Department is to provide economic analyses and studies to support the Bank in its operations and in the definition of its positioning, strategy and policy. The Department, a team of 45 economists, is headed by Director Debora Revoltella.

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Contents

Joint report on Georgia	iii
Executive summary	iv
1. Political economy and macroeconomic environment	1
1.1 A country with European ambitions suffering from political polarisation and located in a challenging geopolitical space.....	1
1.2 In a challenging macroeconomic environment, Georgia has plenty of potential to catch up	2
2. Good governance for a better business environment	9
2.1 Good governance standards need to remain high on Georgia's reform agenda.....	9
2.2 Strengthening and increasing the efficiency of the judiciary is key to improving Georgia's investment climate.....	12
2.3 Enhancing the capacity, effectiveness, accountability and transparency of Georgia's civil service	14
2.4 Building on improvements in corporate governance standards would boost performance and investment opportunities.....	15
3. Improving human capital and broadening economic opportunities to boost competitiveness.....	17
3.1 Georgia's labour market characteristics reveal underlying structural issues	17
3.2 Labour force skills are out of step with the evolving needs of businesses	19
3.3 To improve workforce skills and resolve youth inclusion issues, weaknesses in the education system and skills mismatches must be addressed.....	21
3.4 With high demand for technical skills, work is underway to strengthen the national technical and vocational education and training (TVET) framework	23
3.5 Gender disparities persist, dampening the country's potential productivity growth.....	24
3.6 Economic opportunities for people with disabilities and older workers	26
4. The financial sector and private sector access to finance.....	29
4.1 Financial intermediation has increased substantially with banks dominating the landscape	29
4.2 Despite notable improvements, firms' propensity to invest is still hampered by credit constraints and financial autarchy	35
5. Boosting external competitiveness to accelerate economic development	43
5.1 Expansion of goods exports and the booming tourism sector have been driving economic growth	43
5.2 The Deep and Comprehensive Free Trade Agreement with the European Union presents a significant opportunity that is yet to be fully utilised	47
5.3 Foreign investments could serve as facilitators for penetrating markets in the European Union and beyond.....	49
5.4 Specific sectors offer diverse sets of opportunities, but face distinct challenges	51

6. Competitiveness and growth-enabling infrastructure: a snapshot	55
6.1 Investment in Infrastructure needs to be scaled up to enable further economic development	55
6.2 Transport infrastructure in need of investment and maintenance, particularly in the road, maritime and aviation sectors.....	57
6.3 Access to water supply, sanitation and waste management is not yet inclusive	60
6.4 Information and communications technology infrastructure compares well with peers, but accessibility is not uniform across the country	62
6.5 Medical infrastructure and hospitals benefited from a series of reforms. However investment and improvements are needed in service provision, notably in terms of inclusiveness and universal services	64
7. Ensuring the sustainable transition of the energy sector and advancing green principles	67
7.1 Consistent policy implementation and ongoing harmonisation with EU regulations are transforming Georgia's energy sector.....	67
7.2 The energy sector plays a prominent role in the economy	70
7.3 Investments in generation capacity trail behind growing demand	71
7.4 The ongoing liberalisation of the energy market is at odds with the growing role of gas and its preferential conditions in the sector.....	72
7.5 Long-term business opportunities offered by decarbonisation.....	74
References.....	77
Sources used by chapter	77
1. Political economy and macroeconomic environment	77
2. Good governance for a better business environment	77
3. Improving human capital and broadening economic opportunities to boost competitiveness	78
4. The financial sector and private sector access to finance.....	79
5. Boosting external competitiveness to accelerate economic development.....	80
6. Competitiveness and growth-enabling infrastructure: a snapshot	80
7. Ensuring the sustainable transition of the energy sector and advancing green principles	82

Joint report on Georgia

The European Bank for Reconstruction and Development (EBRD) and the European Investment Bank (EIB) jointly produced this report on Georgia. The report aims at identifying the key challenges and opportunities in promoting private sector development and investment in Georgia. This collaboration between the EBRD and the EIB builds on the Country Diagnostic Working Group, which helps international financial institutions to share perspectives and experiences regarding the preparation of Country Diagnostic, and develop cross-institutional collaboration where possible¹.

The work on the report was jointly led by Dimitar Bogov² and Ana Kresic³ from the EBRD and Luca Gattini⁴ and Joana Conde⁵ from the EIB. Luca Gattini and Joana Conde are the authors of Chapter 1 on macroeconomic developments, Chapter 4 on access to finance and Chapter 6 on infrastructure. Oleksandr Pavlyuk (EBRD) authored the political economy section in Chapter 1, and Pentidou Polyxeni, Borbala Siklos and Florian Lalanne (EBRD) wrote the Box on the development of the money and capital markets in Chapter 4. Marcel Schlobach (EBRD) contributed to the infrastructure chapter with information on the EBRD's road transport connectivity index and analysis of the road sector. Dimitar Bogov and Ana Kresic co-led the drafting of the remaining chapters, working with Hester Coutanche and Christine Hagedorn (EBRD) on Chapter 2 on good governance, Marko Stermsek and Ines de la Pena (EBRD) on the chapter discussing improving human capital, Lia Alscher (EBRD) on the external competitiveness chapter and Giuseppe Grimaldi and Ketis Sandroshvili (EBRD) on the final chapter on the energy sector and advancing green principles. Lia Alscher provided excellent research assistance.

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¹ For more details, see <http://www.countrydiagnostics.com/>

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Executive summary

Underpinned by European aspirations and, more recently, its commitment to implement the Association Agreement with the European Union (EU), Georgia has over the years pursued wide-ranging reforms. These reforms, while significantly slowing down in recent years, have transformed the Georgian state and economy, lifted its potential growth rate and improved the living standards of the population. With gross domestic product (GDP) per capita still considerably below the level of EU members, strong private sector-led economic expansion remains paramount for improving the standard of living. The COVID-19 pandemic further emphasised the need to reinvigorate the structural reform agenda as overreliance on the buoyant hospitality sector, the main driver of robust economic growth in recent years, had become a key source of vulnerability. To advance on the path of economic convergence with EU economies, Georgia needs to address lingering private sector constraints.

Despite the widely recognised successes following the Rose Revolution, the transformation of the public sector's governance framework and its application has been uneven and remains incomplete, prompting the need to keep governance standards high on the reform agenda. Political volatility is the most widely identified business challenge affecting investment decisions in the immediate term, as well as the country's progress in making reforms for the long term. Strengthening judicial independence, accountability and capacity as well as increasing efficiency in the court system are key to improving Georgia's investment climate. Other areas to improve in order to facilitate the economic recovery and support further reform implementation are public administration (including e-government efforts), public procurement, the efficient operationalisation of the insolvency resolution regime and corporate governance standards, in particular for state-owned enterprises.

Increasingly, labour force skills are out of step with the evolving needs of businesses, which is becoming one of the main obstacles facing the private sector's competitiveness. To improve workforce skills, weaknesses in the education system must be addressed and skills mismatches eliminated by strengthening national technical and vocational education and training, among others. Georgia's productivity growth would also be boosted by addressing other persistent inclusion issues, such as gender disparities and regional differences.

Enhancing suitable access to finance would improve the resilience and competitiveness of Georgian small and medium businesses and corporates. The banking sector is well managed and regulated, comfortably capitalised, consistently profitable and relatively efficient in channelling credit to the real sector. However, dollarisation is traditionally high, making the banking sector susceptible to economic crises and the transformation of exchange rate risk into credit risk. Micro, small and medium enterprises, particularly in the regions, are facing difficulties in accessing financing, while underdeveloped local capital markets are limiting the growth of corporates.

Given the small and open nature of the Georgian economy, continuously pursuing integration with global markets through export-driven growth and the diversification of exported goods to include higher value-added products is the fastest route to increased prosperity. To fully utilise the opportunities presented by the Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union, a number of challenges must be addressed. Foreign investments could serve as facilitators for penetrating markets in the European Union and beyond if the declining trend in greenfield investments can be reversed. Specific sectors offer diverse sets of opportunities, but face

distinct challenges, both for potential investments and for scaling up exports. Advancing logistics and infrastructure, both physical and digital, remain crucial for boosting external competitiveness.

Georgia's prime geographical location as a transit region in Eurasia is held back by the relatively poor transport infrastructure and quality of logistics which hamper integration with external markets as well as internal connectivity. Investment in maintenance and new projects in the transport sector, especially in rural areas, are key to accelerating growth and diversifying the private sector. Looking at domestic enabling infrastructure, needs have been detected in the water supply segment, sanitation facilities and waste management, particularly in rural areas. Access to information and communications technology infrastructure compares favourably to regional peer countries. Nonetheless, from an inclusion perspective, there are still clear differences in access to digital infrastructure according to gender and geographical location. Finally, yet importantly, healthcare access and quality need investment.

Traditionally one of the largest receivers of foreign investments on the back of consistent regulatory and policy transformation, the energy sector plays a prominent role in the economy. More recently, reforms have focused on harmonising with EU regulations, including through the ongoing liberalisation of the power market. However, ensuring a free and competitive electricity market is at odds with the growing role of gas and its preferential conditions in the sector, as these distort the market for other sources of electricity. The situation poses a particular challenge for renewables which, with the exception of hydropower, are nearly non-existent despite the vast potential. Clarifying the regulatory framework for renewables, in particular non-hydro sources, would be conducive to further investments. The focus should be on decisively advancing in the green transition as Georgia is in a prime spot to take advantage of the long-term business opportunities offered by decarbonisation, and enhancing the country's climate resilience in the energy sector.

1. Political economy and macroeconomic environment

2021 marks the 30th anniversary of Georgia's independence and the beginning of its post-communist transition. For years, Georgia has pursued a wide-ranging political and economic reform agenda, underpinned by the implementation of the 2014 Association Agreement with the European Union, and has achieved many successes. However, significant structural challenges remain, particularly in the areas of the rule of law and justice sector reform, and Georgia's reforms and development suffer from volatility often arising from polarised and personalised politics. In spite of challenges facing the political economy, economic activity expanded steadily in recent years, with annual growth in real GDP averaging around 5% between 2017 and 2019. The size of the tourism sector gained importance, representing about 8.4% of value added in GDP in 2019 and contributing directly to close to 12% of total employment in 2019. The COVID-19 pandemic halted this positive trend abruptly. A fall in global demand and a significant drop in tourism and remittances contributed to a steep recession (-6.1% drop in GDP) in 2020. Over the same period, exports increased, but the current account position was persistently negative. The economy remains significantly dollarised, although visible de-dollarisation was achieved in recent years under a programme put in place by the Georgian authorities. Against this backdrop, sound fiscal, monetary and supervisory policies in Georgia should remain an anchor to preserve domestic macro-financial stability. The fiscal deficit has widened considerably as a result of the pandemic while prudent fiscal policy is expected to keep public debt levels manageable. Monetary policy — carried out by the National Bank of Georgia — has kept inflation under control, thus increasing the central bank's credibility over the past decade, with several supervisory measures also introduced to foster financial stability.

1.1 A country with European ambitions suffering from political polarisation and located in a challenging geopolitical space

Over the years, Georgia has pursued wide-ranging political and economic reforms aimed at transforming itself into a modern European state. The country's reform agenda is underpinned by its commitment to the implementation of the Association Agreement, including the Deep and Comprehensive Free Trade Agreement, with the European Union. The landmark agreement, which was signed in June 2014 and fully entered into force in July 2016, is a key anchor for reforms, providing a legally binding framework for converging Georgian legislation and regulations with those of the European Union. A visa-free regime for short-term stays in the EU Schengen area for Georgian citizens came into effect in March 2017, as Georgia had met the benchmarks set out in the visa liberalisation action plan. The political association and economic integration with the European Union enjoys broad public support (up to 80% of the population). The recent developments in the country are a matter of concern for the EU at the current juncture⁷.

Despite progress made, reforms have slowed down in recent years, and important challenges remain, particularly in the areas of the rule of law and justice sector reform. Georgia is the highest-scoring country in the EEC region⁸ on the international transparency indicators. Transparency International ranked Georgia 45th out of 180 countries on its 2020 Corruption Perceptions Index:

⁷ For example, among others the withdrawal from the EU-brokered political agreement of 19 April 2021.

⁸ EEC stands for Eastern Europe and the Caucasus and is used to describe Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. It is used interchangeably with the Eastern Partnership (EaP) throughout the paper.

Georgia scored 56/100, unchanged from 2019, but down from 58/100 in 2018⁹. Nevertheless, allegations of high-level corruption persist, and anti-corruption efforts are seen as having stagnated. Strengthening the independence, transparency and accountability of the judiciary is a key task to be fulfilled to continue the development of Georgia's democratic institutions, improve the business and investment climate and ensure sustainable economic growth (see more in Chapter 2).

Following the adoption of constitutional amendments in 2017-2018, Georgia has completed the transition of its political system towards a parliamentary model. The powers of the president have become largely representative, and, as of 2023, the president will be elected by the parliament. In the new system, the government is the supreme body of executive power that implements Georgia's domestic and foreign policies. The parliament is the supreme representative body which defines the main directions of the country's policies and controls the government. As such, the parliament is meant to be the central forum for political debate, including discussions of the socioeconomic challenges aggravated by the COVID-19 pandemic. The proper functioning of the legislature has, however, been hindered by the persisting political polarisation.

Georgia's reforms and development suffer from polarised and personalised politics, which often fuel political volatility. The last parliamentary elections held in October-November 2020 triggered the political stalemate that risked undermining the country's reforms, democracy and stability. A compromise agreement "A way ahead for Georgia" was reached on 19 April 2021, after several rounds of negotiations, mediated by the European Union with the support of the United States. The agreement was meant to defuse political tensions and provide the foundation for an inclusive way forward on the democratic reform agenda. Nevertheless, as political disagreements and mutual mistrust persist, the ability of majority and opposition parties to find common ground and overcome political polarisation remains critical for Georgia's political stability, reforms and development.

The persistent problem of territorial integrity continues to pose an additional political and security risk. The international community maintains firm support for Georgia's sovereignty and territorial integrity within its internationally recognised borders.

1.2 In a challenging macroeconomic environment, Georgia has plenty of potential to catch up

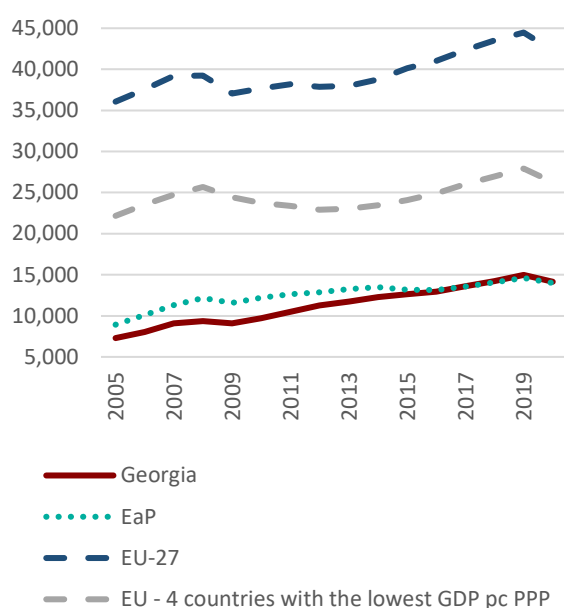
Economic activity in Georgia expanded solidly prior to COVID-19, but economic convergence with the European Union's standards is still incomplete. Wide-ranging political and economic reforms brought rapid growth in the past two decades. Between 2004 and 2008, Georgia achieved remarkable annual growth rates in real GDP, averaging around 10%. Annual GDP growth slowed as a consequence of a set of overlapping global and regional factors. Georgia was hit almost simultaneously by the 2008-2009 global financial crisis, a war with Russia and a domestic change in the political leadership immediately after. From 2011 onward, Georgia demonstrated a rather robust economic performance considering the continued regional distress with, for instance, weak external regional demand, international sanctions on Russia and oil price swings. For example, Georgia was the only economy in the Eastern Partnership region that didn't contract during the 2014-2015 conflict in Ukraine. Moreover, real GDP growth solidified in 2016 to reach an average annual growth rate of 5% between 2017 and 2019. Georgia has shown continued progress in building political and economic institutions, scoring relatively high on government effectiveness (77th percentile) and regulatory quality (83rd percentile) in the latest (2019) World Bank Governance indicators, even when compared to regional and income-

⁹ The Corruption Perceptions Index ranks countries by their perceived levels of public sector corruption according to experts and business people, using a scale from 0 to 100, where 0 is highly corrupt and 100 is very clean.

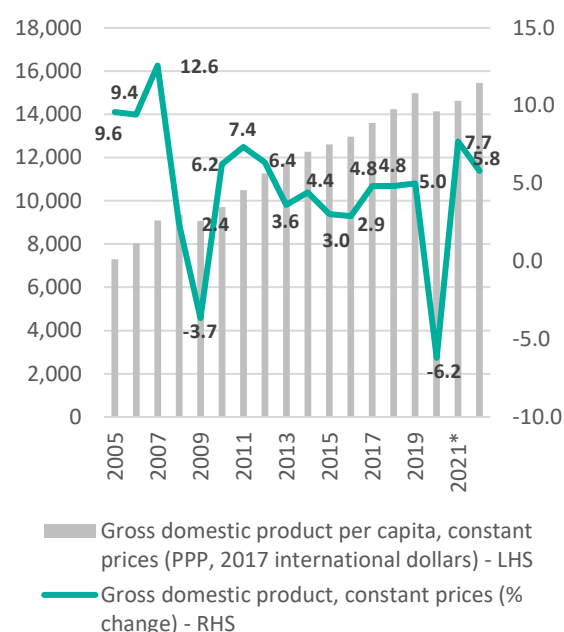
group peer countries (see more in Chapter 2). The Deep and Comprehensive Free Trade Agreement with the European Union offers medium-term economic benefits, including improved access to European markets and potential increases in inflows of foreign direct investment. Against this backdrop, Georgia is still a lower to middle-income country with GDP per capita of USD 4 405 (USD 15 028 at purchasing power parity) and a population of 3.7 million in 2020 (Figure 1; Table 1). Moreover, Georgia is still behind when it comes to labour productivity, as shown by the share of the population working in low-productivity sectors (the most notorious example being agriculture, which represented around 19% of employment in 2019), and by the large disparities in salaries across different sectors of economic activity¹⁰ (see more in Chapter 3). Ultimately, GDP per capita income levels track the region's development fairly well, but are far below even the lowest-income countries in the European Union, and the EU-27 average even more so (Figure 1 — Panel A). Large potential to catch up therefore exists, and continued strong expansion is needed to enable Georgia to achieve its European ambitions.

Figure 1: Economic activity in Georgia

Panel A — GDP per capita, constant prices (purchasing price parity; 2017 international dollars), 2005-2020.



Panel B — GDP developments and forecasts



Source: International Monetary Fund, World Economic Outlook Database, April 2021, EIB calculations.

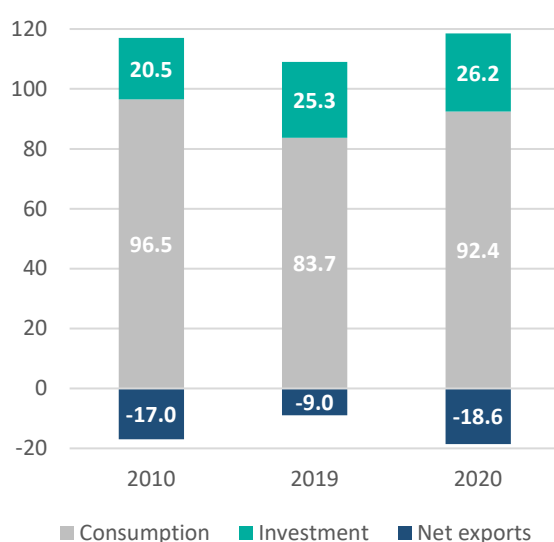
Note: Panel A — 1) The Eastern Partnership, EU-27 and EU-15 with the lowest GDP per capita at purchasing price parity (PPP) are simple averages; purchasing price parity is used to allow a direct comparison across countries with different currencies by removing the exchange rate effect. 2) The four EU countries with the lowest GDP per capita at purchasing price parity in 2019 are Bulgaria, Croatia, Greece and Romania. Panel 2 - *IMF Country Report No. 21/215.

¹⁰ In 2017, transport and communications, financial intermediation, construction, energy, real estate and manufacturing were pointed out as the most productive sectors per employee, on the back of significant direct investment flows. Ministry of Economy and Sustainable Development of Georgia (2018). "Labour Market Analysis of Georgia 2018."

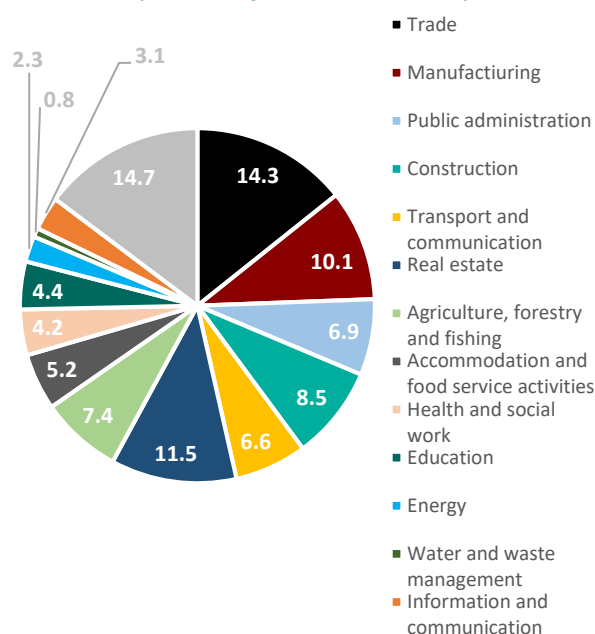
Georgia's largest component of GDP continues to be household consumption, which has increasingly become a major driver of growth. Breaking down GDP by category of use shows that, structurally, consumption has always been the largest component — going from 96.5% of GDP in 2010 to 83.7% in 2019 — followed by investment and finally by the negative trade balance whose drag was exacerbated in 2020 by trade disruptions (Figure 2 — Panel A). In terms of contributions to real GDP growth, while investment is by nature a more volatile component, household consumption has been a steady source of growth (with the exception of 2016) and in fact was the only element sustaining growth in 2020 during the pandemic. The large remittances that families receive from abroad were a contributing factor, because they allowed these families to maintain, to a certain degree, standard consumption patterns even in times of economic recession.

Figure 2: GDP breakdown

Panel A — By category of use



Panel B — By sector of economic activity



Source: National Statistics Office of Georgia, EIB calculations.

Note: Panel A — Originally, consumption was labelled “Final consumption expenditure,” investment was “Gross Capital Formation,” and net exports are the difference between “Exports of goods and services” and “Imports of goods and services.” Panel B — Other includes: mining and quarrying financial and insurance activities; professional, scientific and technical activities; and administrative and support services.

Georgia has a relatively diversified economic structure. Trade, manufacturing, construction and real estate activities represent the lion's share of the Georgian economy (Figure 2 — Panel B). Prior to the COVID-19 outbreak, tourism had been booming and became a key driving force for the Georgian economy, albeit also increasing risks associated with climate impacts. Tourism numbers had been steadily increasing, and reached a volume of about 7.3 million people in 2019. This positively spilled over to several segments of the economy, including the retail and trade sectors as well as the construction sector. An increase in the number of tourists also increased demand for home-grown and local products as well as hosting facilities such as buildings. As a result, public and private construction and related real estate activities are drivers of growth. Agriculture represents roughly 7.4% of GDP, accounting for a large part of total employment and a significant contribution to Georgian exports. The main export products are nuts, wine, mineral water and alcoholic spirits. Notably, Georgia is among

the world's top five producers of hazelnuts, along with Turkey, Italy, the United States and Azerbaijan (FAO, 2021). On the other hand, the main agricultural product yields, which are significant contributors to Georgian exports, are highly sensitive to climate risks.

The 2020 COVID-19 pandemic brought about a deep recession. In 2020, Georgia's economy is estimated to have contracted by 6.2%. The COVID-19 shock triggered a decrease in the output share of the accommodation and food service sectors from 5.2% in 2019 to 3.1% in 2020. Overall, tourism and remittances (the latter was worth 12.7% of GDP in 2019) are also key sources of foreign currency revenue. Given that their cumulative share is particularly high in Georgia compared to other countries in the Eastern Partnership, the country suffered significantly because of the fall in tourism revenues. The Georgian economy is expected to bounce back to 7.7% growth in 2021. These forecasts assume that normal activity will resume in the trade sector and that tourism will recover at least 50% of business volumes compared to pre-crisis levels. These developments also highlight how COVID-19 has temporarily stopped the convergence process, thus exposing weaknesses in the growth model.

Georgia is dependent on foreign financing and its external debt increased further in 2020, starting from an already high level. Georgia has been particularly successful in attracting foreign capital, with, for example, inflows of foreign direct investment averaging 9.9% of GDP over the period 2014-2019. Similarly, foreign reserves amounted to USD 3.5 billion or 3.8 months' worth of imports in 2020. On the other hand, Georgia's foreign debt stock stood at roughly 106.6% of GDP in 2019 and is estimated at 129.5% of GDP in 2020. In 2019, the private sector accounted for roughly 66.8% of total external debt — out of which 36.1% belonged to the banking sector, 37.3% to the corporate sector and 26.6% to intercompany lending. A potential mitigating factor is that only a small part of public and private external debt has a maturity of below one year. Nonetheless, its large size poses downside risks, considering that the Georgian economic base remains in low value-added segments with limited capacity for generating foreign-exchange earnings, especially during protracted periods of macro-financial turbulence and instability. This situation, coupled with a persistent (and large) current account deficit, does not shield Georgia from risks of liquidity shortages and capital reversals. In the medium term, should the global financial situation not stabilise, foreign investors may decide to decrease intragroup funding or even reverse equity investments — thus generating a longer-lasting and entrenched shortage of financial resources. To avoid such an adverse scenario which would have significant and persistent effects, prudent macroeconomic management and the continued support of international financial institutions' investment are paramount for reassuring investors, above all during the COVID-19 crisis and the subsequent recovery path.

The current account position has been persistently negative. Export activities hovered at around 30% of GDP until 2009 but have increased since then to reach around 55% in 2018. At the same time, imports of goods and services have been historically large at 50-55% of GDP, reaching 67% in 2018¹¹. The current account deficit shrank to 5.5% in 2019, but it is expected to jump again to 11.3% on average in 2020-2021, reflecting the still-limited domestic saving capacity. A consequence is the high dependence of the country on foreign capital to finance investment, leaving it vulnerable to regional and global volatility. In 2019, some of Georgia's top exporting partners were neighbouring countries: Azerbaijan (13.4%), Russia (13.1%), Armenia (11.4%), Bulgaria (7.5%), Ukraine (6.6%), China (5.9%) and Turkey (5.3%).

¹¹ Broken down by major commodity group, the largest contributors to exports were copper ores, motor cars and ferroalloys while the largest imports were petroleum oils, motor cars and copper ores because Georgia is a large regional re-exporter of these components and materials.

Table 1: Selected statistics for the Georgian economy

Indicators	2014	2015	2016	2017	2018	2019	2020
GDP (current prices, USD billion)	17.6	15.0	15.1	16.2	17.6	17.5	15.7
GDP per capita (current prices, USD)	4 742.5	4 017.6	4 060.9	4 358.6	4 718.8	4 693.7	4 247.9
GDP per capita (PPP basis, international \$)	12 262.9	12 616.6	12 960.0	13 595.6	14 241.8	14 979.4	14 140.9
Real GDP (% change)	4.4	3.0	2.9	4.8	4.8	5.0	-6.2
Unemployment rate (% total labour force)	23.0	21.9	21.7	21.6	19.2	17.6	18.5**
Inflation (CPI annual average, % change)	3.1	4.0	2.1	6.0	2.6	4.9	5.2
General government gross debt/GDP (%)	30.9	36.7	40.3	38.6	37.5	40.4	60.0
Gross external debt/GDP*	79.3	102.4	105.3	106.6	101.3	106.6	129.5
General government net lending/borrowing	-1.8	-1.2	-1.5	-0.5	-0.8	-1.8	-9.2
Current account balance/GDP (%)	-10.2	-11.8	-12.5	-8.1	-6.8	-5.5	-12.5
Foreign direct investment/GDP (%)**	10.4	11.6	10.9	12.1	7.2	7.1	3.8
International reserves (USD billion)*	2.7	2.5	2.8	3.0	3.3	3.5	3.9
International reserves (months of imports)*	3.2	3.5	4.0	3.9	3.7	3.8	5.2

Source: International Monetary Fund World Economic Outlook April 2021, authors' calculations.

*Notes: *Source National Bank of Georgia, authors' calculations. ** Source Geostat, authors' calculations. 2020IMF Country Report No. 21/215.*

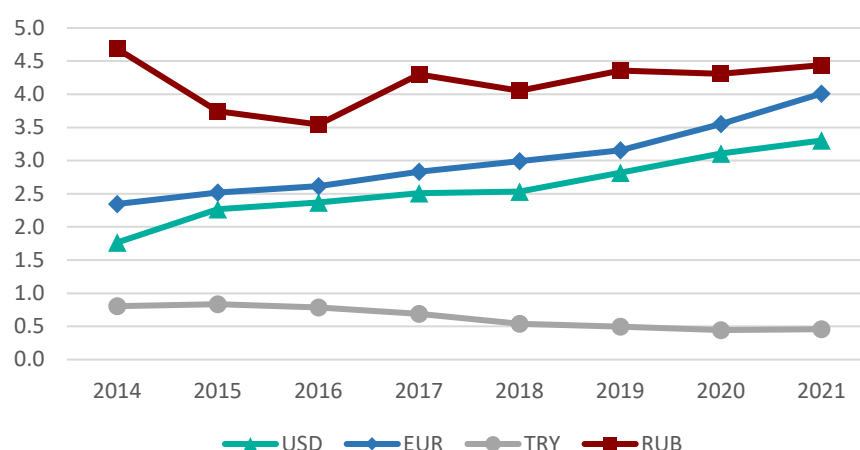
Remittances and tourism are a significant source of balance-of-payment financing and have suffered greatly during the COVID-19 crisis. Remittances have been fairly stable in terms of GDP but dropped significantly in value in 2020 due to the COVID-19 crisis (Figure 3). They are estimated at roughly USD 1.9 billion in 2020, down from USD 2.3 billion in 2019. Moreover, the size of the tourism sector has gained importance in Georgia, representing about 8.4% of value added in GDP in 2019¹² and contributing directly to close to 12% of total employment in 2019 (Geostat and Knoema, 2019). Tourism is also a source of foreign currency, especially relevant for dollarised economies like Georgia where in 2019 it generated receipts of roughly USD 3.5 billion. Finally, tourism numbers dropped to roughly 4.5 million in 2020 — representing a 40% fall from 2019 levels — due largely to the decrease of inbound international tourism by roughly 80%, thus showing the severe impact of the COVID-19 crisis. Overall, the combined drop of remittances and tourism has triggered a major reduction in significant sources that support the balance of payment position of Georgia. On the other hand, the drop is assessed as temporary while the medium-term impacts are still uncertain.

Exchange rate developments have been somewhat volatile, reflecting external sector weaknesses. Dollarisation levels in the economy are elevated, with roughly 60% of bank assets and liabilities denominated in US dollars (see Section 4.1 for details). A non-negligible share of banks' clients have unhedged positions¹³ and hence are highly exposed to exchange rate fluctuations. Recurrent bouts of exchange rate volatility as well as a depreciation trend against the US dollar and euro (Figure 3) have exerted upward pressure on foreign-currency denominated debt. Significant exchange rate volatility generated by the COVID-19 shock is, in turn, an impediment to a de-dollarisation of the system.

¹² Georgian National tourism administration (2021). "Economic indicators."

¹³ This evidence is derived from a micro analysis making use of the latest EIB-EBRD-WBG Enterprise Survey 2019 and it is dealt with in the access to finance chapter in greater detail.

Figure 3: Exchange rate dynamics — 1FX= LC (Lari)



Source: National Bank of Georgia, EIB calculations.

Sound fiscal, monetary and supervisory policies in Georgia should remain an anchor to preserve domestic macro-financial stability. Monetary policy is carried out in the context of an inflation-targeting regime. Inflation has largely remained below the National Bank of Georgia's medium-term moving target since 2011. An increase in inflation was recorded in 2020 due to temporary factors, including depreciation, bringing the average annual figure to 5.2% in 2020. Average annual inflation is currently forecast at 9.3% for 2021 and is expected to settle at 5.4% in 2022. The National Bank of Georgia is also in charge of financial sector supervision, covering banks and non-bank institutions. A lot of progress was made in recent years, particularly in terms of raising the standards for capital, liquidity and financial transparency. For example, minimum capital and capital buffer requirements, additional capital buffers (unhedged currency, credit portfolio concentration, net stress and general risk assessment programme buffers) and disclosure requirements were introduced. A financial stability department was also created within the national bank to further monitor business and credit cycles. Fiscal policy has also been fairly prudent. Public debt stood at 42.6% of GDP in 2019. It is estimated at 56.3% of GDP in 2020 as fiscal spending has been ramped up to support the economy throughout the pandemic. The International Monetary Fund (IMF) assesses the widening of the government deficit (expected at -8.8% of GDP in 2020) as temporary. Moreover, interest payments relative to revenues are low, reflecting the prevalence of loans granted by international institutions on favourable terms.

2. Good governance for a better business environment

Georgia's widely recognised success in overhauling its business and investment climate following the Rose Revolution was accompanied by significant improvements to public sector governance, bringing large economic gains. However, the transformation of the public governance framework and its application has been uneven and remains incomplete, prompting the need to keep governance standards high on the reform agenda. Political volatility is the most widely identified business challenge affecting investment decisions in the immediate term, as well as the country's progress in making reforms for the long term. Increasing transparency across all spheres of political and economic decision-making would help build trust in public institutions. Strengthening judicial independence, accountability and capacity as well as increasing efficiency in the court system are key to improving Georgia's investment climate. Building on improvements in corporate governance standards would boost performance and investment opportunities, in particular for state-owned enterprises.

2.1 Good governance standards need to remain high on Georgia's reform agenda

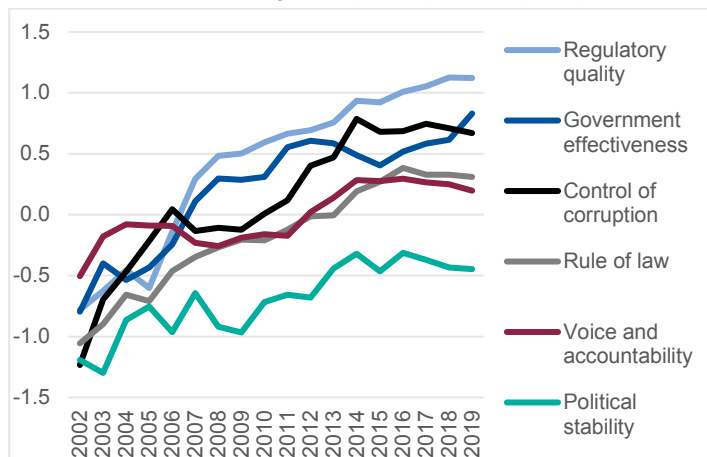
Georgia has launched a series of political and economic reforms over the past two decades aimed at improving its business and investment climate as well as public sector governance. This ambitious reform agenda that started with the Rose Revolution and continued with commitments to implementing the Association Agreement with the European Union has resulted in intensive state-building and brought improvements across all dimensions of public governance (Figure 1 Panel A), albeit unevenly, and the business environment. Georgia has often been showcased as a success story: improving the regulatory environment for businesses does bring significant economic gains. Still, Georgia is also a prime example of how the entire public governance system, and not just business regulations, matters. For the private sector to thrive, investment obstacles need to be addressed, in particular those in the sphere of public governance.

Despite commendable progress, significant weaknesses in the area of public governance persist and good governance standards need to remain high on Georgia's reform agenda. Georgia remains behind EU countries in nearly all dimensions of governance measured by the Worldwide Governance Indicators (Figure 1 Panel B). In particular, the pockets of significant weaknesses still to be addressed include political instability, accountability (which is in need of strengthening), vested interests, institutional capacity, rule of law (where there are challenges) and justice reform (which is unfinished). Most recently, the need to improve the governance and performance of state-owned enterprises, among others, has become evident in light of plans to further accelerate privatisation. The participation of the private sector in developing effective and business-supportive policies and regulations has improved in recent years, but would benefit from being further systematised. According to the Organisation for Economic Co-operation and Development (OECD),¹⁴ Georgia has, in recent years, made significant strides towards establishing a regulatory and institutional framework that underpins and promotes sustainable development and responsible business conduct. Awareness of the principles of responsible business conduct, while still modest, is on the rise and a continuing focus on awareness-raising, particularly for small and medium enterprises and sectors identified as high-risk, would be beneficial.

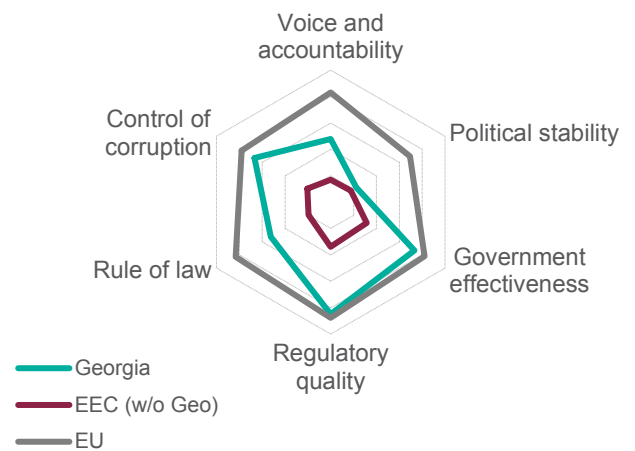
¹⁴ OECD (2020). "OECD Investment Policy Reviews: Georgia."

Figure 1: Despite the successes in the improving governance standards, Georgia lags behind EU countries on most dimensions

Panel A: Trend in scores on the Worldwide Governance Indicators, on a scale of -2.5 (worst) to 2.5 (best)



Panel B: Comparison of scores on the Worldwide Governance Indicators

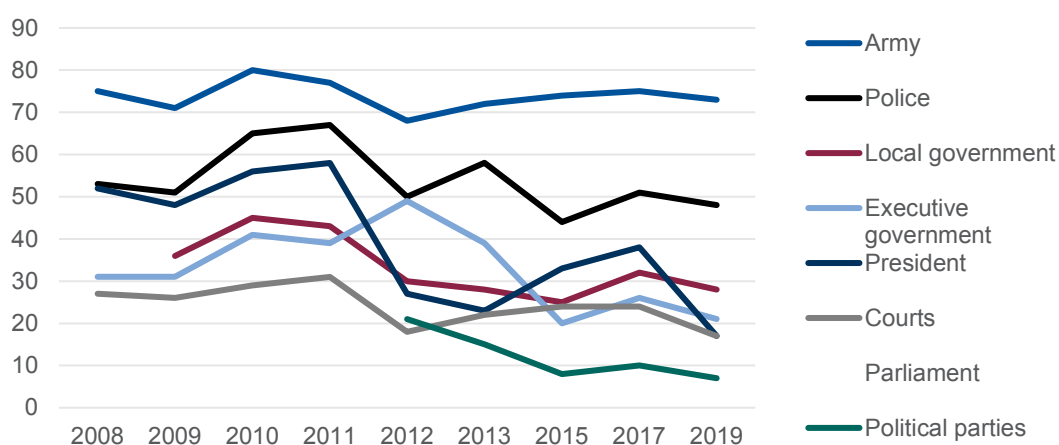


Source: World Bank Worldwide Governance Indicators, EBRD calculations.

The need for continued improvement in governance is also reflected in the low and declining trust of the general population in most government institutions (Figure 2). Just as trust influences the relationship between citizens and the government, it also, in turn, impacts public policy and the sustainability of reforms. In order to preserve progress made and instil further confidence among businesses and investors, the government should continue to prioritise good governance standards and transparency in its reform agenda, particularly as it seeks to build a resilient and sustainable economic future for Georgia following the COVID-19 pandemic.

Figure 2. With the exception of the army and police, trust in government institutions is low and has been declining in the past decade

Share of respondents who trust specific institution



Source: The South Caucasus Barometer.

Political volatility is the most commonly identified governance shortfall in Georgia. The EIB-EBRD-WB Enterprise Survey, which captures the opinion of private sector businesses, repeatedly reported political volatility as the key obstacle to doing business in Georgia. 30% of respondents in 2019 and 42% of respondents in 2013 stated that political instability is the single largest business constraint. In 2009, this figure stood at 17.4%, placing political instability in second place immediately after access to finance (18%). The 2019 Worldwide Governance Indicators¹⁵ rank political stability lowest of all six of its good governance indicators for Georgia, while the 2019 World Economic Forum Competitiveness Report ranks Georgia 86th out of 141 countries for “government long-term vision.” Georgia’s political economy is characterised by a polarised and personalised political scene with strong mutual mistrust (see also Chapter 1 on Political Economy). Deepening political polarisation is threatening to negatively impact parliamentary pluralism, as seen in the six-month political stalemate following the last parliamentary elections in October-November 2020. This also helps create an enabling environment for the excessive centralisation of power and a lack of continuity and predictability in policymaking, in part due to the frequent turnover of government staff and the potential for vested interests. Transparency International’s National Integrity Assessment of Georgia identifies the ruling party’s control over a majority of public institutions as a main concern.¹⁶ This kind of environment risks undermining the country’s stability and does not bode well for reform progress or economic development.

Political instability has significant implications for the private sector, in particular consumer and business confidence as well as investment decisions. For instance, investments in manufacturing do not offer a quick pay-off or easy exit as their value is determined within a given supply chain. These kinds of investments, which are also crucial for knowledge transfer and wider productivity improvements, need stability in the political and business environments in the medium to long term.¹⁷ Furthermore, instability in the political sphere in Georgia often maps to increased volatility in the macroeconomic environment. While overall macroeconomic stability has been maintained largely due to prudent management, certain political incidents in recent years were immediately reflected in exchange rate dynamics, which were impacted via the confidence channel.

Georgia ranks high among the regional comparators on corruption perception indicators, though there is space for further progress and continued vigilance is needed. Amongst the comparators, Georgia has the lowest level of perceived corruption as measured by Transparency International’s 2020 Corruption Perception Index¹⁸, ranking 45th out of 180 countries. However, recent years have not seen any significant improvements (see Figure 3.3) and continued vigilance is needed to ensure that the incidence of corruption and its perception remain low. While petty corruption — particularly within the public administration — is considered to be low, high-level corruption is still considered an issue. The judiciary and public procurement in particular are frequently mentioned as key areas of concern.¹⁹

¹⁵ World Bank (2019). “Worldwide Governance Indicators 2019.”

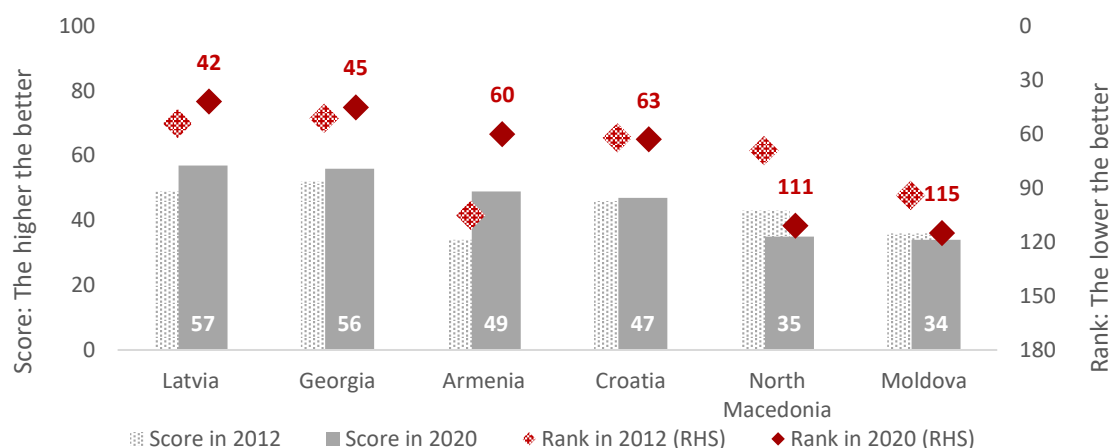
¹⁶ Transparency International (2020). “Georgia National Integrity System Assessment 2020.”

¹⁷ GeoWel (2020). “Why Doesn’t Georgia Export More to Europe: An Assessment of the Challenges of Enhancing Georgian Trade with the EU.”

¹⁸ Transparency International (2019). “Corruption Perception Index 2019.”

¹⁹ Transparency International (2020). “Corruption and Anti-Corruption Policy in Georgia: 2016-2020.”

*Figure 3.3. Corruption perception is low vis-à-vis comparators, though the trend is stagnating
Scores are on a scale of 1-100 (the higher, the better) and the rank is out of 180 countries in 2020
and 176 in 2012*



Source: Transparency International Corruption Perception Index 2020.

2.2 Strengthening and increasing the efficiency of the judiciary is key to improving Georgia's investment climate

Georgia's judicial system has been subject to major reforms in recent years. Over the past decade, four “waves” of reforms have been undertaken, with major improvements including the: (i) electronic allocation of cases; (ii) streamlining of case management; (iii) improved norms on disciplinary liability of judges and on legal proceedings; (iv) increased number of cases resolved through alternative dispute resolution; and (v) introduction of the Office of the Independent Inspector of the High Council of Justice.

Nonetheless, more needs to be done to strengthen the independence, transparency and accountability of the judiciary. The perception of a lack of institutional independence persists, with the judiciary and government institutions at both federal and national levels considered susceptible to political interference.²⁰ According to the World Justice Project's (WJP's) Rule of Law Index, Georgia ranks 42nd out of 128 countries. However, the worst performance is observed on indicators measuring the extent of the government's improper influence on the criminal (91st out of 128 countries) and civil justice systems (88th), non-discriminatory practices of courts (86th) and timeliness of justice proceedings (85th).²¹ Steps have been taken to increase transparency within the High Council of Justice, but allegations persist that the administration of the judiciary continues to be controlled by a narrow group of influential judges.²² While the 2019 nomination and (lifetime) appointment of Supreme Court judges was assessed by the Organisation for Security and Co-operation in Europe/Office for Democratic

²⁰ Transparency International (2020). “Georgia National Integrity System Assessment 2020.”

²¹ The WJP scores and ranks countries on 44 factors which cover eight dimensions of rule of law. The scores are based on survey data from the representative sample of the general population and expert questionnaire.

²² Transparency International (2020). “The State of the Judicial System 2016-2020.”

Institutions and Human Rights as having involved some positive measures to build public trust in the judiciary, the report also noted that the overall process lacked transparency and accountability, undermining a genuine merit-based nomination process.²³

Allegations of judicial partiality and a lack of accountability in large and politically sensitive cases remain a concern.²⁴ As these high-profile court cases receive significant media coverage, the negative demonstration effect — even before any judgment has been made — is significant, fuelling mistrust in the judiciary and discouraging future investment, particularly from international investors.

Confidence in the judiciary is further undermined by inefficiencies within the court system. A large backlog of cases is leading to long delays in justice proceedings and judgments.²⁵ The average case clearance rate²⁶ is 91.1% at courts of first instance (European median 100.7%) and 79% at the Supreme Court (European median 98.8%) and the disposition time²⁷ is 273 days at courts of first instance (European median 201 days).²⁸ A lack of resources and judicial capacity further impedes the effective and timely adjudication of commercial disputes. With the exception of prosecutors and lawyers, Georgia employs significantly fewer professional judges (8.2 per 100 000 population compared to the European median of 17.7), less non-judge staff (40.4 compared to 60.9) and less non-prosecutor staff (6.2 compared to 14.9). In terms of financial resources, Georgia spends around six times less than the European median (EUR 10.1 per inhabitant compared to EUR 61.30) largely due to significantly fewer resources in the court system.²⁹ Furthermore, judicial capability also needs strengthening, particularly in commercial and business law. Georgia lags behind the other countries in the region, in particular Armenia, Moldova, Azerbaijan and Ukraine, in most of these categories.

Introducing e-courts for administrative processes and further promoting the use of alternative dispute resolution mechanisms could help alleviate the burden on the private sector. The introduction of e-courts are an important initiative. If implemented and managed effectively, they could avoid any further build-up of cases, potentially help reduce the existing backlog and allow for socially-distanced justice processes in light of COVID-19. Alternative dispute resolution mechanisms provide an efficient alternative to court processes, but uptake in Georgia has been slow due to limited public awareness, public mistrust of arbitration procedures and a shortage of adequately qualified arbitrators.³⁰ Concerns have also been raised with regard to the enforcement of arbitration decisions. Efforts to support business-to-business arbitration are also underway, for which there are hopes that Georgia could potentially become a regional hub.

²³ Organization for Security and Co-operation in Europe (2019). “Report on the First Phase of the Nomination and Appointment of Supreme Court Judges in Georgia.”

²⁴ Transparency International (2020). “The State of the Judicial System 2016-2020.”

²⁵ Council of Europe (2020). “Evaluation of the judicial systems (2018 - 2020) Questionnaire.”

²⁶ Clearance Rate = (Resolved Cases / Incoming Cases) *100.

²⁷ Disposition Time = (Pending Cases / Resolved Cases) *365.

²⁸ Council of Europe (2020). “European judicial systems CEPEJ Evaluation Report, 2020 Evaluation Cycle (2018 data), Part 2 – Country Profiles.”

²⁹ Ibid.

³⁰ EU4Justice and UNDP (2018). “Legal and Practical Aspects of Arbitration in Georgia.”

2.3 Enhancing the capacity, effectiveness, accountability and transparency of Georgia's civil service

Weaknesses in public administration persist. The high turnover of personnel, particularly at senior levels due to frequent political changes, has compromised institutional memory and capacity in recent years. Relatively low levels of compensation for civil servants also pose a challenge for the government in its attempts to attract and retain qualified professionals, particularly in areas where private sector experience is required. The 2018 Support for Improvement in Governance and Management (SIGMA) baseline assessment on policy development highlighted the importance of further strengthening policy planning, coordination, monitoring and reporting in particular.³¹

Efforts to upgrade public administration should be stepped up. Georgia recognises the importance of public administration reform to build an effective, accountable, transparent and professional civil service in the context of its EU accession aspirations. A law on the civil service — the necessary legislative framework to enable the development of a professional and unified civil service — and an action plan to implement it have already been developed. New classification and remuneration systems are being applied to all civil servants and a new performance appraisal approach is being rolled out across government institutions.³² However, further steps are required to develop Georgia's civil service into a world-class public administration.

The COVID-19 crisis highlighted the need to re-energise the efforts to digitalise government services. Digitalising public services ensures the uninterrupted availability of these services and often improves their quality by enhancing transparency and reducing corruption, thereby instilling trust in public institutions, optimising costs and increasing the resilience of a country. Georgia benefited early on from the experience of Estonia, the global leader in digitalising all its public sector operations. This is reflected in the country's ascent in the rankings, as it moved up from 100th out of 193 countries in the United Nations 2010 E-Government Survey to 56th in 2014, making Georgia one of the regional leaders and a frequently cited good example. Since then, however, higher rates of development in other countries caused Georgia to slip to 65th place in 2020. Similarly, Georgia fell from 49th place in 2014 to 80th in 2020 in the E-Participation Index. The main challenge for the country is the lack of e-governance initiatives at the local level, resulting in a digital divide between central and local administrations. Moreover, the country currently does not have an updated e-governance strategy.

Successfully dealing with the aftermath of the pandemic also requires the successful operationalisation of the new insolvency framework. Inadequate insolvency frameworks have featured as a constraint to Georgia's investment climate across global ratings. However, good progress is being made, with new legislation on: banking resolution and corporate insolvency; creditor rights protection; and a framework for timely insolvency processes and effective rehabilitation, operational since early 2021.³³ Ensuring the effective implementation of this new legislation will be crucial, along with the establishment of a new profession of insolvency practitioners. Ensuring an efficient insolvency resolution regime would facilitate the “creative destruction process” in the aftermath of COVID-19, enabling the economic recovery. The focus should now shift to resolving the system for personal insolvency, with the development of a special law to regulate these issues and a new enforcement code required.

³¹ Support for Improvement in Governance and Management (SIGMA) (2018). “Baseline Measurement Report: The Principles of Public Administration – Georgia.”

³² European Commission (2019). “Joint Staff Working Document – Association Implementation Report on Georgia.”

³³ IMF (2020). “Country Report No.20/149 – Georgia.”

Increasing transparency in public procurement would enhance competition and create an even playing field. Public procurement is one of the areas currently being reformed under the Association Agreement. Georgia moved its public procurement processes online a decade ago, with digital procurement now having fully replaced its earlier paper-based system. Despite these efforts, corruption is still considered to be a risk. While digital procurement should enhance competition and increase the number of firms bidding for government contracts, the average number of bids for open tenders in 2019 was only 1.8 to 2.6. This might point to a range of weaknesses, including the small size of the Georgian market or a potentially excessive focus on price criteria due to, for instance, a lack of capacity and engineering skills to precisely evaluate complex projects. The latter could also deter foreign companies from participating. There are also heightened concerns that large government tenders are awarded in non-transparent procedures to well-connected individuals and firms. COVID-19 has exacerbated this concern further, with an increased number of simplified, direct procurement procedures now being applied to government tenders. An analysis by Transparency International of the public procurements conducted during the national state of emergency (March — May 2020) suggests that more than half of the tenders during this time had only one bidder, which is unsurprising given the challenges during the initial lockdown.

2.4 Building on improvements in corporate governance standards would boost performance and investment opportunities

Further improving the corporate governance framework and practices would improve access to finance and the general performance of enterprises. According to the EBRD's 2016 Corporate Governance Assessment³⁴, several elements of the framework were judged as “weak” or “very weak.” The assessment highlights the lack of a corporate governance code in Georgia, with rules of conduct currently defined by several different laws. While Georgia has taken a number of steps in recent years to strengthen corporate governance and transparency, including the passing and implementation of a new Accounting, Reporting and Audit Law governing company transparency and disclosures and imposing audit and financial reporting requirements on companies according to their size, further efforts are needed. Instituting a corporate governance code or a unified legal act on corporate governance would help businesses understand the requirements and value of good corporate governance and incentivise reforms and improvements. Efforts to strengthen the functioning and independence of audit committees and enhance the use of codes of ethics, including a comprehensive framework for whistleblowing, are also needed. In addition, the integration of environmental, social and governance considerations into corporate governance regulations and practices, in line with the country's roadmap for sustainable finance³⁵, would enhance the sustainability of companies' operations. Finally, the appointment of professionals to supervisory board positions would help address concerns raised about the structure and functioning of company boards and instil potential investors with more confidence. Upgrading corporate governance standards further would also support easier and more diversified access to finance, including via the development of the capital markets (see more in Section 4.1 Box 1).

Motivated by the recent deterioration in the financial performance of state-owned enterprises, the government is preparing a comprehensive governance reform for these entities to limit fiscal risks and increase efficiency. In recent years, the authorities have been working on establishing effective

³⁴ EBRD (2017). “Corporate Governance in Transition Economies Georgia Country Report.”

³⁵ National Bank of Georgia (2019). “Roadmap for Sustainable Finance in Georgia.”

fiscal risk monitoring systems, culminating in the publication of fiscal risk statements capturing transfers between the state and key state-owned enterprises, contingent liabilities for the national budget and the categorisation of these enterprises by risk level based on their financial reports. In addition, a recently completed sectorisation exercise for these enterprises disaggregated government units and public corporations to place any non-market activities conducted by state enterprises under the appropriate fiscal oversight framework³⁶. According to the IMF³⁷, the state-owned enterprise sector is relatively large compared to the otherwise lean public sector balance sheet. With consolidated public sector assets at 149.3% of 2018 GDP and liabilities at 81.3% of GDP, the net worth of the entire public sector is estimated at 68% of GDP, placing Georgia in the top third of countries analysed by the IMF. Assets of state-owned enterprises amount to nearly one-fifth of the entire public sector's assets, standing at 27.9% in 2018.³⁸

The deteriorating financial performance of Georgian state-owned enterprises exposes the underlying need for commercialisation reforms targeting these enterprises, the strengthening of their corporate governance and a better exercise of the state ownership function. The state-owned enterprise sector has been a net draw on the budget in recent years with increasing leverage and government on-lending, decreasing average returns on assets and falling equity values despite large equity injections by the government and significant upcoming financing requirements for the largest enterprises of the sector. The gross financing needs of the six largest enterprises accounting for two-thirds of the sector are estimated at 18% of GDP over the next three years, with around half to be raised from the private sector. Significant foreign-exchange mismatches, as the large majority of state enterprise debt is denominated in foreign currency while revenues are in Georgian lari, expose major state-owned enterprises to currency fluctuations. The lack of an overarching approach enabling the state to retain companies and set them performance objectives, inconsistent policies for accounting and compensating for public service obligations, underdeveloped company-level governance institutions and the operational involvement of the state in key decisions taken by these enterprises — all these are major problems to be resolved. The authorities have initiated discussions to develop a state enterprise reform strategy which aims to bring the management of these enterprises closer to the highest standards of corporate governance. This strategy is expected to result, among others, in a new governance law for state-owned enterprises.

³⁶ The sectorisation exercise determined that 196 of 241 Georgian state-owned enterprises should be classified as "government units" based on the criteria of a lack of operational independence, dependence on regular financial assistance from the state, or providing economic goods or services at below-market prices. Moreover, about 50 companies were found to be inactive.

³⁷ IMF (2020). "Technical Assistance Report – The Public Sector Balance Sheet and State Owned Enterprises."

³⁸ These figures do not take into account a more precise classification of institutional units as general government units or public corporations depending on whether the entity operates on a market or non-market basis. For more details, please see the referenced IMF report.

3. Improving human capital and broadening economic opportunities to boost competitiveness

The challenges posed by skills and labour shortages in Georgia are among the main obstacles facing the private sector as labour force skills are increasingly out of step with the evolving needs of businesses. To improve workforce skills, weaknesses in the education system must be addressed and skills mismatches must be eliminated, which would also help address youth inclusion issues. With high demand for technical skills, work on strengthening the national technical and vocational education and training framework could be stepped up. Georgia's potential productivity growth would also be boosted by addressing persistent gender disparities and regional differences as well as by enhancing economic opportunities for disadvantaged groups.

3.1 Georgia's labour market characteristics reveal underlying structural issues

Georgia's total population is declining gradually, having fallen from roughly 5 million residents at the time of independence to some 3.7 million today — mainly due to mass outward migration during the 1990s.³⁹ The population continues to shrink incrementally year-on-year and, according to the UN Population Division's projections, will reach 3.5 million by 2050.⁴⁰

Outward migration is consistent, though relatively modest. Net international migration is estimated at between -2 000 and -11 000 per year in recent years (representing an annual loss of roughly 0.1-0.3% of the total population). For clarity, the net migration figure of -8 243 in 2019 is made up of 96 864 inward migrants and 105 107 outward migrants — both relatively voluminous flows for a country of Georgia's size. Georgian citizens accounted for the majority of both flows, with 56.2% of the inflow made up of returning Georgian nationals and 78.0% of the outflow consisting of emigrating Georgians. Both the inward and outward migrant flows were composed of slightly more men than women (about 55-60%) and were mostly made up of individuals in their twenties and thirties.⁴¹

Economic activity is likely to be sustained, however, due to relatively slow population ageing and rising labour productivity. The labour force has shrunk over time, also as a reaction to episodes of economic hardship. Georgia is currently the “old man” of its neighbourhood (alongside the Russian Federation) with a median age of 38.3 against Armenia's 35.4, Azerbaijan's 32.3, Turkey's 31.5 and Russia's 39.6. However, the trend is for rapid demographic convergence, with Georgia reducing its current demographic disadvantage considerably compared to neighbouring countries.⁴² Meanwhile, Georgia's labour productivity (output per worker) has maintained robust growth of 4-6% in most recent years, signalling a positive trajectory for rising living standards.⁴³

³⁹ National Statistics Office of Georgia (2020). “GeoStat Database.”

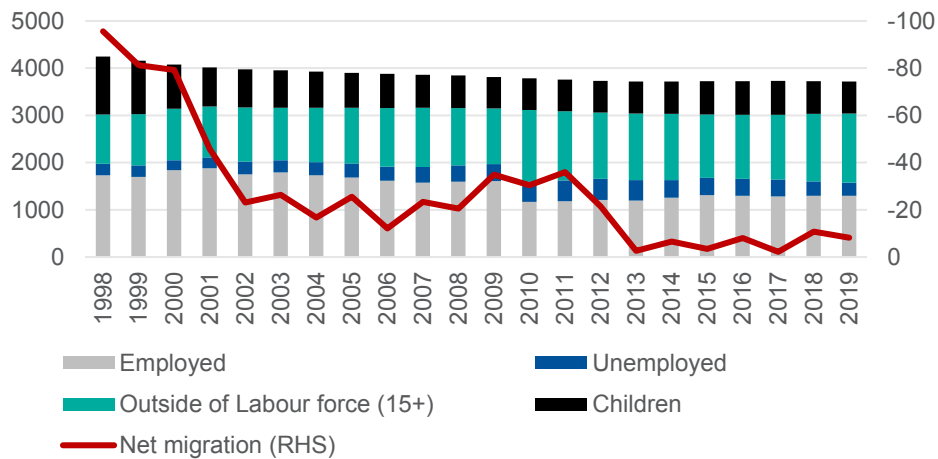
⁴⁰ United Nations Population Division (2019). “World Population Prospects 2019.”

⁴¹ National Statistics Office of Georgia (2020). “GeoStat Database.”

⁴² While Georgia's median age is projected to rise only modestly to 40.9 by 2050, Armenia's will leapfrog to 43.2 by then; Azerbaijan will catch up to 40.3; and Turkey's will climb by an entire decade to 41.7 years, equalling the Russian Federation's. Similar convergence is projected for other measures of population ageing such as the old-age dependency ratio. Based on the “medium variant.” United Nations Population Division (2019). *World Population Prospects*.

⁴³ International Labour Organization (ILO) (2020). “ILOSTAT Database.”

Figure 1: Population and net migration (in thousands)



Source: National Statistics Office of Georgia (2020).

While overall labour productivity is gradually growing, a large share of employment is still focused on traditional sectors with low value added. Georgia's transition from a centrally planned economy has shifted the employment structure across sectors to a more services-oriented economy. The contributions of both agriculture and industry to gross value added have declined over the past two decades. Nevertheless, the agriculture sector still employs nearly one-fifth of Georgia's total workforce. Meanwhile, it contributes a mere 8% of Georgia's gross value added. With nearly half of the economically active population employed in one of the least productive sectors in the economy, the overall labour productivity potential in Georgia is significantly limited. So despite significant leaps in economic development and strong output growth, the Georgian labour market is characterised by limited ability to create opportunities for high-skill employment in more productive sectors. The situation also points to related issues of skills supply and quality which are holding back the structural transformation of Georgia's economy and labour market.

Tbilisi has gained in importance as Georgia's foremost residential hub. While Georgia's total population is declining, Tbilisi's population has remained relatively stable at 1.1-1.2 million residents since the mid-1990s. Consequently, the share of Georgia's population living in the capital has increased from 25.4% in 1995 to 31.9% today. More generally, the share of residents of urban centres has increased from 54% to 59% over the same period.⁴⁴ The concentration of population growth in major metropolitan areas compared to rural areas points to better economic opportunities in those areas: more densely populated areas benefit from larger potential markets, a greater pool of skilled workers and economies of scale in the provision of public goods.⁴⁵

Higher economic activity in urban areas combined with higher unemployment rates come on the back of large-scale subsistence farming activities in rural areas. The share of the economically active population — the labour force participation rate — stood at 53.9% in urban areas and 46.0% in rural areas in 2020. At the same time, the unemployment rate amounted to 20.3% and 15.8%, respectively.⁴⁶ These indicators also exhibit large regional variations. These results point to large-scale self-employment outside the capital, in large part through subsistence farming activities. Combining these data with low productivity levels in agriculture compared to other industries reveals the issue of

⁴⁴ National Statistics Office of Georgia (2020). "GeoStat Database."

⁴⁵ EBRD (2018). "Transition Report 2018-2019 – Work in Transition."

⁴⁶ National Statistics Office of Georgia (2020). "GeoStat Database."

hidden unemployment in rural areas which is not easily detectable in the headline unemployment figures. Coastal zone populations engaged in agriculture are facing additional risks as these areas are highly vulnerable to any climate impact which would then affect the performance of the agricultural sector and employment.⁴⁷

Rates of economic activity remain much higher among men than women. In 2020, 40.4% of working-age women were either employed or looking for work, compared with 62.0% of men.⁴⁸ Both the female and male rates have shifted only very slightly — by 3-4 percentage points, up or down — over the past decade. Consequently, while the unemployment rate for women was lower than for men in 2020, at 16.2% compared to 20.2% for men, their employment-to-population ratio (or “employment rate”) was significantly lower at 33.9% compared to 49.5% for men.

Unemployment data since the outbreak of the COVID-19 pandemic have showed a modest change. According to the official figures, unemployment increased from 16.6% in the last quarter of 2019 to 20.4% a year later, while the labour force participation rate remained nearly stable in the same period. With a modest drop in the total number of employed, the employment-to-population rate declined from 42.1 to 39.8%.⁴⁹ Nevertheless, according to a survey of Georgian businesses conducted in May 2020, 60% of respondents thought they would need to reduce their number of employees or put them on unpaid leave in the following three months.⁵⁰ As of October, 22% of respondents had to reduce employment and 15% had to put their employees on unpaid leave in response to the pandemic, as revealed in the follow-up survey.⁵¹

Informal employment⁵² remains stubbornly high in Georgia. It accounts for 34.7% of employees in the non-agricultural sectors, according to official Labour Force Survey data from 2019.⁵³ The share was broadly even across urban and rural areas (33.8% and 36.8%, respectively) but somewhat higher among men than women (39.3% and 29.2%, respectively).

3.2 Labour force skills are out of step with the evolving needs of businesses

A large share of Georgian firms report poor workforce skills as one of the top constraints for their businesses. The latest wave of the EIB-EBRD-WB Enterprise Survey conducted in 2019 reveals that nearly 15% of private firms find an inadequately educated workforce the single biggest obstacle to doing business. This places skills as the third most significant constraint after political instability (29.9%) and access to finance (26.4%). Not all private companies are equally affected — 22% of large companies, 25% of all companies in the retail sector and 21% of all companies in other services in particular suffer from a lack of qualified personnel.

This area only recently took centre stage in the business community, likely reflecting the evolving needs of businesses on the back of Georgia’s economic development. Less than 5% of respondents

⁴⁷ World Bank (2020). “Impacts of Climate Change on Georgia’s Coastal Zone: Vulnerability Assessment and Adaptation Options.”

⁴⁸ National Statistics Office of Georgia (2020). “GeoStat Database.”

⁴⁹ National Statistics Office of Georgia (2020). “GeoStat Database.”

⁵⁰ PwC (2020). “Georgian Business in the face of the COVID-19 Pandemic.”

⁵¹ PwC (2020). “Follow up survey of Georgian businesses in the face of the COVID-19 Pandemic.”

⁵² Informal employment includes non-standard, alternative, irregular, precarious or other types of employment which leaves employees unprotected in certain ways. As such, it does not equate to employment in the informal sector. ILO, Defining and measuring informal employment (see: <https://www.ilo.org/public/english/bureau/stat/download/papers/meas.pdf>).

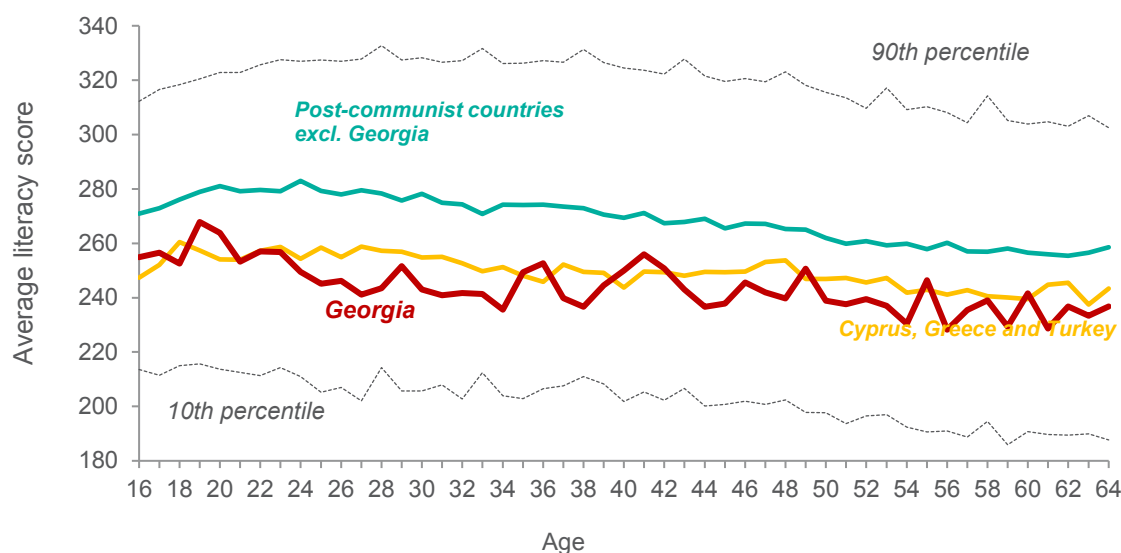
⁵³ National Statistics Office of Georgia (2020). “GeoStat Database.”

identified an inadequately educated workforce as the main constraint in the previous two waves of the same survey conducted in 2012-13 and 2009. The trend of skills shortages is exacerbated by trends of outward migration of skilled workers: the majority of Georgian nationals residing abroad have attained a higher educational level than secondary education.⁵⁴

The skills of the Georgian workforce compare poorly at an international level. The average level of adults' key information-processing skills in Georgia as measured by the OECD is below the levels of advanced countries and other post-communist countries (Figure 2). The skills level also declines with age — a trend observed among other countries as well, highlighting the need for lifelong learning and on-the-job training. Furthermore, in the World Economic Forum's 2019 Global Competitiveness Index, Georgia's worst performing areas included “skills of current workforce” and “ease of finding skilled employees,” which ranked 125th and 120th respectively out of 141 countries.

Figure 2: Average skills scores of Georgians lag behind

Average scores on the programme for the international assessment of adult competencies (PIACC)



Source: EBRD (2018), *Transition report 2018-2019*.

Note: The post-communist countries group includes Estonia, Lithuania, Poland, Russia, Slovak Republic, Slovenia, Czechia and Kazakhstan.

Deficiencies in information and communication technology skills can threaten future employment opportunities in the digital economy. The World Economic Forum's 2016 “The Future of Jobs” report considers mobile internet and cloud technology industries along with big data processing and analytics to be the top drivers of the future global job market. Therefore, science, technology, engineering, and mathematics (STEM) education is gaining importance for future workforce development. So far, the Georgian population has been significantly lagging behind in terms of STEM and digital skills. Georgia's quality of mathematics and science education, as measured in the World Economic Forum's 2017 Global Competitiveness Index, places 103rd out of 137 countries worldwide, while the quality of digital skills among the active population ranks 107th out of the 141 countries measured in the Forum's 2019 index. In addition, Georgian students score consistently lower than international and regional averages

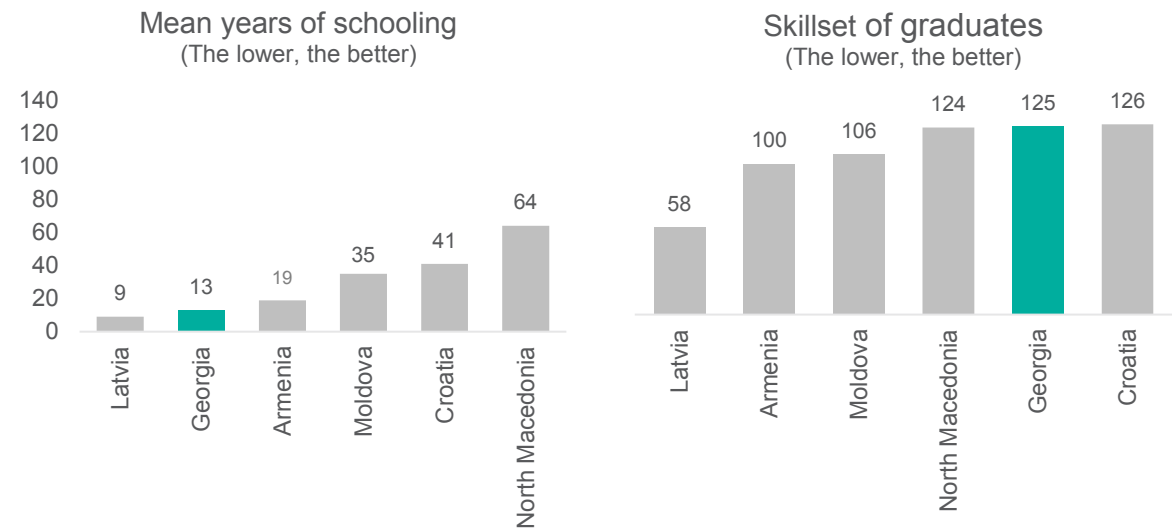
⁵⁴ Georgian State Commission on Migration Issues (2017). “2017 Migration Profile of Georgia.”

on components of the Trends in International Mathematics and Science (TIMSS) study 2019⁵⁵, making the skills mismatch especially grave in the information and communication technology sector.

3.3 To improve workforce skills and resolve youth inclusion issues, weaknesses in the education system and skills mismatches must be addressed

High educational attainment levels are at odds with the poor quality of education (see Figure 3). With an average of 12.8 years of schooling, Georgia is ranked 13th best in the world out of the 141 countries featured in the World Economic Forum’s competitiveness index⁵⁶, and 55th out of 174 countries ranked in the Human Capital Index according to the “expected years of school” indicator based on school enrolment rates at different education levels. However, the same indices point to shortcomings in the education sector. The competitiveness index ranks skills of graduates in Georgia as the second worst indicator (125th in the world) out of 74 measured indicators in total, while according to the expected years of school adjusted for harmonised skills test scores, Georgia only ranks 81st out of 174 countries in the 2020 Human Capital Index. According to international tests measuring student learning outcomes, Georgia is behind most comparators. The programme for international student assessment (PISA) conducted by the OECD places Georgia’s 15-year old students 71st out of 79 countries in their ability to use their reading, mathematics and science knowledge and skills to meet real-life challenges.

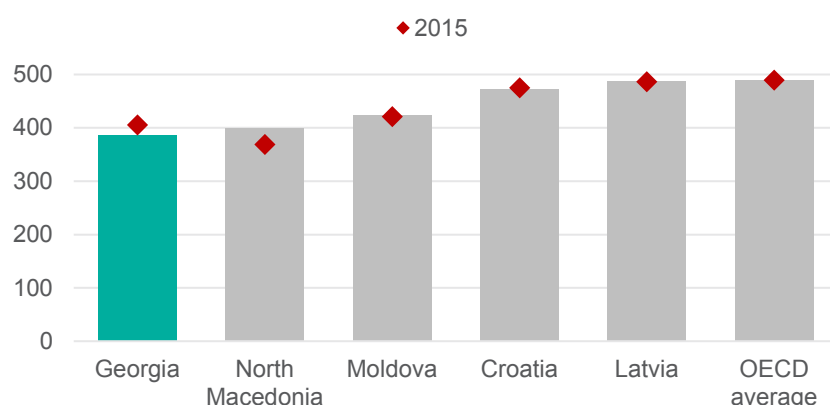
Figure 3: High educational attainment levels are at odds with the poor quality of graduates’ skills
 Panel A: Global Competitiveness Index, ranking out of 141 countries in 2019 Panel B: Global Competitiveness Index, ranking out of 141 countries in 2019



Source: WEF Global Competitiveness Report Source: WEF Global Competitiveness Report.

⁵⁵ International Association for the Evaluation of Educational Achievement (2019). “Trends in International Mathematics and Science.”
⁵⁶ World Economic Forum (2019). “The Global Competitiveness Report 2019.”

Panel C: PISA, average scores, in 2018



Source: OECD PISA.

The learning outcomes in Georgia vary according to several dimensions. According to the OECD, the PISA results depend on students' socioeconomic profile (disadvantaged students tend to perform more poorly), geographic location (students from rural areas score behind their peers in the cities), mother tongue (students from minority groups who do not speak Georgian at home score lower) and educational path (those enrolled in general education score significantly better than those in the vocational sector).^{57 58} This suggests that there is space to increase access to and equality in education.

Efforts to revamp the education system need to be reinvigorated. Over the years, Georgia has implemented a series of gradual reforms to upgrade infrastructure, improve the curriculum and teaching methods, develop a professional development scheme for teachers and decentralise school governance and education financing practices.⁵⁹ Most recently, authorities started working on a comprehensive reform of the education system which would include setting curriculum standards, a new teacher policy framework and more effective vocational training and adult learning. In 2019, the authorities introduced a floor on education spending at 6% of GDP from 2022, subject to the implementation of comprehensive education reform and improved efficiency in spending.⁶⁰ However, the comprehensive strategy of the education reform was never finalised, partly influenced by a government reshuffle in the same year.

Shortcomings in matching the skills supply, education, training and lifelong learning with employers' needs on the demand side remains a long-standing obstacle to Georgia's labour market development.⁶¹ For instance, higher education has a relatively low economic return in Georgia, as it does not provide a significant uplift in employability or remuneration. More than 60% of young people in Georgia attend higher education, while less than 40% of entry-level positions require a degree.⁶² The World Bank estimates that around a third of Georgia's population is overqualified.⁶³ Such skills mismatches are further aggravated by the lack of robust mechanisms for anticipating and matching

⁵⁷ OECD (2019). "OECD Reviews of Evaluation and Assessment in Education: Georgia."

⁵⁸ Please note that these conclusions are based on PISA results for 2015 and 2009.

⁵⁹ IMF (2018). "Georgia Selected Issues and OECD (2019) OECD Reviews of Evaluation and Assessment in Education: Georgia."

⁶⁰ IMF (2019). "IMF Country Report No. 19/372y."

⁶¹ European Business Association (EBA) Georgia (2020). "EBA Position Paper on Vocational Education after COVID-19."

⁶² Galt & Taggart (2020). "Georgia's Education Sector."

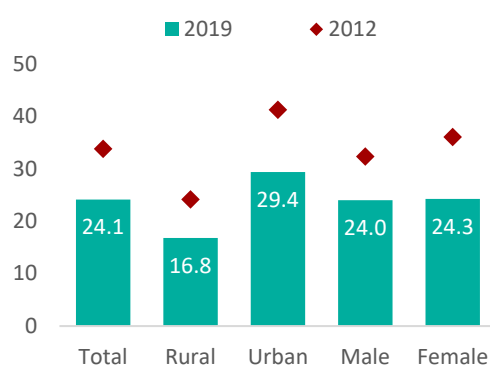
⁶³ ILO (2019). "Skills and jobs mismatches in low- and middle-income countries."

skills. Stakeholders identify a lack of systemic, national-level mechanisms to ensure that the skills required by the private sector are reflected in education and training. This translates into comparatively low levels of enrolment in engineering, manufacturing and construction programmes (8% in Georgia compared to 16%, on average, across the EU-27⁶⁴) and high levels of enrolment in business, administration and law programmes (33% in Georgia against 18% in the United Kingdom).

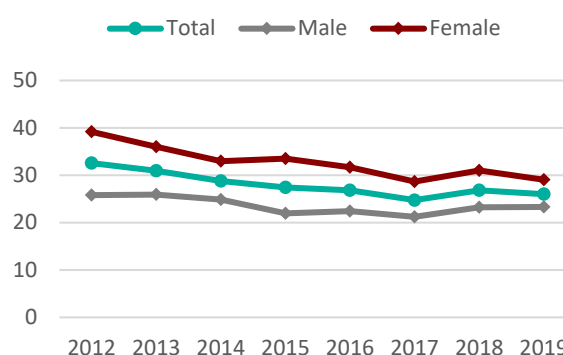
Skills mismatches often translate not only into poor employment outcomes, but also discouragement and inactivity for young people. Youth unemployment has been decreasing in recent years, but remains high at 24.1% in 2019 (see Figure 4). While there are no visible gender disparities, the difference between urban and rural youth unemployment is significant. Furthermore, the proportion of young people aged 15-24 in Georgia who are neither in education, employment nor training, the so-called “NEET rate,” stood at 26.0% in 2019, on aggregate, and higher still among young women at 29.1%⁶⁵. Although this share has also come down in recent years from 32.6% in 2012, worries remain about a “lost generation” of Georgian youth unprepared for accessing educational and economic opportunities.

Figure 4: Youth employment outcomes are weak

Panel A: Youth unemployment rate, in %



Panel B: Share of youth not in employment, education or training (NEET), in %



Source: ILO (2020), ILOSTAT Database.

3.4 With high demand for technical skills, work is underway to strengthen the national technical and vocational education and training (TVET) framework

In recent years, Georgia’s government has made significant and systemic efforts to reform the national TVET framework, attracting support from a variety of international donors. The National Agency for Vocational Skills (or “Skills Georgia”) was established in 2019 thanks to a multi-stakeholder effort to improve skills standards and secure better coordination across the private sector. This has led to the creation of a dedicated sectoral skills organisation for the agricultural sector (named “Agro-Duo”), with more expected to follow in the coming years. The organisation’s primary objective is to foster public and private cooperation by establishing educational programmes in collaboration with the private sector to encourage the timely supply of competitive skills responding closely to labour market demand.

⁶⁴ Eurostat. “Tertiary education statistics.”

⁶⁵ ILO (2020). “ILOSTAT Database.”

Efforts to improve TVET are needed given Georgia's high unmet demand for technical skills such as the expertise provided by technicians and craft workers,⁶⁶ and under-education in medium-skill occupations.⁶⁷ It is particularly difficult for companies to fill blue-collar vacancies in some sectors, including industries related to food processing, and openings for stationary plant operators and similar.⁶⁸ The key challenges for TVET development in the country include: low and declining levels of enrolment (only 6% of the eligible age group was registered as of 2019); relatively low state expenditure on vocational education (3.2% of total spending on education in 2019); and regional disparities in access to TVET, with Tbilisi encompassing 46% of Georgia's complete stock of TVET institutions.⁶⁹ According to a survey conducted by Georgia's Ministry of Education⁷⁰, the majority of Georgia's TVET graduates report being employed (62%), and around a tenth are self-employed in the first year-and-a-half following graduation. Nevertheless, almost one-third of TVET graduates are unemployed, and there is a disparity in levels of employment for female (54%) and male (70%) graduates. Among unemployed respondents, 22% replied they have been unable to find a job because their profession is not in demand, which indicates that the skills mismatch with the labour market also exists for TVET programmes.

The COVID-19 crisis has generated setbacks for the delivery of TVET. Many enterprises have stopped offering study placements due to market uncertainty, changing work patterns, and health and safety concerns.

3.5 Gender disparities persist, dampening the country's potential productivity growth

Women are very active in high-skill occupations in Georgia. Although a relatively lower share of women workers in Georgia are occupied as managers (4.5% compared to 7.0% among men), many more have high-skill occupations as professionals (18.4% compared to 7.2% among men) and technicians and associated professionals (8.6% compared to 6.8% among men). Taken together, the three high-skill occupational categories account for roughly one-third of women's economic activity, compared with only about one-fifth among men, signalling positive labour market opportunities and outcomes for women (see Figure 5).

⁶⁶ Galt & Taggart (2020). "Georgia's Education Sector."

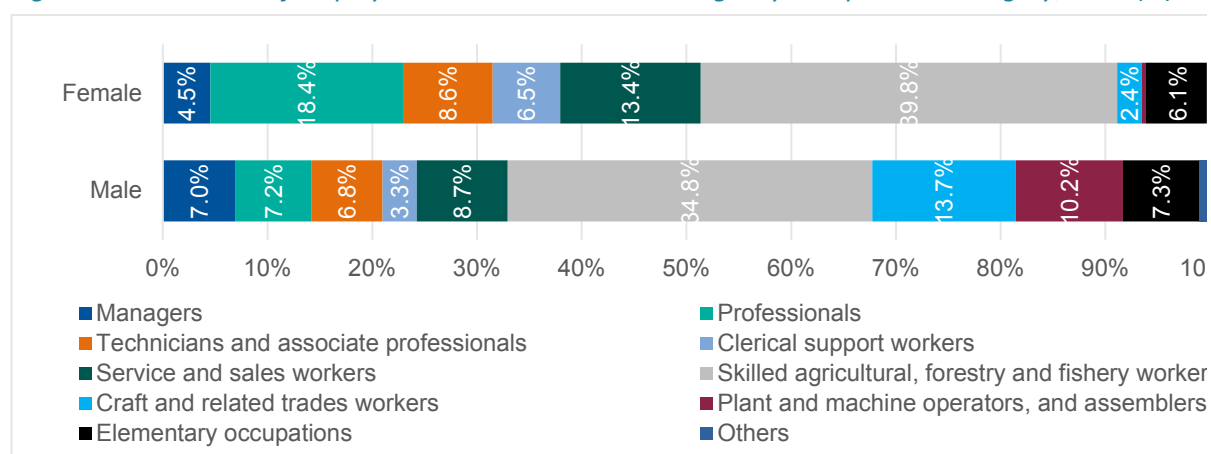
⁶⁷ ETF (2018). "Georgia - Education, Training and Employment Developments 2018."

⁶⁸ ETF (2018). "Georgia - Education, Training and Employment Developments 2018."

⁶⁹ Galt & Taggart (2020). "Georgia's Education Sector."

⁷⁰ Ministry of Education, Science, Culture and Sport of Georgia (2018). "Tracer Study of 2018 VET Program Graduates."

Figure 5: Distribution of employed women and men in Georgia by occupational category, 2019 (%)



Source: ILO (2020) ILOSTAT Database, based on Labour Force Survey.

Nevertheless, women’s high-skill economic activity does not translate into higher earnings as large-scale gender pay gaps persist in virtually every sector of Georgia’s economy. At the most highly skilled “manager” occupational level, the average woman earned GEL 1 651 per month in 2017, compared with GEL 2 432 per month for their male counterparts (i.e. 47% higher).⁷¹ While the average woman employee in Georgia earns GEL 869.1 per month, their male counterparts earn about 56.7% more, at GEL 1 361.8 per month, according to official data for 2019.⁷² As such, Georgia has the highest gender pay gap among comparator countries. In 2019 in Armenia, men earned on average 41.4% more than women, in Latvia 19.0%, in Moldova 16.4% and in Croatia and North Macedonia the gap was the smallest, with men earning on average 10.2 and 10.5% more than women per month.⁷³ On a sectoral level, the biggest gaps are observed in financial and insurance services (where men earn 85.8% more than their female colleagues, on average); manufacturing (65.0%); and scientific research (64.7%). The sectors closest to gender earnings parity are utilities (where women earn 11.9% more than their male colleagues, on average); public administration (where men earn only 1.6% more than women, on average); and education (15.1% in favour of men). This is partly explained by differences in working time — men worked for 41.2 hours per week, on average, in 2019 compared with 33.8 hours among women employees. A study by UN Women from 2020 shows that once workers’ characteristics, such as education and experience, and other important indicators are taken into account, the unexplained gender wage gap reduces, but remains positive,⁷⁴ highlighting the need to ensure more equal opportunities, particularly in the private sector.

Conservative attitudes towards gender roles remain common in Georgia and continue to dampen women’s economic and political inclusion. In Georgia’s care economy, women tend to take on the majority of the duties and tasks. Though many participate in economic activity — benefiting from broadly western attitudes towards women in work — studies show that the burden of household tasks

⁷¹ National Statistics Office of Georgia (2020). “GeoStat Database.”

⁷² National Statistics Office of Georgia (2020). “GeoStat Database.”

⁷³ ILO (2020) ILOSTAT database: mean nominal monthly earnings of employees by sex and economic activity. Note that the most recent numbers for Croatia and North Macedonia are from 2014. According to the same source, the gender pay gap in Georgia is 55.7%, which almost matches national statistics. In general, some caution with wage data is necessary, as definitions of earnings, wages and remuneration often differ across countries. Given these discrepancies, it is difficult to source data from one place. The ILO only irregularly publishes data.

⁷⁴ UN Women (2020). “Analysis of the gender pay gap and gender inequality in the labour market in Georgia.”

is disproportionately placed upon women and does not decrease in line with full-time work. As one stakeholder put it: “It is true that women are fairly well represented in Georgia’s labour market, including at various levels — we have no major issues there. It is only that on top of this they have to cook and clean and take care of the kids and organise the household...” Furthermore, women tend to be seen primarily as wives and mothers and tend to be less valued as daughters due to lingering perceptions that daughters eventually leave their birth families to join and serve their husband’s families. Such attitudes result in the attribution of a dominant role to men in economic and political terms, and as carriers of the bloodline or family name.⁷⁵ Georgia’s conservative gender roles are reflected in the limited access to tertiary education for girls. Whereas there is gender parity in school enrolment rates in Georgia⁷⁶ at the primary and secondary levels, patriarchal norms often lead families to prioritise tertiary education (vocational or higher) for their sons rather than daughters if they are unable to afford such education for all of their children.⁷⁷

Finally, gender-based violence remains a pressing issue in Georgia. High rates of violence against women⁷⁸ are often combined with enabling social attitudes that do not unanimously condemn it.⁷⁹ Victims of gender-based violence in Georgia lack resources and meaningful treatment by the relevant authorities. According to N. Dudwick⁸⁰: “In cases of abuse, women have few resources to call upon. Although police are being trained [...], most women noted that they were likely to advise women to return home and make peace with their husbands.”

3.6 Economic opportunities for people with disabilities and older workers

People with disabilities face discrimination and intolerant public attitudes in Georgia.⁸¹ A Unicef study from 2015⁸² found that 41% of respondents in Georgia hold negative attitudes towards people with disabilities. Due to stigma and discrimination, people with disabilities experience barriers to education, further constrained by educational infrastructure that is not adapted to physical or sensory impairments or special educational needs. For instance, only four out of 31 public schools in Batumi (in the Adjara region) had accessible toilets in 2017.⁸³ Nevertheless, in 2018, new provisions were introduced in the Law on General Education. These provisions granted the specialists engaged in inclusive education with the status of “teacher,” envisioned appropriate social guarantees and

⁷⁵ World Bank, Nora Dudwick (2015). “Missing Women” in the South Caucasus: Local perceptions and proposed solutions.”

⁷⁶ National Statistics of Georgia (2019). “Women and Men In Georgia.”

⁷⁷ Millennium Challenge Account Georgia (2014). “Social and Gender Integration Plan.”

⁷⁸ A nationwide survey conducted in 2017 by UN Women and the National Statistical Office of Georgia found that, on average, one in every four women had experienced sexual violence and/or sexual harassment by a person who was not a partner. The survey also found that one in every seven women aged 15-64 had experienced physical, sexual, or emotional violence at the hands of a partner. From UN Women (2017) National study on Violence against Women in Georgia.

⁷⁹ According to the survey, 22% of women and 31% of men agreed that violence against women is justifiable in some circumstances, while 33% of women and 50% of men agreed that domestic violence is a private affair and not a legal matter. From: World Bank, Nora Dudwick (2015). “‘Missing Women’ in the South Caucasus: Local perceptions and proposed solutions.”

⁸⁰ World Bank, Nora Dudwick (2015). “‘Missing Women’ in the South Caucasus: Local perceptions and proposed solutions.”

⁸¹ Unicef (2016). “Georgia’s children with disabilities struggle against stigmatization.”

⁸² Unicef (2015). “Welfare Monitoring Study.”

⁸³ Coalition for Independent Living (2017). “Realization of the Right to Housing of Persons with Disabilities in Georgia.”

addressed the transition of special boarding schools towards resource-centres. The law also set definitions for integrated and special classes. It created a solid basis for building a truly inclusive education system and legally bound the government to remove barriers standing in the way of children with disabilities.⁸⁴

Barriers to education for people with disabilities translate into weaker employment and economic outcomes. Data from 2014 show that there were only 24 disabled employees out of over 100 000 public employees in Georgia. With an estimated share of 3-10% of the population living with a disability⁸⁵, this number shows that people with disabilities are not effectively integrated in the workforce, even in the public sector.

Georgia's government has taken action to adopt the "2014-2016 Government Action Plan to ensure equal opportunities for people with disabilities" and has established a "State Coordinating Council on the Issues of Persons with Disabilities." Nevertheless, advocacy groups continue to demand stronger governmental support for people with disabilities, including through better access to education, housing and financial support.⁸⁶

Older workers in Georgia get limited support. Economically active older workers (55+) account for approximately 26% of the labour force. The unemployment rate is generally lower than the national average, at 11.5% for the 55 to 64 age group and 7.6% for the 65+ group.⁸⁷ While the law prohibits discrimination in the labour market based on age, there are no specific incentives to hire older workers, and workers who have reached retirement age are not entitled to unemployment benefits or government measures to promote employment. Little information is available on older workers' access to employment or skills development opportunities, though work-based learning and lifelong learning policy initiatives tend to be primarily focused on younger workers. Targeted efforts to promote or support older workers in entrepreneurship development are limited, although this does not seem to necessarily impede entrepreneurship as the prevalence of self-employment among older workers is higher than in other segments of the population. A very low universal pension, with the minimum currently set at GEL 240 (approximately USD 70), just above the subsistence minimum of around GEL 200, entails the need to remain employed, even when past retirement age.

⁸⁴ Save the Children (2018). "Save the Children Georgia leads the Inclusive Education System Strengthening Efforts on Legislative and Policy Levels."

⁸⁵ IDFI (2015). "Statistics of Persons with Disabilities in Georgia."

⁸⁶ Coalition for Independent Living (2017) Realization of the Right to Housing of Persons with Disabilities in Georgia

⁸⁷ National Statistics Office of Georgia (2020) GeoStat Database

4. The financial sector and private sector access to finance

Financial intermediation grew significantly in Georgia over the last decade, with total assets almost doubling over the period. Banks dominate the financial sector with 94% of total assets, and dollarisation is a key feature of the Georgian financial sector. On the other hand, considerable progress has been made in raising regulatory and supervisory standards. Nonetheless, access to finance continues to be a major obstacle for small and medium enterprises, as assessed in the latest EIB-EBRD-WB Enterprise Survey. The share of credit-constrained firms was around 31%, with loan applications from a minority of firms being rejected and, for the most part, firms simply becoming discouraged and not even applying for credit lines. Interest rates were still the main discouragement factor. Firms' propensity to invest was hampered by credit constraints and firms not carrying any loans from the financial sector had a very low propensity to invest. This suggests that further outreach and deepening of the financial sector is required to support small and medium enterprises and investment, thus fostering long-term growth.

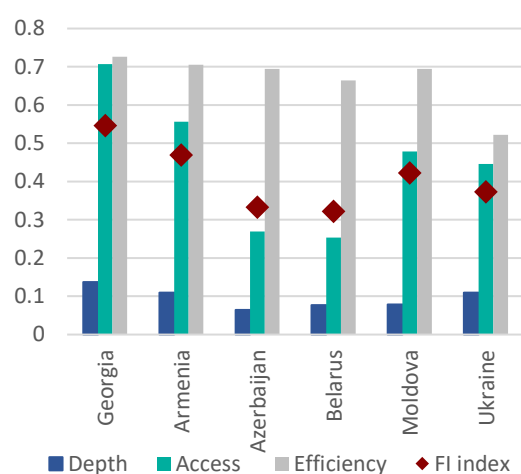
4.1 Financial intermediation has increased substantially with banks dominating the landscape

Financial intermediation in Georgia has grown rapidly in recent years. Total assets as a share of GDP have increased from 52.2% in 2010 to roughly 100% in 2020. This trend has benefited from a strengthened operating and regulatory environment as well as an improved institutional framework. For example, the Georgian financial sector has a high score in terms of access (such as availability of ATMs for the general population) and efficiency (including a focus on profitability metrics) in the Eastern Partnership (EaP) region according to the IMF Financial Institutions Index 2018 (Figure 1 — Panel A). At the same time, financial depth — defined as the ratio of pension, insurance and bank exposures to GDP — is still largely underperforming in Georgia as well as in the Eastern Partnership region according to the same index.

Account ownership and other indicators attest to the outreach of financial intermediation, even from an inclusion perspective. From a regional perspective, on average only 53% of the working population in the Eastern Partnership countries owned an account in a financial institution in 2017, against 61% in Georgia. When comparing across certain segments of the population that have a tendency of being more excluded from access to finance — females, young adults, the poorest (defined as the bottom 40% in income distribution) and those living in rural areas — Georgia scores relatively well compared to regional peers. Nonetheless it is clear that significant parts of the population are still underserved and further efforts for outreach are very much in need. Notably, the younger cohorts in Georgia seem to be in a more disadvantageous position compared to regional peers (see Table 1).

Figure 1: Financial intermediation compares favourably to peers with banks dominating the landscape

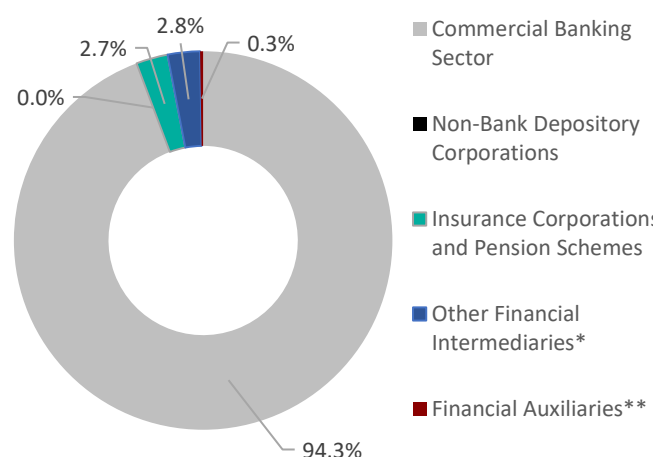
Panel A — IMF Financial Institutions Index 2018



Source: IMF, Financial Development Index Database, author's calculations.

Note: Panel A - The Financial Institutions Index is an aggregate of the depth, access and efficiency indices. Depth is measured using data on bank credit to the private sector (% of GDP), pension fund assets to GDP, mutual fund assets to GDP, and insurance premiums to GDP. Access is measured using data on bank branches and ATMs per 100 000 adults. Efficiency is based on data on the banking sector's net interest margins, lending-deposits spreads, non-interest income to total income, overhead costs to total assets, return on assets and return on equity; Panel B - *Includes microfinance institutions and pawnshops (until 2017), **Includes stock exchanges, brokerage companies and exchange bureaux.

Panel B — Financial institutions' share of net assets - % total net assets of the financial sector



Source: National Bank of Georgia, author's calculations.

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Table 1: Financial inclusion metrics - % 15+

	General		Female		Young		Poorest 40%		Rural	
	GEO	EaP	GEO	EaP	GEO	EaP	GEO	EaP	GEO	EaP
Account	61%	53%	64%	51%	31%	42%	46%	42%	55%	48%
Borrowed from a financial institution	24%	15%	20%	14%	8%	12%	21%	12%	20%	14%
Made or received digital payments in the past year	53%	49%	55%	47%	26%	38%	38%	39%	45%	44%

Source: World Bank, Global Findex database (2017).

Note: EaP is a simple average of the countries in the Eastern Partnership region.

Access to finance is one of the main barriers to women's economic empowerment in Georgia.⁸⁸ Men in Georgia are 80% more likely than women to own a non-agricultural company.⁸⁹ For women who own a business, access to finance, training and connections will often be barriers to expanding their companies.⁹⁰ One of the most significant reasons behind difficulties in accessing finance is a lack of collateral as women in Georgia own significantly less property than men do. Georgia's long-standing inheritance laws and practices are partly responsible for this. Most property to be inherited is given preferentially to sons, rather than daughters, and married women can only make claims on assets or property that they and their husbands acquired after marriage (women have no ownership rights on property owned by their in-laws or even inherited by their husband before marriage). Even when women are considered owners, their influence on the decision to sell the asset is significantly more limited compared to male asset-owners.^{91 92}

Banks dominate the financial sector. Net financial sector assets have almost quadrupled since 2011. As a result, financial intermediation has become increasingly important in the country, with net total assets of GEL 50 billion reported in 2019. In 2020 there were 827 exchange bureaux, 199 loan issuing entities, 40 microfinance institutions, 18 insurance companies, 15 commercial banks, four pension schemes, two stock exchanges and one non-bank institution. Banks hold by far the largest share in terms of net assets. The share stood at about 94% and represented 89% of GDP in 2019 (Figure 1 — Panel B).

Two key features define the Georgian banking sector: private ownership and a two-tier system. First, bank ownership is fully private with a large share of foreign ownership (93%). Second, the sector operates under a two-tier system, whereby the two largest competitors — Bank of Georgia (BoG) and TBC Bank (TBC) — jointly accounted for approximately 77% of total banking assets in 2019. Conde and Gattini (2019)⁹³ found that although many features are similar across all banks, some differences appear to be significant. For example, the two largest banks are more diversified in terms of business model, product palette, sophistication, client spectrum and funding structure. Their average profitability has been also higher historically. Smaller banks tend to have a larger part of their portfolio denominated in lari, a thinner deposit base, and larger regulatory capital and liquidity ratios. Finally, yet importantly, unlike smaller banks, BoG and TBC are internationally listed and have access to multiple sources of direct finance, including medium-term loans and deposits. Nevertheless, smaller banks have retained substantial potential in unutilised regulatory capital and an ample liquidity position.

⁸⁸ UN Women (2017). "Women's Economic Empowerment in Georgia."

⁸⁹ ADB (2018). "Measuring asset ownership and entrepreneurship from a gender perspective."

⁹⁰ ADB (2018). "Georgia Country Gender Assessment."

⁹¹ The exclusive right to sell assets such as dwelling units, agricultural land, large agricultural equipment and real estate, as opposed to the joint (consultative) right and no right, is significantly higher among men compared to women. ADB (2018). "Pilot Survey on Measuring Asset Ownership and Entrepreneurship from a Gender Perspective."

⁹² ADB (2018). "Georgia Country Gender Assessment."

⁹³ Conde and Gattini (2019). "Financing in Georgia: Small and medium enterprises and the private sector."

The Georgian banking sector's capitalisation levels are adequate while asset quality has started to deteriorate somewhat. The capital adequacy ratio stood at 17.6% in late 2020, which is far above the 8% minimum requirement imposed by the regulator ahead of the pandemic. In 2019, the aggregate non-performing loan ratio was 1.9% (IMF definition) or 4.4% according to the National Bank of Georgia's definition. Non-performing loans based on the IMF definition reached 2.3% whereas according to the National Bank of Georgia's definition, they increased to 8.2% at the end of 2020.⁹⁴ The low level of non-performing loans reached in 2019 was possible thanks to relatively stable employment and economic growth, high credit standards and effective restructuring mechanisms employed by banks in recent years. On the other hand, Georgia's high level of dollarisation exposes banks to currency-induced credit risk via exchange rate fluctuations. This seems more important for the hospitality and real estate sectors. Moreover, these sectors have seen loan extensions and their contribution to economic growth increase in recent years. In order to diminish the potential risk, the National Bank of Georgia introduced higher risk weights on loans and stricter requirements for unhedged forex lending before COVID-19. These instruments may prove very useful in limiting the negative effects of the COVID-19 crisis.

The COVID-19 crisis has hit bank profitability. The returns on assets (ROA) and on equity (ROE) were relatively high in 2019 for the Georgian banking sector, also propelled by the high interest rate spread (i.e. 577 basis points) between lending and deposit rates. They were impacted severely during the first two quarters of 2020, but closed the 2020 fiscal year in low but positive territory at 0.2% for ROA and 1.4% for ROE, supported by monetary policy, regulatory actions and a rebounding real sector.

Table 2: Financial soundness indicators in the fourth quarter of 2019 and 2020 — Georgia versus the Eastern Partnership countries — in%

	2019Q4					Most recent 2020 data*				
	GEO	ARM	BLR	MDA	UKR	GEO	ARM	BLR	MDA	UKR
Regulatory Capital to Risk-Weighted Assets	19.5	17.6	17.8	25.3	19.7	17.6	17.4	16.4	27.3	21.9
Liquid Assets to Short-Term Liabilities	24.2	111.7	155.6	207.4	94.4	25.2	119.3	116.7	221.1	89.7
Non-performing Loans to Total Gross Loans	1.9	5.5	4.6	8.5	48.4	2.3	5.7	4.9	8.6	45.6
Return on Assets	2.5	1.5	1.9	2.6	4.7	0.2	1.8	1.4	1.6	3.4
Return on Equity	20.4	10.3	12.8	14.6	37.5	1.4	12.4	10.2	9.0	26.2
Spread Between Reference Lending and Deposit Rates	576.7	350.1	165.5	-	622	510.6**	350.5	59.6	-	763.0

Source: Georgia: National Bank of Georgia. Others: IMF.

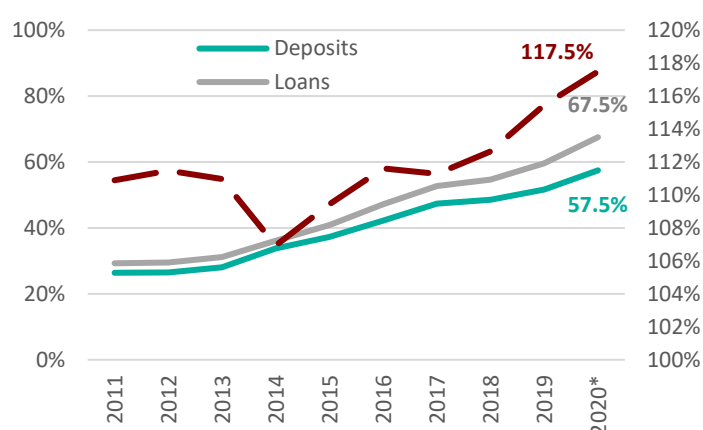
Note: *Georgia (2020Q4), Armenia (2020Q2), Others (2020Q3). **From the IMF and dating back to 2020Q1.

Leverage has increased lately. The ratios of deposits and loans to GDP have steadily grown. Loans stood at 67.5% and deposits at 57.7% of GDP in July 2020 (Figure 3). However, they have been growing at different paces over the past ten years or so. Specifically, the loan to deposits ratio contracted and/or stagnated in 2014 and 2016 amid two negative shocks to the economy and significant exchange rate depreciations⁹⁵, while it accelerated significantly from 2017 onward. This points to a more leveraged banking sector, with the loan to deposit ratio currently standing at 117.5%.

⁹⁴ This suggests that the National Bank of Georgia's approach is more conservative and sensitive to the cycle than the IMF's approach.

⁹⁵ At the time, the global fall in commodity prices had spill-over effects on the banking sector, via decreased remittances, depressed demand from Russia and neighbouring countries and contagion effects from their banking sectors whose vulnerabilities were exposed, especially in Ukraine. This contributed to exchange rate volatility in Georgia.

Figure 3: Monetary aggregates to GDP ratios — % GDP



Source: National Bank of Georgia, author's calculations.

Note: *July 2020.

Dollarisation has been a long-standing issue in Georgia. As of September 2020, 56.1% of all loans and 60% of total deposits were denominated in foreign currency. Although these statistics still represent large shares of financial intermediation, they are past the peak of around 2015/2016. This is mainly due to the National Bank of Georgia's mitigating actions and the implementation of the "larisation" programme. The results of the policy efforts are more visible on the asset side of banks' balance sheets, with a significant increase in GEL-denominated loans since 2015. Nonetheless, businesses' and households' deposits in local currency also represent a higher share in 2020 compared to 2015 (Figure 4 — Panel A).

Microfinance is the key sector for non-bank financial institutions, representing GEL 1.4 billion in assets as of the third quarter of 2020, or 2.8% of total net financial sector assets and GDP. In total, there are 40 licensed organisations, employing more than 4 000 people with close to 400 branches spread throughout the country. Assets accelerated significantly from 2010 and stabilised after a slight hiatus in 2016. 70% of the assets are net loans and 93% of them are issued in local currency because of the type of clients (very small on average) and the recently adopted regulation. This regulation requires loans below GEL 200 000 to be issued in local currency, which essentially involves a large part of the microfinance loans.

The National Bank of Georgia is in charge of financial sector supervision, covering banks and non-bank institutions. Generally, Basel III standards are implemented for the banking sector and a lot of progress has been made in recent years, particularly with raising the standards for capital, liquidity and financial transparency. Concerning capital, the regulatory framework implements minimum capital and capital buffer requirements, additional capital buffers (for instance, unhedged currency, credit portfolio concentration and net stress) and disclosure requirements. These instruments and their employability have been revised and tweaked in response to the COVID-19 pandemic. A financial stability department was also created within the National Bank of Georgia to further monitor business and credit cycles.⁹⁶ Liquidity standards are mainly defined by the liquidity coverage ratio and in future will also be determined by the net stable funding ratio.

⁹⁶ With the aim of improving transparency, quarterly and annual reports detailing each bank's regulatory capital elements, risk-weighted assets, and other corporate governance- and risk management-related matters are requested and publicly available. Finally, macroeconomic and financial forecasts under IFRS 9 for different risk scenarios are published bi-annually and serve as guidance for financial institutions.

Box 1. Money and Capital Markets Development

High dollarisation is holding back the development of money markets but measures adopted by the National Bank of Georgia have improved access to lari liquidity over the past decade⁹⁷. The National Bank of Georgia has notably developed and modernised its liquidity management tools since the adoption of its inflation-targeting mandate in 2009. The establishment of a more robust TIBR benchmark interbank rate in 2018 and the adoption of a Repo Master Agreement have fostered the development of liquidity on interbank markets and contributed to bringing down short-term interest rate volatility. Activity on the interbank market remains largely dominated by the increasing volume of unsecured operations, while repo transactions have tended to decline. The market for government financial paper has grown steadily over the past few years. Further deepening the markets for short-term sovereign debt securities will be paramount for strengthening the sovereign yield curve and supporting the development of other market segments.

Although it has grown steadily in recent years, the Georgian government securities market remains small. Government securities issued in lari are mostly held by local banks as collateral for refinancing purposes. The secondary market for government bonds is shallow, with trading taking place over the counter and custody and settlement services provided free of charge by the National Bank of Georgia. The Ministry of Finance of Georgia, with the support of the national bank, is launching a primary dealer pilot programme to support the deepening of the Treasury bill and bond markets by enhancing secondary market liquidity via continuous two-way price quoting.

The corporate bond segment is still underdeveloped and bank lending is effectively the main source of funding for the corporate sector, especially for small and medium enterprises. The non-government bond market is dominated by international financial institutions, with only 16 corporate bonds listed on the Georgian Stock Exchange (GSE) at the end of 2019⁹⁸. New issuances remain scarce and are mostly placed with institutional investors, predominantly commercial banks and international financial institutions, pursuing hold-to-maturity strategies. Since the EBRD's inaugural private placement of the first-ever domestic Georgian lari bond by a foreign investor on the local market in March 2014⁹⁹, several international financial investors have issued local currency denominated bonds in Georgia.

A number of Georgian companies have chosen to list on international stock exchanges as opposed to the GSE where liquidity is negligible¹⁰⁰. As at the end of October 2020, 28 companies were admitted for trading on the GSE with a total market capitalisation of GEL 2 377 million (USD 705 million) which amounts to 4.8% of GDP¹⁰¹. Since its peak in 2007, trading activity for stocks listed on the GSE has been steadily decreasing, reaching a mere 56 trades in 2019 with the majority of trades being conducted over the counter.

New debt or equity issuances could potentially come from a number of mature assets currently held by private equity funds, a handful of state-owned enterprises or the private sector. In addition to the low levels of liquidity, the absorption capacity of the narrow local institutional investor base restricts the size of potential issuances on the local stock exchange. The recent creation of the second pillar of the pension system is expected to improve liquidity once the new pension funds accumulate sufficient assets.

⁹⁷ TBC Capital (2020). "Fixed Income Regional Market Watch."

⁹⁸ Georgian Stock Exchange.

⁹⁹ National Bank of Georgia (2014). "EBRD launches its Inaugural Georgian Lari Bond."

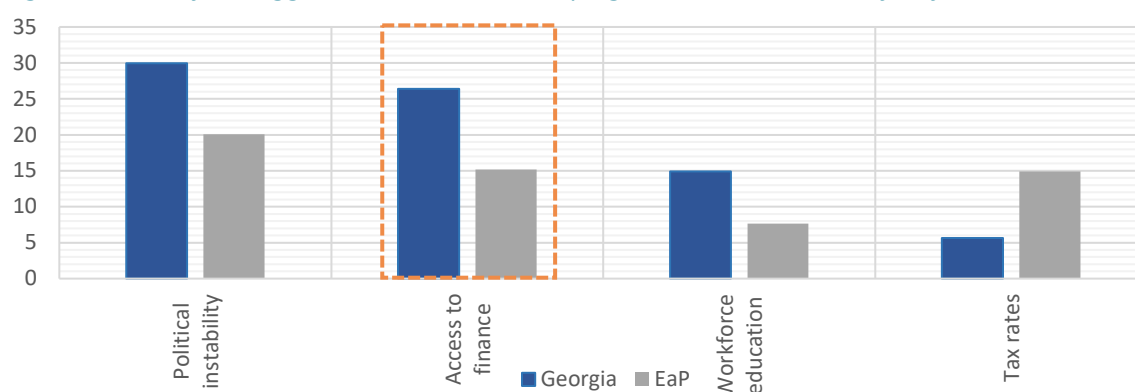
¹⁰⁰ Georgian Stock Exchange.

¹⁰¹ 2019 GDP.

4.2 Despite notable improvements, firms' propensity to invest is still hampered by credit constraints and financial autarchy

Firms in Georgia consider access to finance to be the second most significant obstacle to doing business, according to the 2019 EIB-EBRD-WB Enterprise Survey (Figure 6), despite significant improvements in the sector in terms of outreach, penetration of financial intermediation and services on offer. On the other hand, access-to-finance limits are more concentrated in smaller and younger firms while larger firms are more leveraged and linked more closely to international markets.

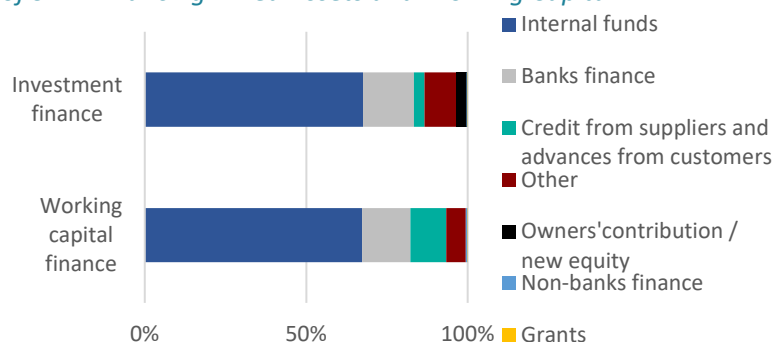
Figure 6: Firms' four biggest obstacles to developing their businesses - % of all firms



Source: EBRD, EIB, WB - BEEPS, 2019. EIB calculations.

Small and medium enterprises have multiple sources of finance for investment and working capital, with a concentration on internal funds. Roughly 67% of investment or working capital is financed with internal funds (Figure 7). The second most used source of financing is bank credit, covering an equal share of investment and working capital (about 15%). Credit from suppliers and advance payments finance working capital more (about 11%) while a small but visible contribution from equity supports investment activity.

Figure 7: Sources of SME Financing: Fixed Assets and Working Capital



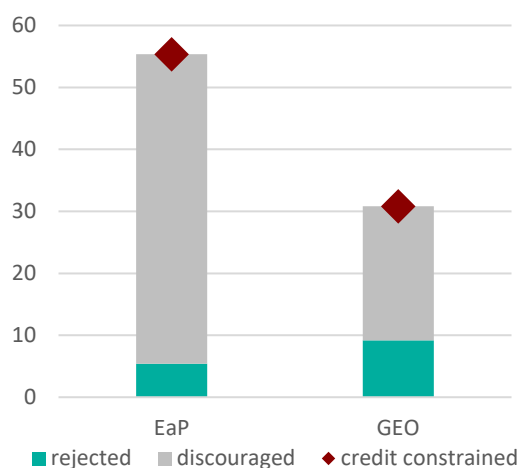
Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

The share of credit-constrained firms is around 31%. Out of these firms, the loan applications of 30% were rejected while 70% were discouraged and did not even apply (Figure 8, Panel A), thus generating

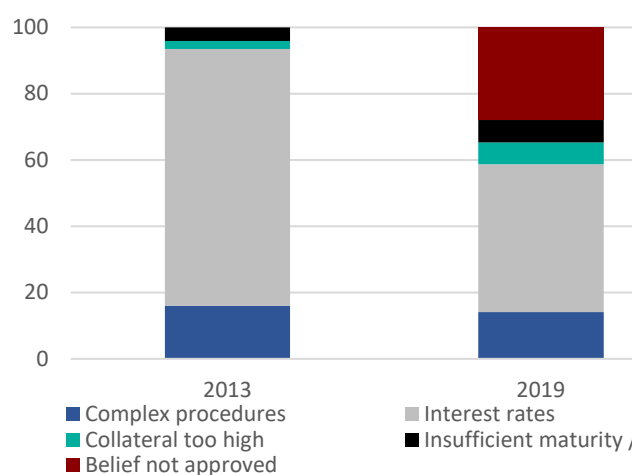
a still-significant level of constraints. On the other hand, the share of credit-constrained firms is lower in Georgia than in the region but the rejection rates compare less favourably. This suggests that banks' risk assessment and credit terms and conditions are more stringent in Georgia compared to the Eastern Partnership average. Accordingly, a significant share of firms did not apply for a loan in the belief that their loan applications would have not been approved (Figure 8, Panel B). All in all, the reasons for being discouraged from applying for a loan have changed considerably over time. Interest rates are still a major discouragement factor, albeit with a decreasing effect between 2013 and 2019, probably thanks to the low and still declining interest rate environment while collateral requirements increased marginally in importance.

Figure 8: Credit-constrained firms are mainly discouraged from even applying for credit lines

Panel A — Credit-constrained firms — % of firms needing a loan



Panel B - Reasons for being discouraged — 2013 vs 2019 — % share

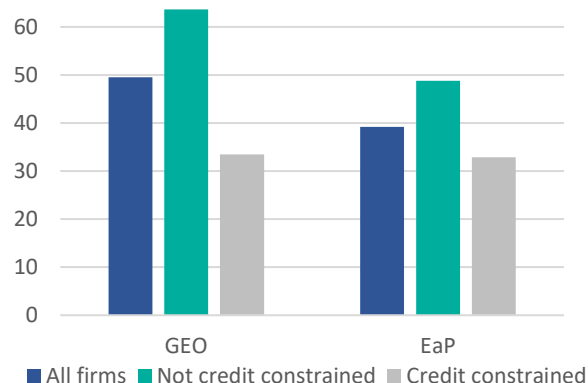


Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

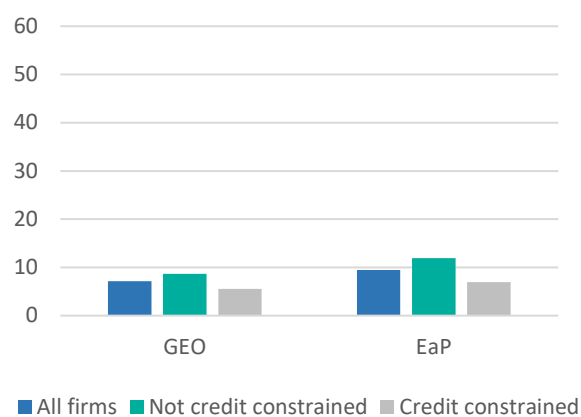
Credit constraints limit firms' ability to invest in fixed and intangible assets. Figure 9 shows firms' propensity to invest in Georgia and the Eastern Partnership region. First, Georgian firms seem to be more likely to invest in fixed assets than their peers. Second, Georgian firms are less likely to invest in intangible assets than firms operating in other countries in the region, suggesting a somewhat lower propensity to innovate among Georgian firms. Third, credit-constrained firms invest less than peers that are not credit constrained. Moreover, this difference is larger in Georgia compared to other Eastern Partnership countries. As a result, credit constraints are comparatively a more limiting factor in Georgia than in other countries in the region. Therefore, removing the obstacles preventing firms from accessing credit at the microeconomic-bank level would be a major driver for investment activity in Georgia. On the other hand, firms' over-leverage is becoming a key issue. Constraints can be alleviated via a proper allocation of credit among firms and the use of alternative funding sources such as private equity. That said, the private equity market still needs to be stabilised and developed.

Figure 9: Credit-constrained firms have a lower propensity to invest-

Panel A — Investment in fixed assets given credit constraints — % of firms



Panel B — Investment in intangible assets given credit constraints — % of firms

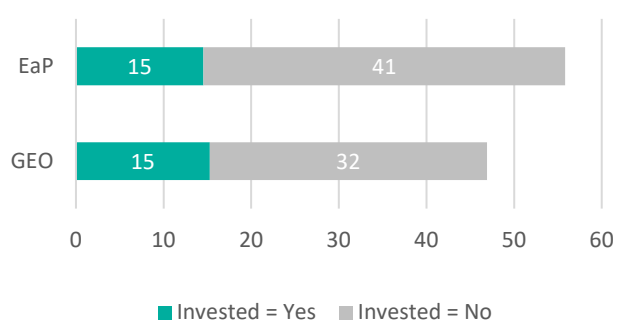
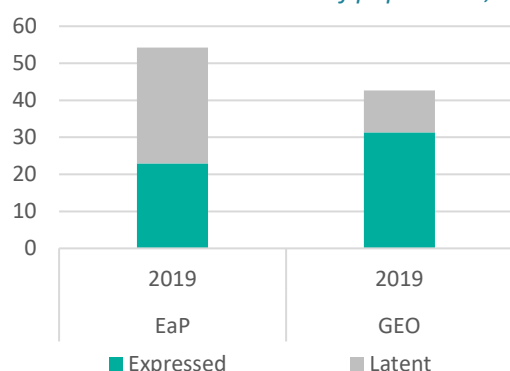


Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

Financial autarchy limits firms' propensity to invest. Financial autarchy refers to firms that do not have any loans and/or financing from banks or other financial sector entities. As a result, they finance their operations with internal funds only. Georgia has fewer such firms than other Eastern Partnership countries, suggesting that more firms in Georgia are connected to the financial sector (Figure 10 — Panel B). Accordingly, expressed demand — firms that have actually applied for a loan — is higher than latent demand — firms that need a loan but have not applied — in Georgia compared to the Eastern Partnership region. However, the vast majority of firms operating in financial autarchy do not invest in Georgia or in this region. This suggests that further outreach and financial deepening of the financial sector is still very much required, including in Georgia, to foster investment levels.

Figure 10: Further financial deepening is needed to foster investment

Panel A - Loan demand — % of population; Panel B — Financial autarchy — investment — % of firms

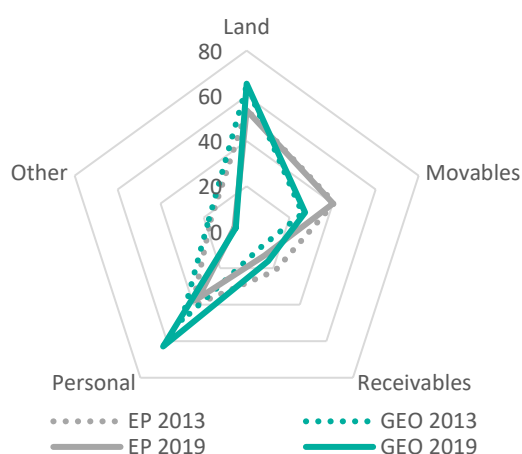


Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

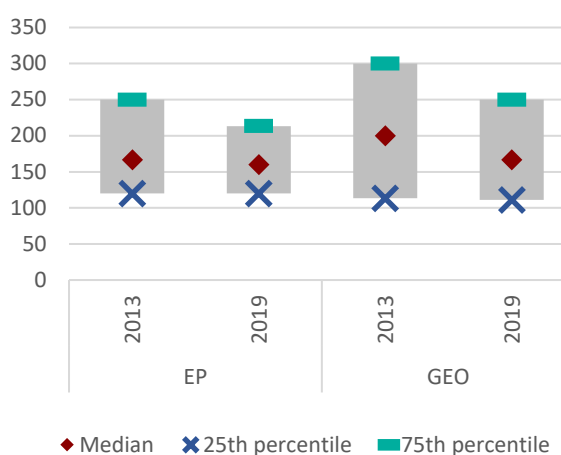
Collateral requirements — the type and amount of collateral required to get a loan — **are still substantial in Georgia, also when compared to the Eastern Partnership region.** Land is the most commonly requested type of collateral in Georgia (65% of firms with a loan posted land as collateral) with the share even higher than in the rest of the region (Figure 11, Panel A). Personal assets are also in high demand in Georgia compared to other Eastern Partnership countries, with roughly 60% of firms posting this type of collateral. On the other hand, movables have a more prominent role in peer countries than in Georgia.¹⁰² Georgia seems to be different from the region in terms of receivables and personal collateral. Their importance waned in the region (comparing the 2013 with the 2019 results of the Enterprise Survey) while it grew in Georgia. The median value of collateral requested — as a share of the loan amount — in the Georgian market was similar to the Eastern Partnership level, scoring 167% and 160%, respectively. Similarly to the region, Georgia showed a declining trend between 2013 and 2019 in the value of collateral required (i.e. the intensive margin of collateral). However, visible differences emerge when looking at the distribution of the value of collateral. For example, the top 75 percentile is markedly higher in Georgia than in the Eastern Partnership region.

Figure 11: Collateral requirements are high and hamper access to credit

Panel A — Type of collateral requested — % of firms



Panel B — Value of collateral requested — % loan amount



Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

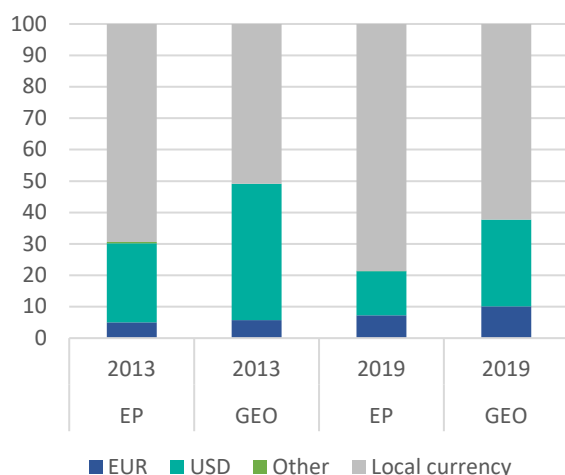
Georgian firms are relatively exposed to foreign currency fluctuations. Dollarisation is a feature of the Georgian financial sector. This is also mirrored in the financial structure of small and medium enterprises. A higher share of foreign currency loans is extended to Georgian SMEs compared to the average in the Eastern Partnership region (Figure 12 — Panel A). However, the share of foreign currency loans decreased in 2019 compared to 2013. The largest share of these loans is denominated in US dollars. Nonetheless the share of euro-denominated loans has increased visibly over time, particularly in Georgia. Finally, yet importantly, the vast majority of the small and medium businesses taking out foreign currency loans do not seem to be exporting (directly or indirectly). As a result, they might be largely unhedged against exchange rate risks because they are not matching their capacity to

¹⁰² These shares are not mutually exclusive because firms can be requested to post a mixture of collateral types.

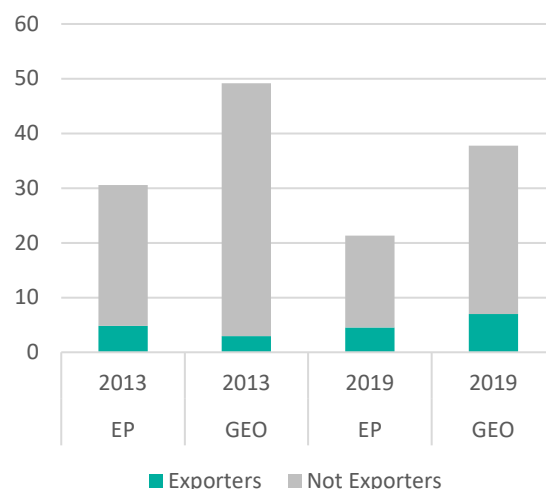
repay in local currency (i.e. revenues in local currency) with their outstanding liabilities in foreign currency (i.e. loans).

Figure 12: Similar to the financial sector, the SME segment is also heavily dollarised

Panel A — Currency structure of loans — % of firms with a recent loan



Panel B - Breakdown of foreign currency loans by exporter status



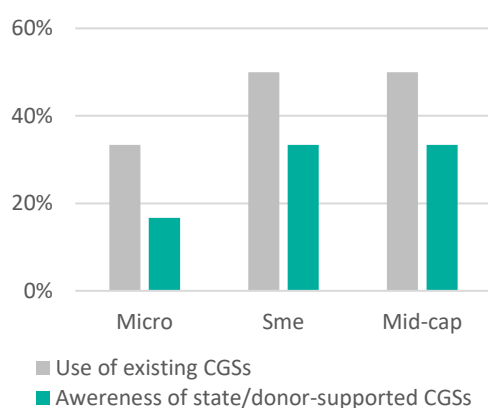
Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

Credit guarantee schemes (CGSs) are an alternative instrument for small and medium enterprises when collateral is insufficient. A lack of reliable information available to creditors about their potential clients or a lack of available collateral may lead to occasions when banks are not willing to lend to SMEs even at interest rates above the market level. This issue could be tackled by making use of credit guarantee schemes. However according to the 2018 EIB Bank Lending Survey,¹⁰³ only 50% of small and medium businesses were already using them (Figure 13 — Panel A). The main factors holding their development back seemed to be the cost of the schemes and administrative burdens. On the other hand, the regulatory framework did not seem to be the main factor hampering the schemes' development, as approval delays or a lack of transparency were not cited as key constraints (Figure 13 — Panel B). Recently, credit guarantee schemes were made more available to respond to the COVID-19 crisis, including under the government-supported Enterprise Georgia Programmes (See Box 1), although investor aftercare is still lacking.

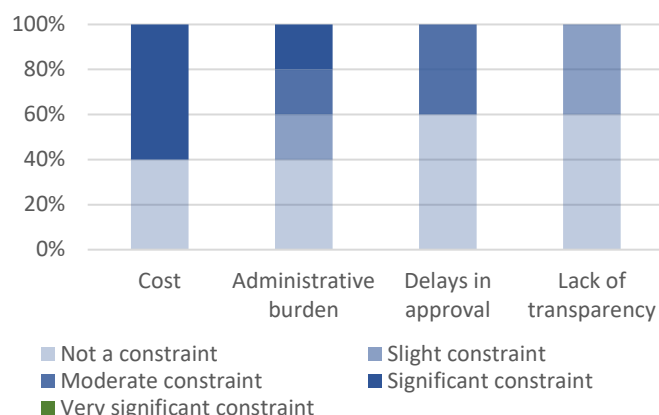
¹⁰³ EIB (2018) Bank Lending Survey

Figure 13: Credit guarantee schemes are not yet widely available in Georgia

Panel A — Use/awareness of credit guarantee schemes — positive responses as % of total — by firm size



Panel B — Constraints on the use of credit guarantee schemes



Source: EIB Bank Lending Survey, 2018.

Box 2. Example of local initiatives in support of small and medium enterprises: Enterprise Georgia¹

Enterprise Georgia is the government agency dedicated to financial inclusion and private sector development. Its activities focus on three major directions: creating and expanding businesses; attracting foreign direct investment; and promoting export potential. Recently, its role was enhanced to respond to the COVID-19 crisis because support for micro, small and medium enterprises was particularly needed.

Enterprise Georgia facilitates access to finance for the private sector through various financial instruments, namely technical assistance/co-financing consulting services, co-financing interest rates on business loans approved by local commercial banks, providing partial collateral guarantees or co-financing the interest rates on leased equipment, and transferring state property (both land and buildings) to private ownership. The credit guarantee scheme was also revamped in response to the COVID-19 crisis to assist small and medium enterprises that did not meet the requirements of banks' loan collateral frameworks. It covers up to 90% of the principal loan amount (or 30% in the case of restructuring). A similar programme for co-financing SMEs' accrued interest was adapted to the hospitality sector. On top of this, a programme is in place which offers a 20-25% cash rebate on eligible expenses incurred in film productions aiming to attract international filmmakers to the country. Finally, a mortgage credit support program was approved to assist individuals not meeting full loan collateral requirements, thus stimulating demand in the real estate sector. The number of firms reached and jobs created so far point to the positive impact of the programmes under Enterprise Georgia's management. For example, as of 2020 "Produce in Georgia" has supported 444 projects (339 enterprises) with a total investment of GEL 890.3 million, resulting in over 15 290 new jobs. As for the hotel industry's development, 170 projects (from 128 hotels) have been supported with a total investment of more than GEL 385.2 million, creating over 3 217 jobs.

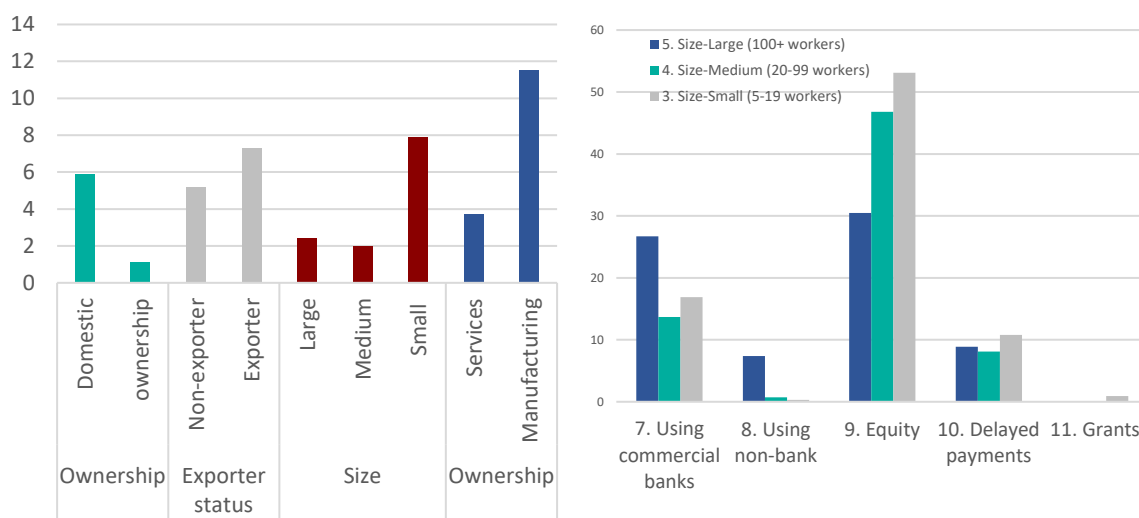
¹Ministry of Economy and Sustainable Development (2015), "SME Development Strategy of Georgia 2016-2020". Enterprise Georgia (2020), "EG – Programs Updated", provided directly by Enterprise Georgia.

Box 3. COVID-19 impact on firms' financing

We have used the Enterprise Survey's special COVID-19 module to sketch a diagnosis of the effects of COVID-19 pandemic on firms. This module provides a representative estimate of the pandemic's impact on the private sector and its financing needs. In a nutshell, the key results impacting financial choices are as follows:

- 1.3% of all firms have permanently closed since the pandemic was declared, as expected with significant differences between firm size with a larger share of smaller firms having closed, followed by medium sized firms and finally large corporates (no closures).
- 5.4% of firms declared insolvency, with manufacturing more affected than the service sector (11.5% vs 3.7%) — see Figure 14 Panel A.
- Remote work seems to have become a recurrent practice with firms also adapting their sales methods and turning more to online services or delivery. This new tendency is more widespread among exporters and foreign-owned companies.
- Average sales decreased dramatically compared to one year ago (47%) and led to widespread liquidity issues and lay-offs of permanent and temporary staff.
- Many firms accumulated overdue payments to financial institutions.
- To address liquidity needs and cash flow shortages, equity finance (49.4%) — largely in the form of retained earnings — was widely employed (see Figure 14 panel B). This is a new pattern that emerged during the pandemic. Bank finance, which used to be the most widespread source of external finance, came in as the second choice for the average Georgian firm (16.3%).
- Government assistance was widespread with 37.2% of firms having received or still expecting to receive some sort of public financial support in the coming months.

Figure 14: Panel A — Insolvency by firm type (% of firms); Panel B — Main source of finance to deal with cash flow shortages by firm size (% of firms)



Source: EIB-EBRD-WB Enterprise Survey 2019; EIB calculations.

5. Boosting external competitiveness to accelerate economic development¹⁰⁴

Given the small and open nature of the Georgian economy, continuously pursuing export-driven growth is the fastest route to increased prosperity. Exports of goods and services have largely been outpacing GDP growth in the last decade with services nearly equal to goods prior to the pandemic on the back of the buoyant hospitality sector. However, the dependence on the tourism sector has proved to be a double-edged sword as the pandemic slashed services revenues. While the geographic orientation of Georgia's goods exports is relatively diversified, the export basket is still dominated by low value-added goods. Additionally, the opportunity that the Deep and Comprehensive Free Trade Agreement with the European Union presents is yet to be fully utilised as many challenges inherent in producing for EU markets remain. Foreign investments could serve as facilitators for penetrating markets in the European Union and beyond if the declining trend of greenfield investments can be reversed. Specific sectors offer diverse sets of opportunities, but face distinct challenges, both for potential investments and for scaling up exports.

5.1 Expansion of goods exports and the booming tourism sector have been driving economic growth

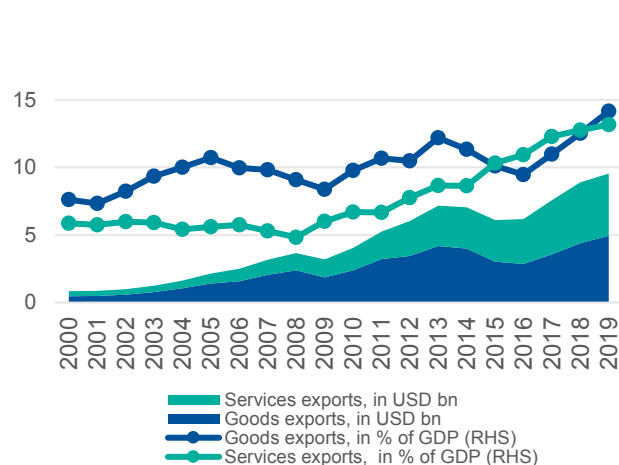
Exports are a major driver of growth for a small and open Georgian economy, though there is significant space to grow further. Exports of goods and services recorded remarkable growth (Figure 1.A.) following the start of reforms and the opening of the economy in the mid-2000s, outpacing GDP growth every year between 2011 and 2019, with the exception of 2014. In this period, exports were among the main drivers of economic growth, significantly outpacing domestic absorption (Figure 1.B). While in 2000 total exports amounted to 27% of GDP (USD 0.3 billion), by 2020 this number had grown to 54% of GDP (USD 3.3 billion)¹⁰⁵. Before COVID-19, the size of services exports nearly overtook the size of goods exports on the back of buoyant tourism (Figure 1.A). The huge hit on the hospitality sector following the pandemic slashed services exports by nearly two-thirds in 2020. Despite significant progress in the last two decades, the size of exports compared to economic output is below some of the comparators (Figure 1.C.), particularly if only goods are taken into account.

¹⁰⁴ The majority of this chapter relies heavily on a report commissioned by the EBRD to look into the Assessment of EU-Georgian trade and investment links in light of the Association Agreement/Deep and Comprehensive Free Trade Agreement. GeoWel (2020). "Why Doesn't Georgia Export More to Europe: An Assessment of the Challenges of Enhancing Georgian Trade with the EU." Unpublished.

¹⁰⁵ National Statistics Office of Georgia (2020). "GeoStat Database."

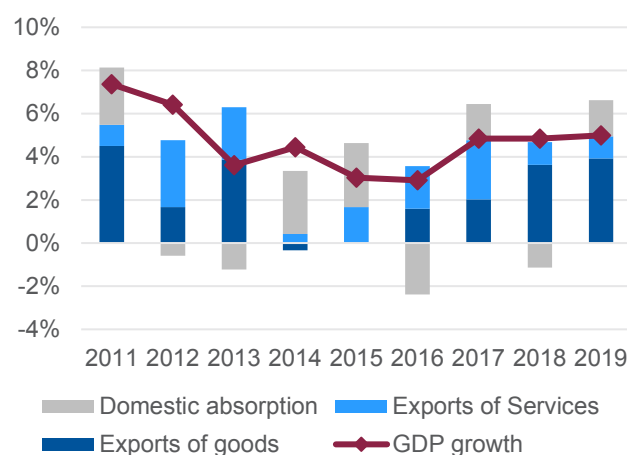
Figure 1: Exports have been increasing in both nominal and real terms

Panel A: Increase in exports of goods and services
In USD billion (LHS) and real growth rate (RHS)



Source: National Bank of Georgia, EBRD calculations.

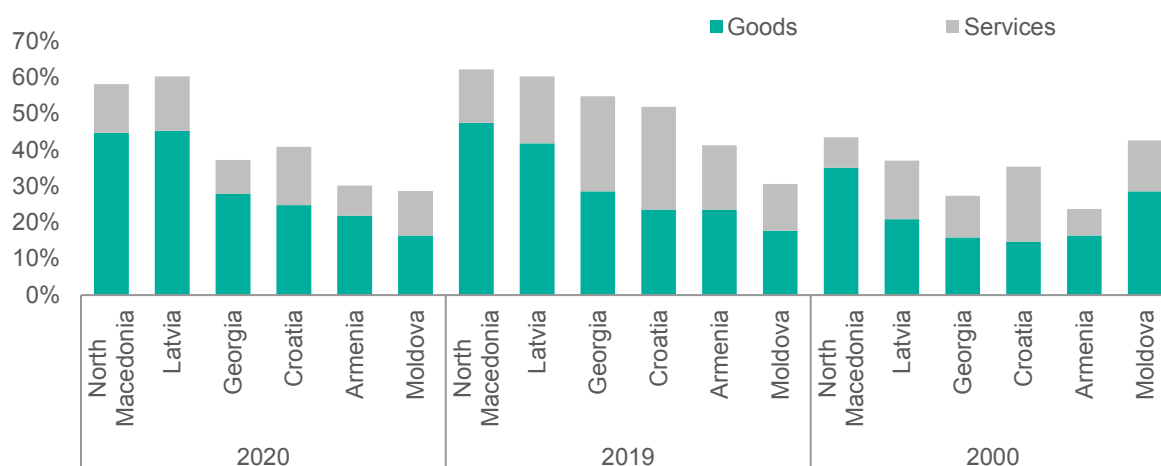
Panel B: Contribution of exports to GDP growth
In %, real terms



Source: National Statistics Office of Georgia, EBRD calculations.

Note: Domestic absorption is calculated by adding investment and consumption and subtracting imports of goods and services.

Panel C: Size of exports in countries' entire economic output
As share of GDP in current prices



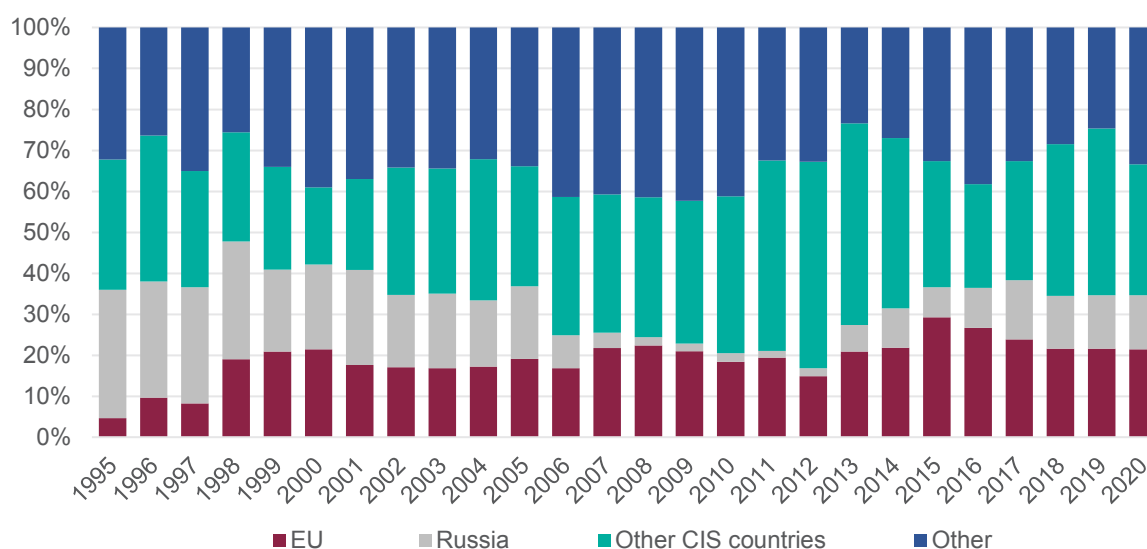
Source: IMF WEO April 2021, EBRD calculations.

The geographic orientation of Georgia's goods exports is relatively diversified, but the basket is dominated by commodities and other low value-added goods. Georgia's trade patterns have been most significantly shaped by trade with countries from the Commonwealth of Independent States (CIS), making up roughly 35 to 55% in total export flows throughout the years, with Russia accounting for half of the share until the early 2000s (Figure 2)¹⁰⁶. The trade embargo by Russia put in place between 2005 and 2013 drastically decreased trade flows between the two countries, in particular exports of food products, beverages and spirits, and metals. The regional economic crisis in 2014-2015 dealt another blow to Georgian goods exports. While these shocks left their mark on Georgian producers, they also forced them to diversify export markets and make use of a number of preferential

¹⁰⁶ National Statistics Office of Georgia (2020) "GeoStat Database."

free trade agreements Georgia currently has in place, including the 13 bilateral trade agreements with Turkey, China, and other neighbouring countries, and the Deep and Comprehensive Trade Agreement with the European Union.¹⁰⁷ Exports to China have increased significantly, in particular since the signing of the trade agreement, rising from 1.1% of total exports in 2012 to 14.3% in 2020, driven largely by minerals. The share of exports to Turkey, on the other hand, has decreased, falling from 19.9% of total exports in 2009 to 5.7% in 2020, while absolute numbers have remained relatively stable.¹⁰⁸ To Turkey, Georgia mainly exports intermediary goods such as metals, textiles and clothing. In terms of the product categories, Georgian exports are dominated by a small number of commodities with re-exported goods (such as used cars) taking a significant share.

Figure 2: Export markets



Source: National Statistics Office of Georgia, EBRD calculations.

Note: CIS countries include Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

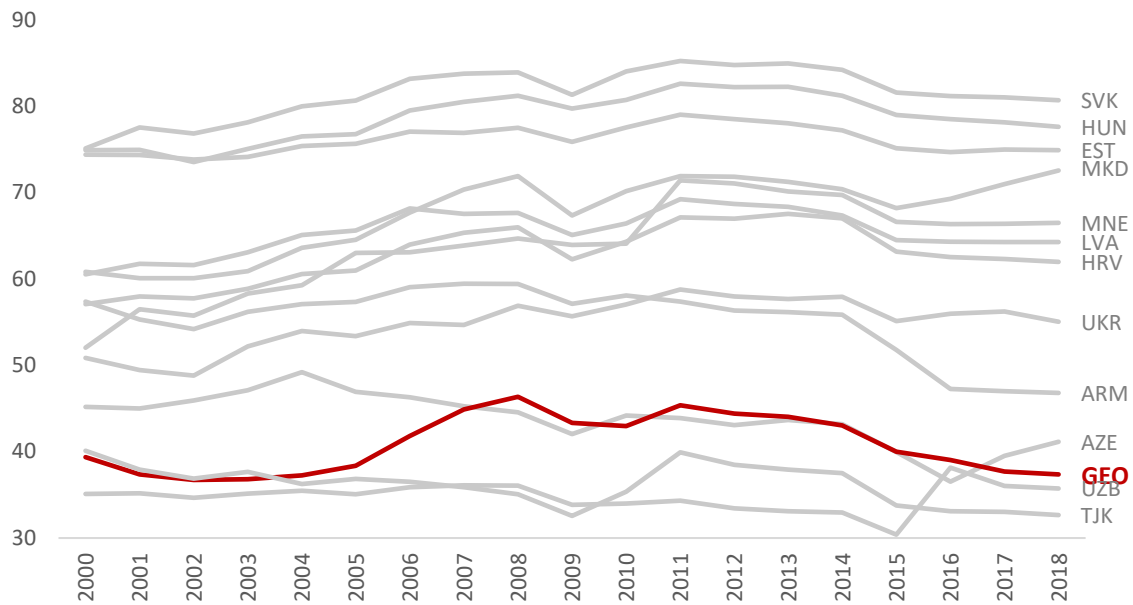
The lack of value chain penetration is a major hurdle to export dynamics. Based on the global value chain participation rate in 2000-2017, Georgia remains one of the economies in the EBRD region that is the least integrated in global production chains (see Figure 3). Georgia contributes to the global production chain relatively upstream compared to other EBRD countries, meaning that it provides input for the exports of other countries (by adding value to intermediate goods for further export). At the same time, a gradual increase in the use of foreign value added in its exports has caused Georgia to gradually shift to a more downstream position since 2000.¹⁰⁹

¹⁰⁷ Invest in Georgia (2021). Free Trade Regimes.

¹⁰⁸ National Statistics Office of Georgia (2020). "GeoStat Database."

¹⁰⁹ Calculated based on UNCTAD-Eora (2020). "Global Value Chain database."

Figure 3: Global value chain participation index, EBRD countries of operation



Source: UNCTAD-Eora Global Value Chain Database, EBRD calculations.

Note: The global value chain participation index is based on both the global value chain backward indicator, measuring the total of foreign value added in Georgia's exports, and forward indicator, measuring the value added used in the exports of other countries as a share of Georgia's gross exports. In the case of Georgia, the decline in the participation rate is due to a continued reduction of the share of Georgian exports used as an input in the exports of other countries. At the same time, the use of imported intermediates (i.e. foreign value added) in Georgia's exports remained higher on average than its level before 2008, but growth stagnated.

Georgia's participation in global value chains is further constrained by a low level of digital transformation. While the overall business environment of Georgia is favourable, the ecosystem for digital solutions and companies is less developed. By propensity to exploit the opportunities offered by information and communications technology, measured by the Network Readiness Index, Georgia ranked 68th out of 134 countries in 2020, only before Moldova. Georgia is lagging behind especially in terms of e-commerce legislation (115th), the rural gap in the use of digital payments (107th), active mobile-broadband subscriptions (104th) and company investment in emerging technology (96th), highlighting significant potential for improvements.¹¹⁰ The low level of digitalisation also constrains innovative companies. On the Global Innovation Index 2020, Georgia is ranked 63rd out of 131 countries and therefore takes the last spot among comparator countries. The worst pillar is infrastructure (ranked 81st), which includes ICT access and use, e-participation, general infrastructure and ecological sustainability. This poses a threat to Georgia's future participation in global value chains on multiple fronts: barriers to access and effective use of digital technologies, dependency on knowledge transfer and a lack of a long-term roadmap for digital transition.

Barriers for e-commerce need to be eliminated to enhance the future competitiveness of Georgian companies. With internet penetration increasing worldwide, e-commerce is also gaining importance. Under the Association Agreement, Georgia has to adopt e-commerce legislation. Currently, no unified law exists on consumer protection, private entities are not regulated in terms of cybersecurity and the

¹¹⁰ Dutta, S. & Lanvin, B. (Eds.) (2020). "The Network Readiness Index 2020: Accelerating Digital Transformation in a post-COVID Global Economy."

activities of online platforms are not regulated.¹¹¹ Local marketplaces selling cross-border are not common. Just as for firms' competitiveness in general, the main obstacles to more widespread e-commerce activities are underdeveloped infrastructure and logistics support. Only 18.4% of enterprises had their own website by January 2020 and only 2.6% of firms were receiving orders via a webpage for their goods and services in 2019.¹¹²

5.2 The Deep and Comprehensive Free Trade Agreement with the European Union presents a significant opportunity that is yet to be fully utilised

The Association Agreement, and the Deep and Comprehensive Free Trade Agreement component in particular, are intended to deepen Georgia's access to the European Union and its market which is worth USD 18 trillion and consists of 500 million people. The agreement was signed in June 2014 and was largely provisionally applied from September 2014 before entering into full force in July 2016. Though Georgia enjoyed preferential tariffs under the previous GSP+ treatment, this was a significant step further because the agreement was intended to bring Georgian norms and standards for industrial and agricultural products into line with the European Union's. The anticipated increase in Georgian exports to the more stable and significantly wealthier EU market as well as the boost to inflows of foreign direct investment in Georgia thanks to those products were hoped to offer a pathway to accelerated economic growth.

The commitment to align with EU regulations has become the biggest driver for legislative reform in Georgia, particularly as it relates to business environment issues, and is expected to bring long-term gains. Georgia committed to aligning with EU regulations in a number of dimensions ranging from democracy and human rights to various aspects of the business environment. The areas of the alignment process that could provide the most support for businesses aiming to export to the European Union are customs, direct EU business support and the development of standards in the country. So far, only alignment on customs procedures and associated government agencies seems to be complete. Other aspects, while incremental in their direct effect on increasing export growth, have also been beneficial and might bring future gains. Georgians' ability to move freely to the European Union without visa restrictions has been a huge boon, allowing business people to easily build relationships thanks to facilitated travel. Training in the European Union and companies' visits to trade shows have increased as a result, with indirect benefits such as improvements in language skills and greater cultural awareness. The increasing familiarity with EU standards, even if they are rarely in force in the country, provides further guidance on how to do business in the European Union, and a range of development programmes have emerged to help build business-to-business ties.

However, the implementation of the agreement is raising regulatory burdens across many areas and is ultimately becoming a constraint on private businesses. While significant technical assistance has been provided to support the government alignment, the costs incurred by private businesses to comply with the new regulations is high.

The immediate impact on the volume of goods exported from Georgia to the European Union has been more modest than anticipated. In total, exports to the European Union made up between 15 to 20% of all Georgian exports in the years before the signing of the Deep and Comprehensive Free Trade Agreement. This number increased to 21.5% in 2018-2020, following a jump to 29.3% of total exports

¹¹¹ Eu4Digital (2020). "eCommerce report: Recommendations proposed for eCommerce harmonization in the EaP countries – Georgia."

¹¹² National Statistics Office of Georgia (2020). "Survey of ICT Usage in Enterprises."

in 2015 on the back of the economic crisis in the neighbouring region. However, these values are driven by a number of categories that skew the analysis. Excluding certain commodities, outliers and re-exports,¹¹³ exports to the European Union declined from 16% of total exports on average over the past decade to 13% in 2019. Even in absolute terms, exports to the European Union (again without copper, hazelnuts and re-exports) decreased between the signing of the agreement and 2019.

A slower-than-anticipated expansion of exports reflects the fact that the Association Agreement has not significantly changed Georgia's terms of trade with the European Union. Prior to 2014, Georgia did not face significant tariffs and quotas for exporting goods and services to the European Union as it was a member of the bloc's General System of Preferences (GSP+).¹¹⁴ Of 220 product categories (covering all export categories with more than USD 1 million in exports), only 20 products saw improvements compared to GSP+. All of these categories are in the agricultural sector and wine is the only major exportable good that has seen a significant tariff reduction. This confirms that it is not sufficient to remove tariff and quota barriers, but that significant efforts are required to remove technical barriers to trade.

Furthermore, the requirement to meet the European Union's rules of origin to be eligible for lower Association Agreement tariffs is challenging. Under the rules, 40-50% of the value of a good, depending on the exact product, must be produced in the country. Given Georgia's small size and narrow industrial base, this requirement can be difficult to meet, as seen in the apparel sector where most of Georgia's fabric is imported from Turkey and China. Even if the apparel products are stitched and finalised in Georgia, they cannot be labelled "made in Georgia" and hence are subject to WTO tariffs, rather than those of the Association Agreement.

However, the weak performance of headline export indicators hides underlying positive trends emerging over the last decade. The decline in exports of goods to the European Union largely reflects movements in the lower-value goods categories such as ores and minerals, fertilisers and manganese. At the same time, categories of higher value added such as food, water, wine and spirits, wooden and paper products and apparel have significantly increased, counterbalancing the decline. Furthermore, there have been some indications that the composition of trade may have been changing in the last five years. A couple of studies¹¹⁵ point to a modest increase in the number of product categories exported to the European Union. While these exporters are generally fairly small in size and it is too early to tell if these newer value-added categories will have a significant impact on the overall picture moving forward, the initial diversification of exports bodes well for future growth.

The main reason why the expected benefits are slow to materialise lies in the inherent challenges of producing for the EU market, with the lack of business networks being the most prominent. Traditionally focused on the neighbouring region, Georgian producers find the European Union a very difficult market to orient towards. They are competing with a well-developed ecosystem of existing

¹¹³ These figures don't take into account copper ore (which is also not affected by the Association Agreement as an extractive) and hazelnuts. These commodities represent significant shares of the total exports of goods to the European Union, but both are outliers and commodities influenced by global prices rather than specific trade relationships, and are therefore not interesting for this analysis. Furthermore, at the time of the analysis, the copper ore captured in Georgian exports was likely a misclassified re-export from Armenia which mainly goes to Romania and Bulgaria. Exports of hazelnuts declined more than three times in 2014-2018 since the stink bug decimated the crops.

¹¹⁴ The GSP+ is a trade agreement which removes tariffs and quota barriers on most industrial products.

¹¹⁵ Ricardo Giucci, Veronika Movchan and Woldemar Walter (2019). "The economic effect of the DCFTA on Ukraine, Moldova and Georgia. A comparative analysis" and GeoWel (2020). "Why Doesn't Georgia Export More to Europe: An Assessment of the Challenges of Enhancing Georgian Trade with the EU." Unpublished.

companies that understand particular national tastes and have already developed networks of clients for their products.

Significantly higher product and production standards are another hurdle. To enter the EU market, Georgian companies need to align their standards with the European Union's, which is costly and time-consuming, while the benefits might not be immediately observable. At the same time, Georgia is a price-sensitive market, and adopting these standards brings cost increases that place companies at a disadvantage vis-à-vis their domestic competitors. The government also does not want to enforce standards if too few companies have adopted them as this would result in many companies closing down. Low demand also leads to weaknesses in the national system of quality control and quality assurance, including a lack of accredited conformity assessment bodies.¹¹⁶ While technical assistance for various government agencies dealing with technical barriers to trade is progressing, Georgia does not have access to the structural adjustment financing that had helped EU accession companies on their path to EU alignment. As a result, the adoption of EU production and product standards by companies has been slow.

These challenges are compounded by broader structural issues. Most notably, Georgia has to contend with poor transport and logistics, which significantly undercuts the openness of the economy and the range of free trade areas (see Section 6.2 for more details), low skill levels amongst workers, narrow financing options, a weak bureaucracy and a weak judiciary. One of the clearest routes to overcoming these challenges is through partnerships and investment from foreign companies as foreign partners already have knowledge about EU markets, established client relationships or certification to produce according to EU standards. However, foreign partnerships that might facilitate the process have been rare so far.

5.3 Foreign investments could serve as facilitators for penetrating markets in the European Union and beyond

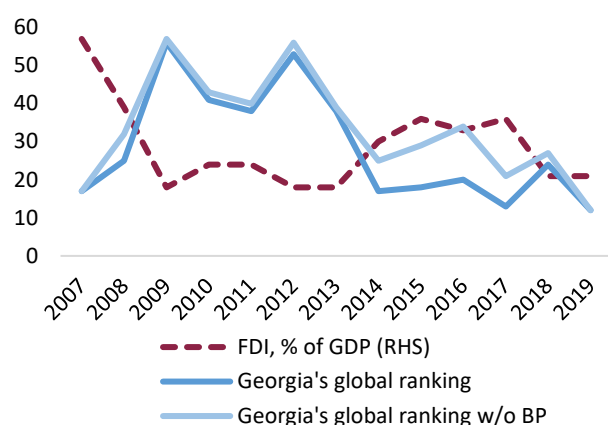
Since the start of the reforms, Georgia has been one of the regional leaders in attracting foreign direct investment. In absolute terms, net foreign direct investment inflows into Georgia (except during the global financial crisis) have stayed on a relatively high level since 2006-2007, amounting to USD 1.3 billion in 2019¹¹⁷. Compared to some comparator countries (Moldova — USD 1 200, Armenia — USD 1 900 and North Macedonia — USD 3 000), Georgian foreign direct investment stock per capita is above average (USD 4 800). However, Georgia is still lagging behind others such as Latvia (USD 9 500) and Croatia (USD 7 200) and foreign direct investment stock per capita is below the EBRD average (USD 5 300). Most foreign direct investment so far has been focused on transport, telecoms, the financial sector, energy, real estate, construction and tourism.

¹¹⁶ UNECE (2018.) "Regulatory and Procedural Barriers to Trade in Georgia: Needs Assessment."

¹¹⁷ National Statistics Office of Georgia (2020). "GeoStat Database."

Figure 4: Foreign direct investment in Georgia

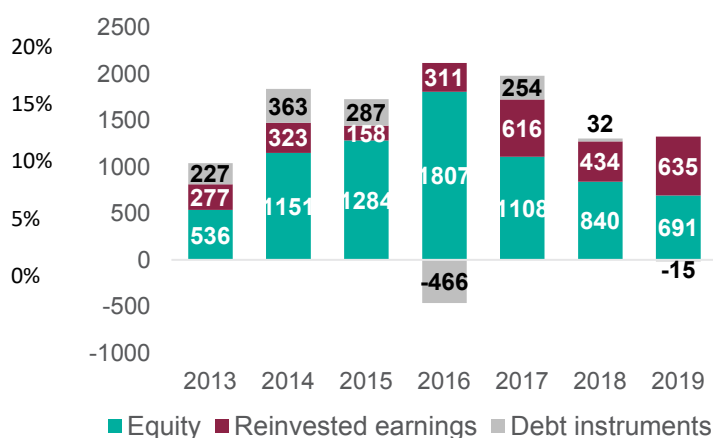
Panel A: Foreign direct investment as a share of GDP and associated global ranking



Source: GeoWel (2020). "Why Doesn't Georgia Export More to Europe: An Assessment of the Challenges of Enhancing Georgian Trade with the EU." Unpublished.

Note: Total number of countries in each year varies between 179 and 184.

Panel B: Composition of foreign direct investment, in USD million



Source: National Statistics Office of Georgia, EBRD calculations.

Still, Georgia cannot avoid the declining global trend. Foreign direct investment as a share of GDP contracted from 19% in 2007 to 7% in 2019¹¹⁸, seemingly suggesting a declining performance. However, this largely reflects lower investor appetite worldwide. Georgia's global ranking reveals that it is still one of the most attractive countries for investors worldwide. Even without the major BP investment in the South Caucasus Pipeline Expansion Project in recent years, worth approximately USD 2.1 billion, Georgia remains in the top 20% of countries by foreign direct investment as a share of GDP.

Greenfield investments have decreased dramatically. The increase in retained income results from Georgia's adoption of the Estonian corporation tax model at the beginning of 2017. Under this model, corporate taxes are only levied when dividends are distributed, creating strong incentives to reinvest earnings. But the large decline in new equity investment is a concern, though it is difficult to determine whether it is just a reflection of global trends, or whether investor interest in Georgia has diminished. Inflows of foreign direct investment are important not only as a source of capital, but also a source of know-how, market-specific knowledge, integration with value chains and access to clients. They also bring positive externalities by transferring expertise and skills to associated local suppliers and other companies. All of the major growth areas of the Georgian economy, including energy, finance, utilities, healthcare and tourism, have been transformed over the past two decades with the injection of foreign expertise which tends to come along with foreign capital.

¹¹⁸ National Statistics Office of Georgia (2020). "GeoStat Database."

The bulk of greenfield investments is directed towards the low-skilled and low-to-medium digital intensity sectors.¹¹⁹ The median project in Georgia created 64 jobs, around one-third of projects created 40 or fewer jobs, and only 7% created more than 600 jobs. Labour intensity has increased over time, in line with the increasing importance of services. While low-skilled services, such as those in construction and transport and storage, still account for the bulk of employment, there is a shift away from high-skilled services, in particular financial services, towards high-skilled manufacturing of goods such as computer equipment and, to a lesser extent, motor vehicles. In addition, a shift in employment created by foreign direct investment from the high-digital-intensity to the medium-digital-intensity sectors is visible when comparing the periods 2003-2008 and 2009-2019. Greenfield foreign direct investment inflows generated a significant environmental footprint during the period. Environmental costs are estimated at more than USD 14 000 per job generated by greenfield foreign direct investment, reflecting significant levels of employment creation in transport in recent years.

Low and declining investments in tradable sectors do not bode well for future economic growth. Manufacturing accounted for around 10% of all foreign direct investment in the last 10 years and is concentrated in traditional heavy sectors with low value added such as extractives. In addition to the other business environment obstacles analysed in this report, investments in manufacturing face additional hurdles related to built-in risks and financing challenges. These kinds of investments have value within a particular supply chain and do not offer a quick pay-off or easy exit, so stability in the political and business environment in the medium to long term is needed for the investor to enter the market. Funding can also be an issue with high collateral requirements making it difficult to find funding from Georgian banks, and current venture capitalists not interested in building companies. Furthermore, such investments require partners with existing supply chains who can bring production expertise and business networks, in particular if the facility plans to export. Finally, investor aftercare is in need of improvement, especially when it comes to dealing with the local administration.

5.4 Specific sectors offer diverse sets of opportunities, but face distinct challenges

Agricultural exports contribute increasingly to total exports and represent a diverse set of opportunities. Exports in the agrifood sector in 2019 contributed about one-third to the domestic total (which excludes re-exports), making it one of the largest export categories. In addition, agricultural exports have increased by 2.5 times over the last 10 years. However, the sector recently experienced two shocks which interrupted its growth — exports deteriorated during the regional financial crisis in 2014-2015, and again in 2016 when the brown marmorated stink bug decimated nut production — but has recovered since. The main exported goods to the European Union and worldwide are hazelnuts, wine, processed food and mineral water. While the European Union is the biggest importer of nuts, the majority of other food and beverage categories are exported to the surrounding region. Distance and transport challenges are especially apparent for fresh fruit and vegetables, as for example the European Union demands that delivered products be of consistently high quality, at low prices and,

¹¹⁹ This analysis is based on new investments (greenfield foreign direct investment) rather than changes in ownership (brownfield foreign direct investment) and draws upon the fDi Markets database from the Financial Times which tracks company investments without information on the equity participation by investors and by date of announcement. This analysis includes announced, opened and closed projects, so numbers on capital expenditure and jobs created should be taken to refer to announcements in a given period, all of which may not have been realised to date, and may be estimates rather than actual values. EBRD (2021). “Foreign investment in the EBRD regions – Georgia country factsheet.” Unpublished.

most difficult for Georgia, “shelf-ready.” Other challenges for the agricultural sector include mature markets, certification costs, logistics and problems of scale. The development of effective cooperatives that could help with scalability is constrained by access to finance, the structure of the cooperatives and a lack of qualified human capital. Due to a reinforcing country effect, when marketing Georgia as a whole as a country of origin, several sectors such as wine and food exports, hospitality or tourism could benefit from a positive image transfer.

Manufacturing goods are mainly exported to Russia and other CIS countries. Manufacturing is one of Georgia’s biggest sectors, amounting to about 10% of GDP in 2019¹²⁰. Much of the manufacturing industry consists of traditional sub-sectors dating back to the Soviet Union, such as manganese, steel, fertilisers, aerospace, automotive, trains, electrical wire and other metal products. Production sites are often outdated, exports are usually oriented toward the neighbouring region and markets are highly commoditised. Other recently expanding categories of goods such as pharmaceuticals, petrochemicals, low-value beverages or glass bottles are also produced mainly for neighbouring countries. The main challenge for these exporters is that much of this production is low value added while its heavy weight makes long-distance transport unfeasible. New industrial manufacturing heavily promoted by Enterprise Georgia is still in its infancy, including electronics, automotive and aerospace-related factories. Companies in these areas are reportedly attracted by a favourable business environment, low labour costs, low taxes and tariff-free access to the region. However, all of these companies report significant challenges with entering EU markets, in particular with regard to certification costs or adhering to rules of origin as few production inputs can be sourced locally. All this emphasises the need for international partners in starting local facilities, and strong government support during the process.

Light manufacturing is dominated by apparel which has seen rapid growth in the recent past. Georgia has a considerable track record in local production, connection to international supply chains and consistent exports in light manufacturing. In particular, apparel production has been growing steadily over the last decade, and was four times higher in 2019 than ten years before. For apparel, Turkey is by far the biggest importer with the European Union taking about 20%. It is the only new manufacturing sector that employs high numbers of people and exports considerable volumes of products. Its main challenges include a lack of skilled workers, transport costs and rules of origin. The biggest potential for growth comes from moving up the value chain from cut-make-trim to becoming a producer of Georgian labels.

Trade restrictions for services are fairly low and continue to be largely connected to issues such as recognition of qualifications. Substantial growth was seen in the export of business process outsourcing and was largely driven by government-supported private investments. Georgia’s main comparative advantage in business process outsourcing comes from the ease of doing business, low taxes, low salaries and an open economy. At the same time, companies repeatedly report the availability of staff with the right skills as a major constraint. However, with the right government support, the right improvements in the business environment, and employees with the right skills, services exports could quickly grow.

Booming tourism has brought prosperity to Georgia in recent years, but over-dependence has proved to be a double-edged sword. With foreign-exchange inflows at nearly 20% of GDP thanks to 7.7 million visitors, the hospitality sector has driven the growth and development of the Georgian economy in recent years¹²¹. However, this dependence on tourism led to increased vulnerability to external shocks, which explains the disproportionately large impact of the COVID-19 pandemic on the

¹²⁰ National Statistics Office of Georgia (2020). “GeoStat Database.”

¹²¹ GNTA (2020). “Economic Indicators: Tourism Value Added.”

Georgian economy. A stronger and more sustainable development of the sector would be supported by improving infrastructure links, particularly digital infrastructure in light of the changing nature of work and rising number of digital nomads, focusing on regional development and developing the entire value chain, and targeting high-growth, high-spend source markets. Climate change and associated risks threaten tourism as many popular pursuits such as hiking, skiing or seaside activities are dependent on weather conditions. The stability of road infrastructure also plays a crucial role in tourism, in particular where erosion and landslides affect roads and accessibility (see Section 6.2 for more information on road infrastructure).

6. Competitiveness and growth-enabling infrastructure: a snapshot

Georgia's geographical location makes it a prime transit region in Eurasia. The relatively poor transport infrastructure and quality of logistics hamper integration with external markets as well as internal connectivity. The country is especially lagging behind in the efficiency of seaport and transport services, the quality of roads, airport connectivity, logistics quality and competence, and tracking and tracing. Investment in maintenance and new projects in the transport sector, especially in rural areas, are key to accelerating growth and diversifying the private sector. Looking at domestic enabling infrastructure, needs have been detected in the water supply segment, particularly in rural areas. While access to running water is widespread, access to safely managed drinking water is not. The high share of the population who lack sanitation facilities also highlights the need for infrastructure development in this area. Waste management in Georgia offers room for improvement, as landfill disposal is still the predominant method of handling waste. Access to information and communications technology infrastructure compares favourably to regional peer countries. Nonetheless, from an inclusion perspective, clear differences persist in access to digital infrastructure according to gender and geographical location. Finally, yet importantly, healthcare access and quality need investment, as reflected, for example, by the low number of hospital beds per 1 000 people.

6.1 Investment in Infrastructure needs to be scaled up to enable further economic development

Pre-COVID-19 aggregate investment levels in Georgia were close to 25% of GDP, while the 2020 drop was still smaller than in the Eastern Partnership region. Investment levels (the gross fixed capital formation to GDP ratio) in Georgia were lower than the average Eastern Partnership country until 2014, at which point they started to increase visibly while the regional levels began to drop (Figure 1). The timing is associated with idiosyncratic events in different Eastern Partnership economies.¹²² As a result, investment levels have averaged 25% of GDP in Georgia versus a regional average of less than 22% over the past five years. Still, this level of investment has not been sustained in Georgia over the medium term. Against this backdrop, it is estimated that to sustain steady economic growth and convergence with high income levels, overall investment rates for middle-income countries should be 25% to 30% of GDP and public investment should be in the range of 5% to 7% of GDP for at least 15 years in a row.¹²³ Georgia — like many other emerging and developing economies — does not yet fully meet these necessary conditions on investment, showing the need for increasing and more persistent investment levels, including infrastructure investment. Moreover, these benchmarks may be necessary, but not sufficient conditions for a successful transition from middle to high income.¹²⁴

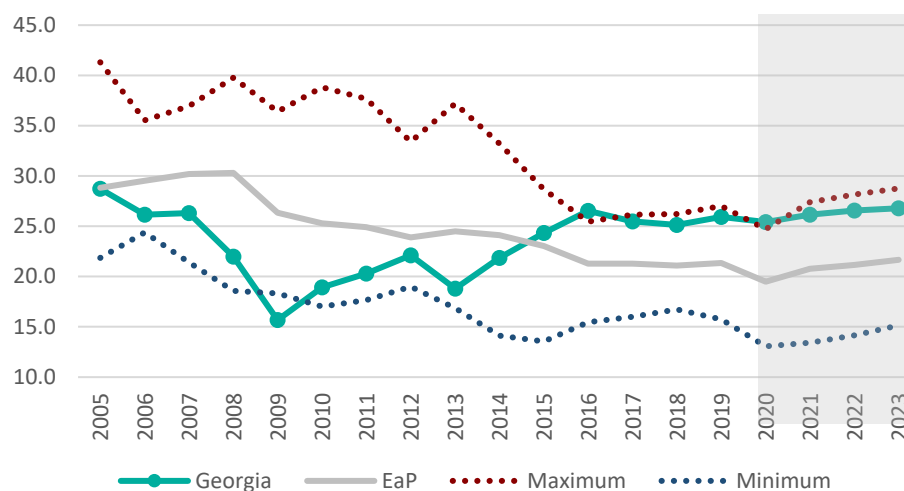
¹²² E.g. the war in Ukraine, a nationwide banking theft in Moldova, the banking crisis in Azerbaijan, etc.

¹²³ The Commission on Growth and Development, an independent expert panel established by the World Bank in 2006, studied policies and strategies that underpin rapid and sustained economic growth (Commission on Growth and Development, 2008). The key question of the analysis was to study how economies are able to successfully graduate from middle income to high income status. They found that since 1950, only 13 economies (Botswana; Brazil; China; Hong Kong; Indonesia; Japan; the Republic of Korea; Malaysia; Malta; Oman; Singapore; Taipei China; and Thailand) achieved the necessary fast, sustained growth to make the leap from middle income to high income. The study established among many other factors these two investment requirements as common factors for successful transitions.

¹²⁴ Many other policy components have been identified as common patterns in the countries observed by the study, including macroeconomic stability, openness to the global economy, sound governance and market orientation, among others.

Finally, many of the region's infrastructure projects do not yet fully support countries' long-term development and climate objectives. Mainstreaming such considerations in infrastructure investment decisions and strategies is needed and requires action on multiple fronts, from upstream sustainable infrastructure planning to project prioritisation, financing and delivery.¹²⁵

Figure 1: Gross fixed capital formation (% GDP)



Note: EaP is a simple average; maximum/minimum refers to the EaP countries' maximum/minimum GFCF (% of GDP) recorded in each year, with different countries attaining that record at different points in time.

Source: World Bank (indicator name: NE.GDI.FTOT.ZS). EIB calculations.

The estimated infrastructure investment level is still relatively low. Estimating levels of infrastructure investment is far from straightforward since investments are spread across different government ministries, agencies, and private and public sector companies. The World Bank (2019)¹²⁶ estimates that infrastructure investment in Georgia hovered at around a maximum of 3.4% of GDP (Figure 2). The quality of the existing capital stock, the level of ambition with respect to the quality of infrastructure countries want to develop, and the goals in adopting more environmentally sustainable energy and transport infrastructure are all elements influencing the desired level of infrastructure investment.¹²⁷ Therefore, the European Council has stressed that supporting sustainable, rules-based, open and secure connectivity in transport, energy and digitalisation, including through promoting quality infrastructure, is key for economic development, regional integration, trade and mobility, for both EU and Eastern Partnership countries.¹²⁸ The following sections will look in more detail at the different infrastructure segments, excluding energy, which is analysed separately in chapter 7.

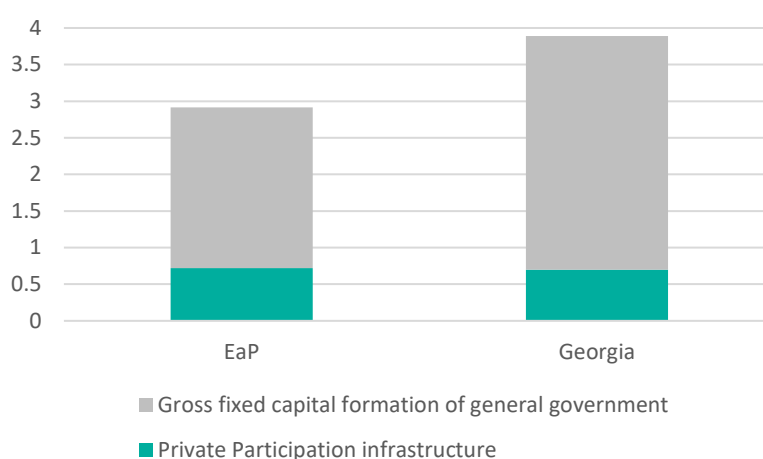
¹²⁵ OECD (2021). "Sustainable Infrastructure for Low-carbon Development in the EU Eastern Partnership: Hotspot Analysis and Needs Assessment." [OECD](#).

¹²⁶ World Bank (2019). "Hitting the Trillion Mark: A Look at How Much Countries Are Spending on Infrastructure."

¹²⁷ Smart planning that increases the use of existing infrastructure, smart policies that increase efficiency in urban planning, and good governance of infrastructure projects can significantly enhance the positive effects of infrastructure investments.

¹²⁸ Council of the European Union (2020). "Council Conclusions on Eastern Partnership policy beyond 2020."

Figure 2: Infrastructure investment — GFCF and private participation



Source: World Bank, 2019 ([World Bank Document](#)). EIB calculations.

Note: The estimates on infrastructure spending draw on two different datasets. The World Bank Private Participation in Infrastructure (PPI) dataset combines private investment commitments (not materialised investments). Gross fixed capital formation of general government (GFCF_GG) is derived from the IMF dataset.

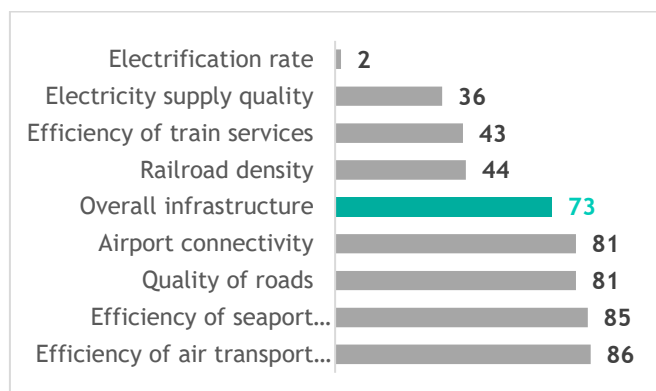
6.2 Transport infrastructure in need of investment and maintenance, particularly in the road, maritime and aviation sectors

Relatively poor transport infrastructure and quality of logistics hamper integration with external markets as well as internal connectivity in Georgia. The country's geographical location makes it a prime transit region in Eurasia, highlighting the importance of high quality infrastructure as an enabler of trade. Despite this, Georgia is below the regional average in a number of indicators, pointing to the need to expand and upgrade its transport network and logistics. Namely, the overall quality of infrastructure ranked 73rd out of 140 countries in 2019 on the World Economic Forum's Global Competitiveness Index (Figure 3 — Panel A), 119th out of 160 countries in 2018 on the World Bank's Logistics Performance Index (Figure 3 — Panel B) and 148th out of 181 countries in the third quarter of 2020 in the Liner Shipping Connectivity Index (Figure 3 — Panel C). The country is especially lagging behind in the efficiency of seaport and transport services, the quality of roads, airport connectivity, logistics quality and competence, and tracking and tracing. In addition to trade-enabling infrastructure, the long-term trend towards an ageing population and higher rates of urbanisation implies rapid growth in demand for urban transport, thus calling for supply-side improvements and convergence with EU norms. It is also important to highlight the need to improve the transport infrastructure's resilience to climate change via smart investments (such as road gradients and storm water drainage infrastructure) as Georgia has been assessed as being prone to floods and landslides.¹²⁹

¹²⁹ World Bank (2020). "Impacts of Climate Change on Georgia's Coastal Zone." [World Bank Document](#).

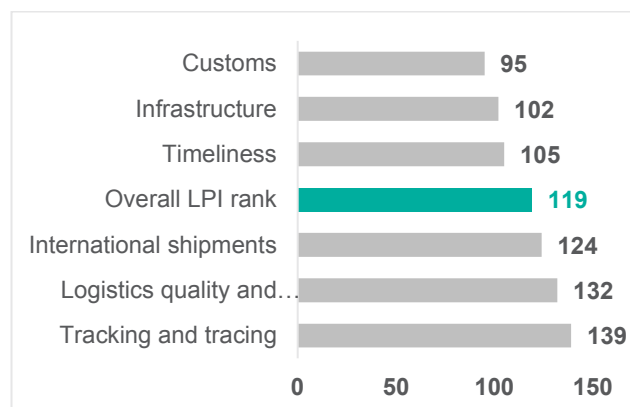
Figure 3: Quality of transport infrastructure

Panel A: Global Competitiveness Index, rank out of 140 countries in 2019



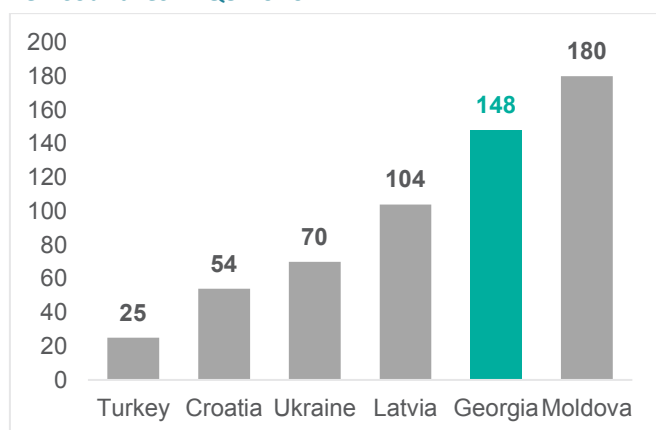
Source: WEF Global Competitiveness Index 2019.

Panel B: Logistics Performance Index, rank out of 160 countries in 2018



Source: World Bank Logistics Performance Index.

Panel C: Liner Shipping Connectivity Index, rank out of 181 countries in Q3 2020



Source: UNCTAD Liner Shipping Connectivity Index.

Note: The index is based on the number of shipping lines servicing a country; the size of the largest vessel used on these services; the number of services connecting a country to the other countries; the total number of vessels deployed in a country; and the total capacity of those vessels.

Road infrastructure improved significantly, albeit still showing investment needs in several sub-segments. Road infrastructure quality seems to be supporting Georgia's overall transport rankings. In recent years, roads have been growing rapidly and the country has a total of 21 301 km of roads, with 1 603 km being international roads.¹³⁰ Still, the extent of the road infrastructure does not seem to match its quality, with Georgia ranking in the bottom ten EBRD countries according to the EBRD's road transport connectivity index¹³¹. Intercity travel times are typically 90% longer than the frontier¹³², compared to the average of 60% for the Eastern Europe and the Caucasus region (EEC). As indicated by Figure 4, most key corridors perform in the bottom quartile of the EBRD region. The average corridor speed of 64 km/h is also slower than both the EEC (70 km/h) and EBRD (76 km/h) average. This can be

¹³⁰ Invest in Georgia (2021). "Infrastructure."

¹³¹ Unpublished at the time of finalising the Georgia Diagnostic.

¹³² The frontier is set "as the crow flies" distance at 110km/h.

partly attributed to the key role of the European E60 route in connecting the major cities in Georgia. As the speeds along this important corridor are slow, the entire road network performs relatively poorly. Given the mountainous nature of the country, the road network in Georgia can also be characterised as indirect, meaning that the average “straightness” of the network (driven distance / distance as the crow flies) is below both the EEC and EBRD averages.

Road safety is still a source of concern. Georgia scores worse than the regional average when it comes to road safety (with 129.3 deaths per million habitants against 79.5, respectively). In 2013 alone, Georgia’s road fatalities were four times higher than the EU average¹³³, although there have been visible improvements as the 2019 figure was lower than the average of the previous ten years. The causes listed for such high levels include a high share of old and non-roadworthy vehicles, irresponsible driving behaviour, inadequate parking and poor road conditions. Further underlining the results of the EBRD’s connectivity index, internal connectivity has also been deemed weak by the World Bank, with one-third of secondary roads and half of local roads identified as being in poor condition (World Bank, 2018)¹³⁴, making them ill-suited for transporting cargo.¹³⁵

Figure 4: Quality of road transport connectivity

Average travel time (actual time / frontier time) across key city corridors															
Origin/ Destination	Largest cities / towns					Smallest cities / towns				Neighbouring capitals				City as origin	Pop. (thous.)
	Tbilisi	Batumi	Kutaisi	Sokhumi	Gori	Poti	Zugdidi	Tchinali	Samtredia	Moscow	Ankara	Yerevan	Baku		
Tbilisi		218%	179%	192%	185%	178%	192%	198%	174%	177%	201%	299%	191%	192%	1178
Batumi	224%		239%	235%	228%	230%	225%	266%	240%	198%	182%	357%	212%	208%	169
Kutaisi	181%	224%		204%	187%	174%	235%	275%	177%	195%	195%	303%	192%	201%	135
Sokhumi	194%	230%	208%		197%	220%	158%	238%	180%	186%	236%	278%	200%	204%	65
Gori	179%	223%	186%	197%		178%	199%	269%	176%	174%	199%	302%	189%	189%	50
Poti	181%	227%	186%	224%	181%		203%	225%	160%	195%	198%	305%	193%	201%	42
Zugdidi	194%	220%	247%	159%	201%	198%		257%	198%	191%	203%	299%	198%	201%	41
Tchinali	200%	259%	270%	236%	271%	221%	254%		237%	171%	207%	298%	196%	192%	33
Samtredia	178%	245%	207%	184%	179%	161%	203%	242%		197%	195%	309%	191%	202%	29
Moscow	177%	198%	195%	186%	174%	195%	191%	171%	197%					202%	10381
Ankara	201%	186%	201%	242%	201%	202%	208%	209%	199%					214%	3517
Yerevan	299%	357%	303%	278%	302%	305%	299%	298%	309%					202%	1093
Baku	189%	209%	190%	198%	188%	191%	196%	194%	189%					170%	1116
City as dest.:	192%	208%	202%	205%	190%	202%	202%	192%	202%	201%	215%	217%	190%	216%	

Corridor in best 5% within country
 Corridor in worst 5% within country
 Major corridor in worst performing quartile within EBRD
 Major corridor in best performing quartile within EBRD

Source: EBRD Road Transport Connectivity Index 2021.

Maritime and aviation infrastructure in need of deepening. Port and maritime infrastructure scores relatively poorly. The maritime infrastructure network is currently composed of two main seaports (the Batumi and Poti seaports — together employing 1 800 permanent staff members¹³⁶), in addition to an offshore oil terminal (Kulevi) and a pipeline (Baku-Supsa). Currently, only a few foreign companies provide shipping services. Further development is needed to enhance linkages with Central Asia, making Georgia an increasingly important key point on the New Silk Road trade route between China and Europe. In addition, further investments aimed at developing cargo and passenger traffic on the Black Sea can improve sea connectivity, thus increasing Georgia’s potential for trade and tourism. Finally, the aviation network is composed of three international and several regional airports, all under the management of a state-owned enterprise, although a private Turkish company has been granted

¹³³ New climate (2021). “Decarbonisation scenarios for the transport sector in Georgia.”

¹³⁴ World Bank (2018). “Procuring Infrastructure Public-Private Partnerships.”

¹³⁵ UNECE (2018). “Regulatory and Procedural Barriers to Trade in Georgia: Needs Assessment.”

¹³⁶ ADB (2014). “Georgia Transport Sector Assessment, Strategy, and Road Map.”

an operational concession of two of the international airports. In the period 2004-2012 alone, after small improvements to the infrastructure, international annual passenger traffic almost doubled while freight traffic increased by about 7% a year, boosting both trade and tourism, two of the sectors the Georgian economy has grown to be the most reliant on.¹³⁶ By 2012, 23 airlines were registered to operate in Georgia as the country was part of 16 bilateral air service agreements in addition to agreements with 11 EU countries, all of which fall in the remit of the Georgian Civil Aviation Agency.

The Georgian rail sector remains significantly under-reformed and a number of steps are required to transform it into a well regulated, competitive and partially liberalised sector. This process includes the unbundling of the country's national railway company — Georgian Railway LLC. First, full transparency and budget separation should be introduced between (i) infrastructure, (ii) freight, (iii) passenger and other, and (iv) non-core services or business areas. Second, the legal and commercial unbundling of these four business areas will need to be combined with an adequate governance and regulatory setup, potentially through a holding company structure for Georgian Railway LLC and an independent and competent sector regulator. The latter is needed to prepare for the liberalisation of selected services such as freight services. Furthermore, to prepare for future competition in the sector, significant restructuring and operational efficiency measures by Georgian Railway LLC will also be needed to spin off non-core activities, increase transparency and improve cost-efficiency.

Investment in maintenance and new projects in the transport sector, especially in rural areas, are key to accelerating growth and diversifying the private sector. The production and export of tradable products such as light industry and agricultural and food products will require a denser transport network. Further to this, Georgia is centrally located in the South Caucasus, making it a vital link in transport corridors in the region, connecting its neighbouring countries. Investment is lacking in rolling stock, notably in the rail sector but also in logistics service providers — including in warehousing and storage facilities. The EU's Eastern Partnership Transport Panel¹³⁷ compiled an indicative investment action plan to help decision-makers in the region to prioritise strategic investments in transport infrastructure. These improvements have the potential to not only enhance local but also international mobility, ultimately increasing access to new markets and services and generating direct economic and business development opportunities.

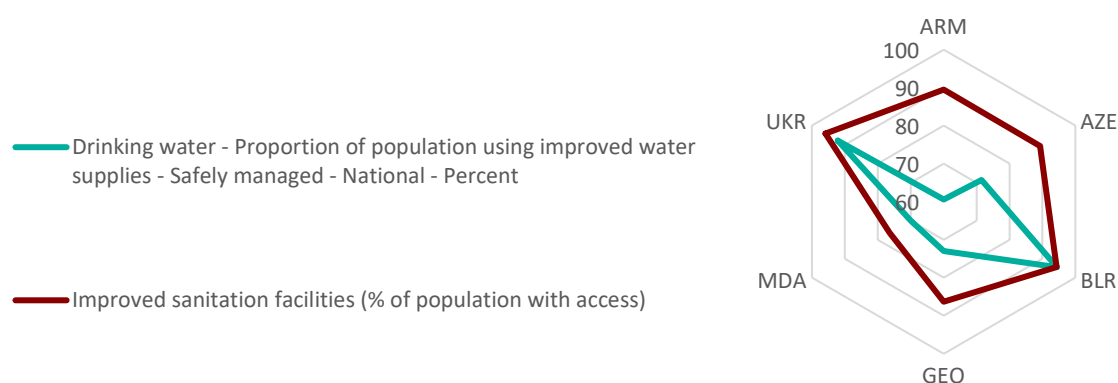
6.3 Access to water supply, sanitation and waste management is not yet inclusive

Infrastructure investment is needed in the water supply segment, particularly in rural areas. While access to running water access is fairly widespread, access to safely managed drinking water is not. Figure 5 shows that Georgia scores below several peers when it comes to safely managed drinking water facilities. In detail, Figure 6 —Panel A shows that access to water with a system directly installed in the dwelling is available for about 70% of households countrywide. In addition, a stark difference exists between the capital city and the other regions. In Tbilisi, almost all households have a connection installed inside their dwelling, with the percentage falling to a little over 55% in other regions in Georgia. Similar to the threats that climate change poses to transport infrastructure, in particular more frequent flooding, and a higher occurrence of water erosion and landslides, water infrastructure also

¹³⁷ The group is a collaboration between the Eastern Partnership governments, the European Union, the World Bank and civil society representatives. One example of the work the group conducts is the east-west road network, which needs upgrading, and the mountainous terrain adds to the project's price. A highway to connect Tbilisi and Kutaisi would cost EUR 1 billion. Overall, the priority investments detected in the EU Eastern Partnership Transport Panel would cost EUR 3.4 billion. Attracting foreign direct investment and promoting private sector involvement (including through public-private partnerships) could help to mobilise finance. EU Eastern Partnership Transport Panel (2019) Indicative TEN-T Investment Action Plan.

carries the risk of physical damage to water intakes, piping, storm water collection and other elements that may interrupt its smooth operation. ¹³⁸¹³⁹

Figure 5: Access to water and sanitation



Source: Our World in Data, EIB calculations.

Note: Safely managed drinking water is defined as an “Improved source located on premises, available when needed, and free from microbiological and priority chemical contamination.” Improved sanitation facilities are designed to ensure hygienic separation of human excreta from human contact. Improved sanitation facilities include flush/pour flush (to piped sewer system, septic tank, pit latrine), ventilated improved pit latrines, pit latrines with slabs, and composting toilets.

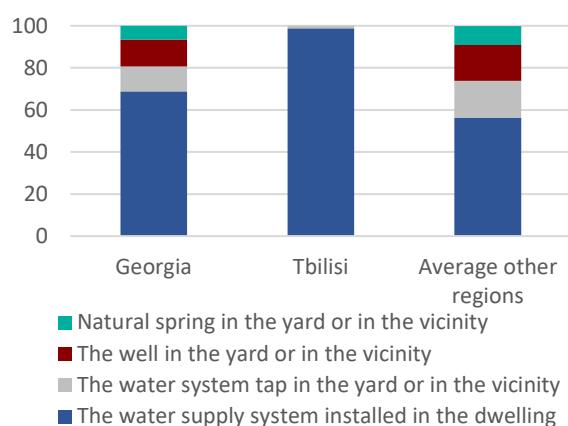
The high share of the population who lack sanitation facilities also highlights the need for infrastructure development. In Georgia, close to 14% of the population still does not have improved sanitation facilities, a statistic that is higher than in other Eastern Partnership countries, with rural areas being the most vulnerable. Moreover, low population density in rural areas raises the cost of providing the service and reduces its revenue potential, making the financing more problematic for both private and public investors.

¹³⁸ World Bank (2020). “Impacts of Climate Change on Georgia’s Coastal Zone.” [World Bank Document](#).

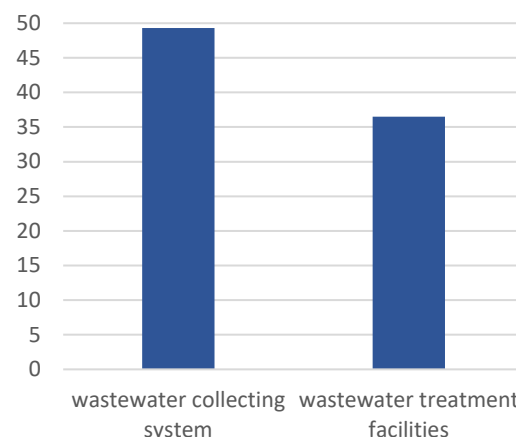
¹³⁹ USAID (2017). “Climate risk profile – Georgia.” [Template \(climatelinks.org\)](#).

Figure 6: Access to clean water

Panel A: Supply sources of drinking water (%)



Panel B: Percentage of the population connected to...



Source: Geostat, EIB calculations.

Waste management in Georgia offers room for improvement as landfill disposal is still the predominant method of handling waste. In 2018, more than 75% of all the country's waste went to one of the 56 official landfills in the country, the overwhelming majority of which did not have an environmental impact permit.¹⁴⁰ The greatest concerns relate to the environmental impacts of the chemicals absorbed by the soil, with indirect consequences for the population's health, although modern sanitary landfills are lined and protect the underlying soil and groundwater. Continuous improvements have been made as these sites have been slowly shut down and are expected to be fully retired by 2023 under the leadership of the state-owned Solid Waste Management Company of Georgia. Beyond this, the goals are to align the operational standards of the new regional landfills with the EU level, while offering support at the municipal level.¹⁴¹

6.4 Information and communications technology infrastructure compares well with peers, but accessibility is not uniform across the country

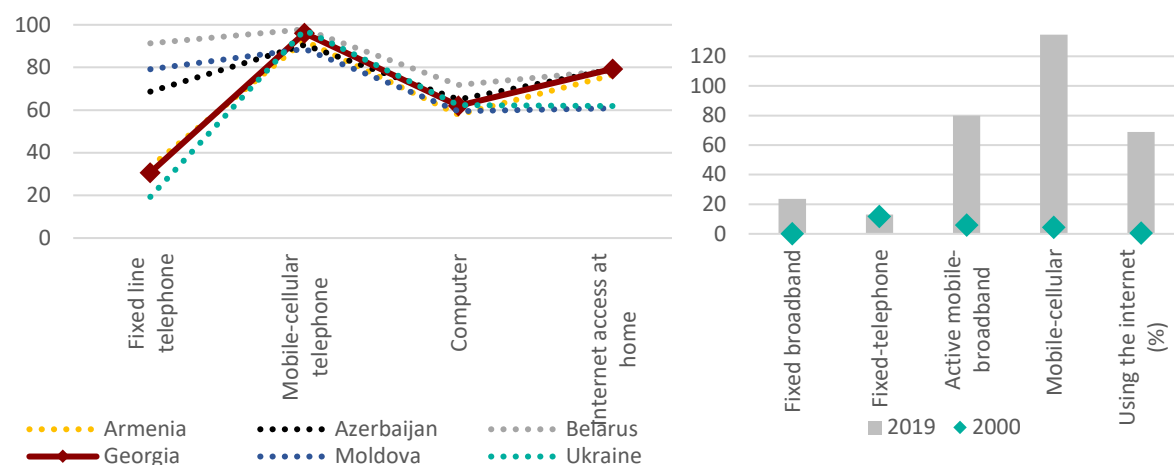
Access to information and communications technology infrastructure compares favourably to regional peer countries. Georgia ranks 55th out of 141 countries in terms of ICT adoption in the World Economic Forum's Global Competitiveness Index. It is the second best rated country in the Eastern Partnership, with only Moldova ranking higher. Breaking down this composite index by household, Georgia is the worst performer in the region in terms of fixed-line telephones, with only 30% of households covered (Figure 7 — Panel A). However, this is a legacy effect. Mobile phone coverage represents 96% of households. Overall, Belarus, known for its advanced ICT and innovation sector, is the clear leader in the region, while Georgia's score is average. Still, Georgia has made progress in the last decade with all relevant metrics per 100 inhabitants having increased tremendously, specifically active mobile band, mobile phones and usage of the internet (Figure 7 — Panel B).

¹⁴⁰ Dato Parulava (2018). "How Georgia is changing its approach to waste disposal with EU support."

¹⁴¹ Solid Waste Management Company of Georgia (2021). About us.

Figure 7: Information and communications technology infrastructure

Panel A — Indicators on access to and use of ICT (% of households) Panel B — ICT subscriptions



Source: International Telecommunication Union, 2020. EIB calculations.

Note: Most recent data point available ranging from 2016 to 2019.

Note: Data on active mobile-broadband is from 2010.

From an inclusion perspective, clear differences persist in access to digital infrastructure in terms of gender and geographical location. Overall, a large share of the Georgian population — 69% — was using the internet in 2019. This still compares unfavourably with the average of advanced economies which stands at 87%.¹⁴² Furthermore, the data still present higher shares of usage for males than females in many countries of the Eastern Partnership region. For Georgia, the split was almost evenly balanced with 70% of males benefiting from the internet vs. 68% of females. Still, within the country, differences persist. For example, in Tbilisi and its metropolitan areas, 84% of the population uses the internet vs. a maximum of only 51% in Guria, in the western part of the country. Affordability of broadband and mobile subscriptions in term of gross national income per capita in the Eastern Partnership countries can be costly compared to OECD countries. This can help explain why a recent survey conducted by the World Bank (Raja & Leuca (2019)) found that for Georgia, the overwhelming reason for not accessing the internet, both in rural and urban areas, are high costs of digital devices and high access fees. The EU4Digital initiative may help in this direction by extending the European Union's Digital Single Market to the Eastern Partnership region, as well as other shorter-term programmes that help firms cover such costs. Information and communications technology firms, more specifically startups, have highlighted access to finance as a challenge when trying to finance efforts to raise their profile in international markets (EU4Business, 2017).¹⁴³

¹⁴² Simple average based on the most recent data point for each advanced economy. The data range from 2017 to 2020.

¹⁴³ EU4Business (2017). "SME Development and DCFTA in Georgia Project – Georgian ICT Cluster Potential: Strengths, Weaknesses and Internationalization Opportunities."

6.5 Medical infrastructure and hospitals benefited from a series of reforms. However investment and improvements are needed in service provision, notably in terms of inclusiveness and universal services

Primary healthcare has improved in Georgia although the privatisation of the provision of services still poses an impasse to inclusive universal health coverage. The health sector is somewhat competitive although mostly private in Georgia with private companies owning 84.3% of all hospital beds and private health insurance generating 43.2% of the total private insurance market in 2014.¹⁴⁴ In recent years, several rounds of reforms — mainly the Georgian Health System State Concept 2014-2020 on universal health coverage — were introduced to increase geographic and financial access to primary healthcare, rationalise expensive and high-tech hospital services by increasing primary healthcare utilisation, and increase financial access to urgent hospital and outpatient services. These efforts were backed by strong political support and have attracted considerable investments in the sector. Together with private sector spending, the Health Ministry's¹⁴⁵ liberalisation policy of easing the regulatory requirements for entering the market and increasing government healthcare spending have created room for sustained growth in Georgia's healthcare sector, although current health expenditure only reached 7.1% of GDP in 2018. However, general access to health services and their affordability have decreased significantly when compared to the Soviet era, exacerbated by mistrust in the private system and the constant back-and-forth with reforms. This is partly highlighted by about 90% of healthcare expenses being currently financed through out-of-pocket payments, which points to difficulties in socioeconomic inclusion¹⁴⁶. In addition, the provision of health services is not equal throughout the country with rural and urban doctors having different contractors, levels of pay and accountability mechanisms.¹⁴⁷

Healthcare access and quality are not up to standard in Georgia. In 2015, the country was the worst scorer in the HAQ index provided by the institute for health metrics and evaluation (2017)¹⁴⁸ which measures amenable mortality — i.e. causes of death that could have been avoided by timely and effective medical care. The country had showed very slow progress since 1990, while its peers made significant strides (Figure 8).

¹⁴⁴ https://2016.export.gov/industry/health/healthcareresourceguide/eg_main_116236.asp.

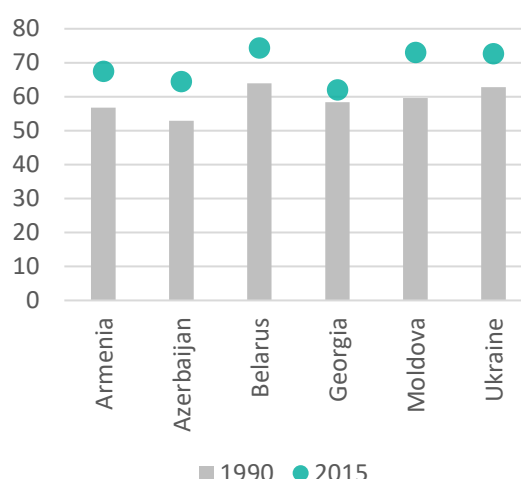
¹⁴⁵ Ministry of Internally Displaced Persons from the Occupied Territories, Labour, Health and Social Affairs of Georgia.

¹⁴⁶ Lela Sehngelia, M. Pavlova, W. Groot (2016). "Impact of Healthcare Reform on Universal Coverage in Georgia: A Systematic Review."

¹⁴⁷ WHO (2018). "Quality of primary health care in Georgia."

¹⁴⁸ Our World in Data (2021). "Healthcare Access and Quality Index, 1990 to 2015."

Figure 8: Healthcare access and quality index — 1990 vs. 2015



Source: Our World in Data (2017). EIB calculations.

Amid the COVID-19 health crisis, the available metrics regarding medical infrastructure further highlight the level of under-equipment in the health sector. For example, with only 4.3 hospital beds per 1 000 people, Georgia is the second-least equipped country in the Eastern Partnership, with numbers in the region ranging from 4.2 in Armenia to double that amount in Belarus. Furthermore, a lack of primary infrastructure causes patients to go directly to hospitals instead of local medical centres for first aid, which lowers outpatient numbers at the expense of inpatient facility usage. This underachievement is balanced by the number of doctors per capita which compares very favourably, even with the EU average. Infrastructure investments are therefore badly needed in this sector. On the other hand, Georgia scores at the bottom of the region again in terms of the number of nurses available with only 0.5 nurses per 1 000 people in 2016, far behind the EU average of 0.9¹⁴⁹. Human capital resources are therefore not allocated adequately in the system, which then becomes inefficient with too many doctors not matched by enough nurses. To counter this imbalance, investment is needed in training, requalification and education. In addition, the medical infrastructure's geographical coverage of the country is strong, although in terms of human capital, there are three times as many doctors in the Tbilisi area than in other regions.

Table 1: Georgia's population dynamics and healthcare infrastructure response

Country	% population 65 or over	Hospital beds / 1 000 people
Ukraine	16.7%	7.3
Georgia	15.1%	4.3
Moldova	12.0%	6.8
Armenia	11.5%	4.2
Azerbaijan	6.4%	4.5
Belarus	15.2%	8.4

Source: World Bank, WHO, Worldometer, OECD, United Nations Population Fund, State Statistics Service of Ukraine, Statistical Yearbook of Georgia, National Bureau of Statistics of the Republic of Moldova, The State Statistics Committee of Azerbaijan Republic, National Statistical Committee of the Republic of Belarus.

¹⁴⁹ European Observatory on Health Systems and Policies (2017). "Georgia: Health System Review".

7. Ensuring the sustainable transition of the energy sector and advancing green principles

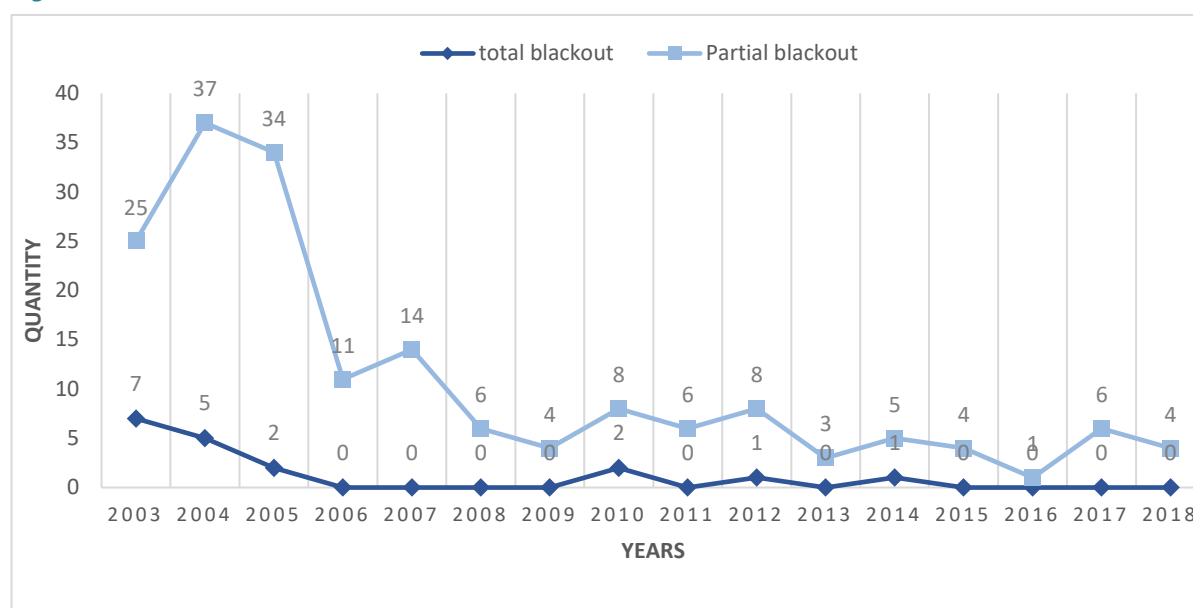
The energy sector plays a prominent role in the economy and it is traditionally one of the largest receivers of foreign investments, partly due to Georgia's transit role in the European energy supply chain. The strong private sector interest in the country's abundant hydropower sources comes on the back of the consistent regulatory and policy transformation of the sector. More recently, reforms have focused on harmonising with EU regulations to meet the obligations of the Association Agreement and Energy Community Treaty. The ongoing liberalisation of the energy market is another key aspect. However, ensuring a free and competitive electricity market is at odds with the growing role of gas and its preferential conditions in the sector, as these distort the market for other sources of electricity. The situation poses a particular challenge for renewables which, with the exception of hydropower, are nearly non-existent despite the vast potential. Consistent policy implementation, strongly growing demand, well-developed infrastructure and largely unexplored potential for renewable energy put Georgia in a prime spot to take advantage of the long-term business opportunities offered by decarbonisation and to enhance the country's climate resilience in the energy sector.

7.1 Consistent policy implementation and ongoing harmonisation with EU regulations are transforming Georgia's energy sector

The energy sector's transformation has come a long way, with significant improvements in the security of energy supply. After regaining its sovereignty in 1991, the country's energy sector began to gradually collapse due to internal political and economic instability. The main energy infrastructure, including generation units, transmission lines and gas pipelines, was deteriorating severely, triggering larger energy deficits and increasing Georgia's dependence on imported energy. At that time, the electricity sector was characterised by frequent blackouts, a lack of supply reliability and non-payments. A set of sweeping economic reforms introduced in the early 2000s included a focus on the energy sector, improving the situation dramatically. Better regulation, including the successful introduction of incentives to reduce network losses¹⁵⁰, and the modernisation of the transmission network significantly improved the quality of electricity supply. As a result, the cases of total and partial blackouts decreased from 25 partial and seven total blackouts in 2003 to four partial and zero total blackouts in 2018 (Figure 1). Despite those significant improvements, Georgia's fossil-fuel-based energy self-sufficiency remains quite low and the country has been a net electricity importer for the last several years (see more in Section 7.2), which poses risks to energy security.

¹⁵⁰ Such as the introduction of fines for exceeding the established norms of the average frequency of supply interruptions (SAIFI) and the average duration of supply interruption (SAIDI).

Figure 1: Blackouts in 2003-2018



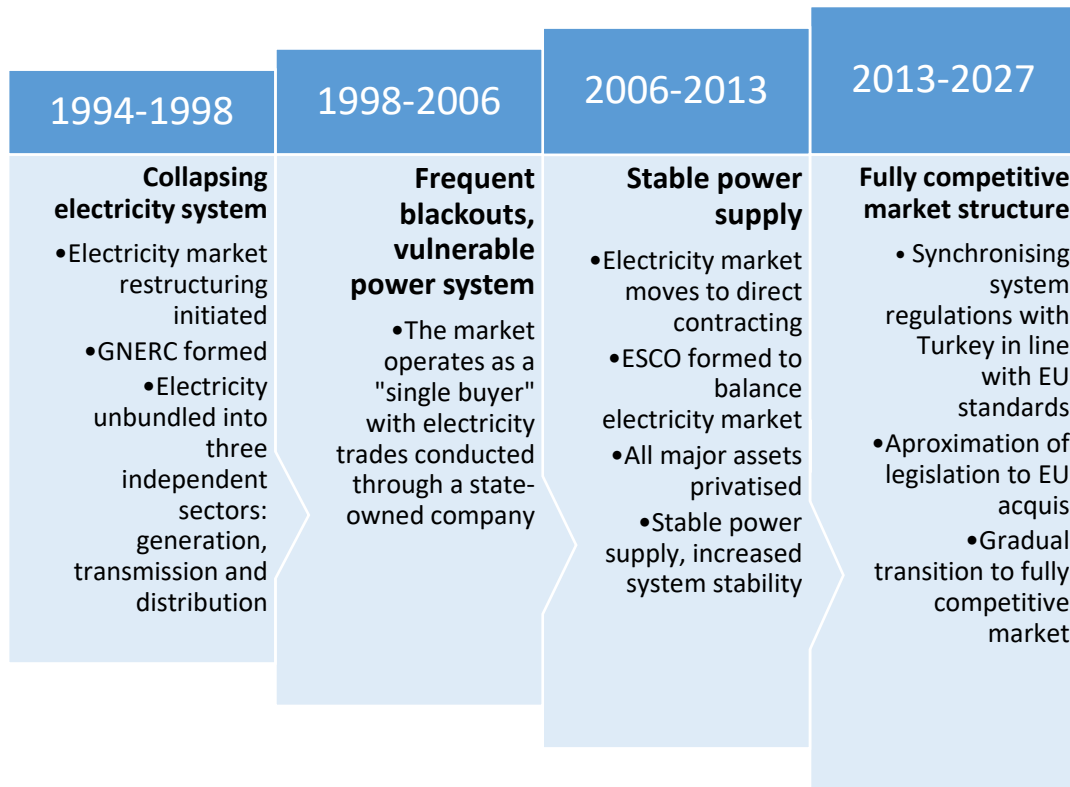
Source: Georgian State Electrosystem, Ten Year Network Development Plan 2020-2030 p. 42

The Association Agreement with the European Union gave additional impetus to the reforms. Georgia has committed itself to transforming the energy sector by achieving compliance with the EU third energy package. To meet its obligations under the Association Agreement and Energy Community Treaty, Georgia is gradually harmonising its primary and secondary legislation with the European Union, with the support of international partners (Figure 2). In November 2020, the Energy Community Secretariat had estimated Georgia's overall level of implementation of the energy acquis (core EU legislation on energy) at 36%, which constitutes an increase of 11% from 2019.¹⁵¹ Promoting free and competitive markets in the field of electricity and natural gas trade while ensuring the security of the energy supply became the central principles of the sector's development. The ongoing market liberalisation aims to separate the natural monopoly on the energy supply to create open markets for producers, distributors, transmission system operators and customers in the electricity and natural gas sectors. Increased liquidity and competition in the energy sector overall would also be supported as a result. Other obligations under the Association Agreement include developing the Southern Gas Corridor and other relevant infrastructure, increasing market integration, and promoting energy efficiency and the use of renewable energy sources.¹⁵²

¹⁵¹ European Commission (2021). "Association Implementation Report on Georgia."

¹⁵² Association Agreement between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia, of the other part (2014/494/EU). OJ L 261/1, 30.8.2014.

Figure 2: Electricity Market Development Stages to 2027



Source: GNERC.

Note: GNERC stands for Georgian National Energy and water supply Commission and ESCO stands for Electricity System Commercial Operator.

The new energy law and the Electricity Market Model Concept mark a milestone in the development of the power and wider energy sector. Adopted in 2020, these documents reflect the vision of the government on the general structure, arrangement and functioning of the Georgian electricity market, determine its future structure and describe the rights and responsibilities of market participants. They set the guiding principles for the organisation and functioning of the electricity wholesale market in Georgia, facilitate the fulfilment of obligations under the Energy Community Treaty, and aim to establish an attractive environment for investors by developing competitive and transparent electricity markets. The documents also oblige the government to establish and adopt the unbundling rules for distribution system operators and the certification procedure for transmission system operators in the electricity and natural gas sector. Moreover, Georgia is currently implementing the common rules for the internal market in the natural gas sector.

Despite the progress on the development of the legal framework, substantial reforms are still necessary to fully operationalise the new market structure. A number of challenges in both the electricity and gas sectors are impeding the transition process, including the need for additional thermal generation capacity and expensive imports due to seasonal patterns in hydropower demand, and gas market distortion caused by large subsidies provided for thermal generation.

7.2 The energy sector plays a prominent role in the economy

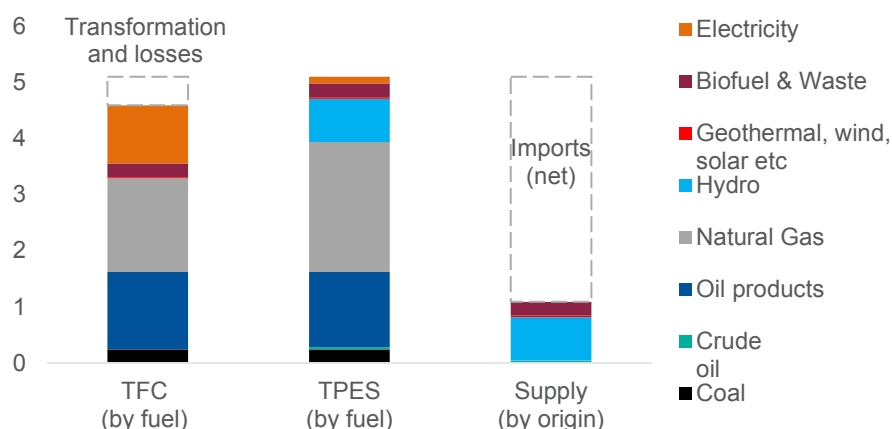
Georgia has an important transit role because it supplies Europe with gas from the Caspian sea. It is part of the Southern Gas Corridor which transports gas from the Shah Deniz field in Azerbaijan via Georgia through the South Caucasus Pipeline and its expansion (SCPX), then through Turkey via the Trans-Anatolian Pipeline, and then to Italy via the Trans-Adriatic Pipeline. Georgia also has a significant role in natural gas transit from Russia to Armenia via the north-south gas pipeline.

The energy sector is traditionally one of the largest receivers of foreign direct investment inflows in Georgia and is mostly private owned, highlighting its importance in the overall economy. The energy sector accounts for around 12% of total foreign direct investment stock. On a cumulative basis, including energy transit infrastructure such as the SCPX (estimated at USD 2.1 billion), the sector is the largest receiver of foreign direct investment. With the exception of two hydropower plants, the majority of installed power generation capacity is privately owned either by local or foreign investors.

Georgia is a net energy importer despite its large hydropower endowment and significant untapped potential for other renewables. In the absence of domestic oil and gas deposits, Georgia imports large quantities of gas and oil (Figure 3), which are mainly used in the transport and heating sectors as well as in thermal power plants for electricity production. Georgia's total energy consumption nearly doubled over 2000-2018, mostly as a result of growth in the transport and industry sectors. Electricity generation is dominated by hydropower which benefits from large natural resources (Figure 3). Other renewable sources of energy are nearly non-existent in the energy mix. The first and only wind power plant became operational in 2016, comprising only 1% of renewable generation in the total electricity supply.

Figure 3: Total energy supply is dominated by imported gas and oil as well as large domestic hydropower sources used for electricity generation

Energy production, supply and consumption by fuel, million tonnes of oil equivalent, in 2019



Source: Geostat, EBRD calculations.

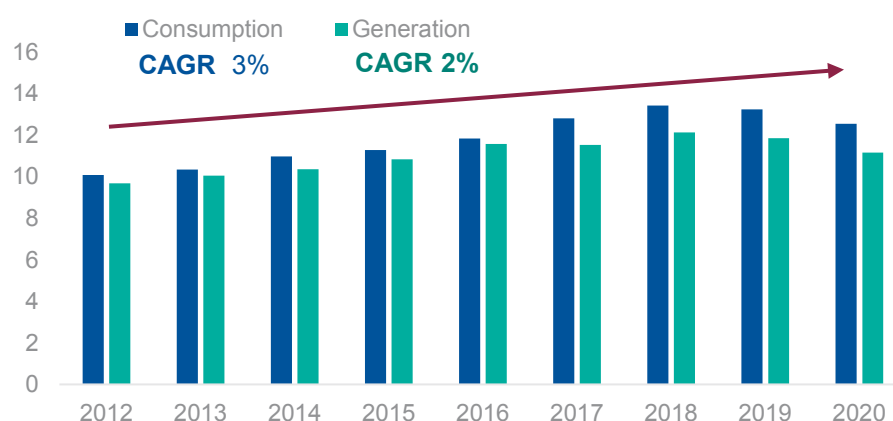
Note: TPES refers to the overall energy supply available for use in a country, while TFC shows the energy that is actually used by final consumers after the energy transformation — the energy used in homes, transport and businesses.

7.3 Investments in generation capacity trail behind growing demand

Energy consumption trends follow overall economic growth. Georgia's total energy consumption nearly doubled over 2000-2018, mostly as a result of growth in the transport and industry sectors, along with bitcoin mining. Electricity consumption correlates strongly with Georgia's economic growth and is not showing signs of decoupling. Despite a continuous increase in electricity generation in recent years, consumption has been consistently higher than domestic supply, turning Georgia into a net importer of electricity (Figure 4). The rate of consumption growth declined by 5.6% in 2020 due to the COVID-19 lockdown and economic restrictions. Nevertheless, generation was still not enough to cover demand, and additional imports were required. With generation falling short of growing consumption, a case is being made for additional investment in new generation capacity.

Figure 4: Electricity consumption growth has been outpacing generation growth, resulting in an increase in net imports

Electricity generation and consumption, in TWh



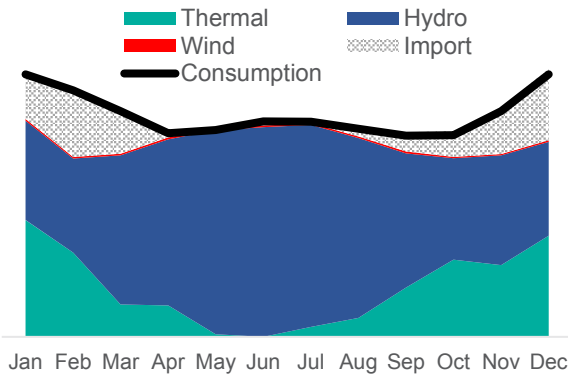
Source: Electricity System Commercial Operator.

Note: CAGR stands for compound annual growth rate

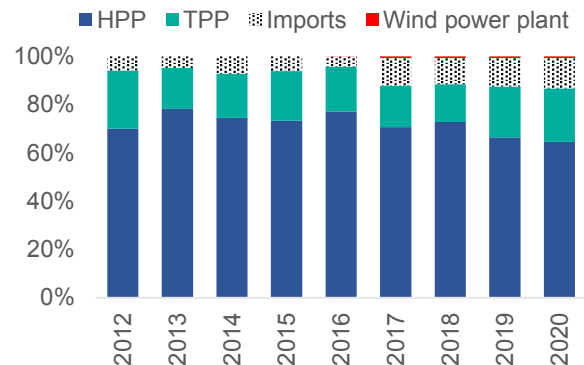
The dominance of hydropower sources leads to seasonal patterns in power generation and the need for supplementary thermal generation and imports. At present, total installed capacity at electric power plants operated in Georgia amounts to 4 514 MW with hydro power plants accounting for around 74%, gas-fired thermal plants accounting for 25% and the rest provided by a single wind power plant (Figure 5, Panel A). The mismatch between hydro production, which generates more energy in the summer season, and demand cycles, with high demand in the winter season, creates export opportunities during the summer and a need for imports and thermal power production during the winter. Despite the overall increase in hydro generational capacity, the importance of gas-fired thermal power plants and imports in overall electricity consumption has been growing in recent years (Figure 5, Panel B).

Figure 5: The power generation market system is characterised by seasonal generation and consumption patterns

Panel A: Generation market in 2020, in TWh



Panel B: Consumption market, share of total



Source: Electricity System Commercial Operator, EBRD calculations.

Note: Chart in Panel B does not contain transit, plant losses and self-consumption, or delivery to the network.

Active cross-border trade to balance seasonal patterns and meet growing demand is made possible by well-developed infrastructure. Georgia's electricity grid is connected to neighbouring countries Russia, Azerbaijan, Armenia and Turkey. On a net basis, Georgia has been an importer of electricity nearly every year in the past decade and the amount of net imports grew from an average of 0.1 TWh in 2012-2015 to an average of 0.9 TWh in 2017-2020. The recent refurbishment of transmission networks has increased their reliability, ensuring an uninterrupted transmission of power. Combined with planned transmission-line projects, this is expected to increase the country's export capacity to neighbouring countries, making it possible to tap into renewable energy's potential in electricity trading.

7.4 The ongoing liberalisation of the energy market is at odds with the growing role of gas and its preferential conditions in the sector

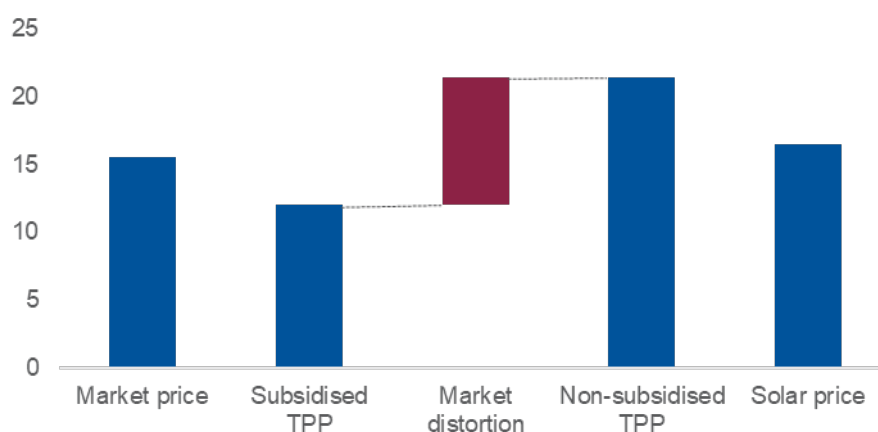
Gas supply is highly concentrated and opportunities to diversify are limited. Over 80% of total gas supplies are sourced from Azerbaijan (94% in 2018) with the rest imported from Russia through the north-south gas pipeline, which also provides transit for Armenia. The exact conditions of the related government agreements are undisclosed. With the overwhelming majority of gas consumption and a quarter of all power consumption dependent on a single supplier, the security of the energy supply is in the spotlight.

Gas from Azerbaijan is imported at discounted prices which are then passed on to households and thermal generation units as subsidies. Gas from Azerbaijan is mainly sourced as a direct import, but a portion is received for free as a transit fee/in-kind payment for the gas transit provided to the Shah Deniz consortium through the South Caucasus Pipeline. This discount is then converted into a subsidised gas price for households, known as social gas, estimated at 40% of the market price. According to the International Energy Agency (IEA), Georgia's gas prices for the residential sector (in US dollars at purchasing power parity) are lower than in many other countries heavily reliant on

imports, such as Armenia, Croatia, Ukraine and Moldova.¹⁵³ Since thermal power plants also receive natural gas at below the market price, they are indirectly subsidised through lower electricity production costs.

Preferential conditions in the gas sector distort the market for other sources of electricity. Since a significant share of electricity is consumed at a regulated low price thanks to the discounted price of gas, increased demand for gas is supported in the residential and thermal power plant sectors. The effect of subsidies goes beyond the gas market — by decreasing the marginal cost of gas technologies, the entire power market is distorted (Figure 6). Furthermore, a generous support mechanism provided by the government for the development, construction and operation of new thermal power plants puts these plants in a relatively comfortable financial position compared to other generation sources.¹⁵⁴ As a result, other technologies such as renewables, particularly those without strong government support, are squeezed out of the market.

Figure 6: Price regulation of social gas decreases the marginal cost of gas technologies
Average power price comparison, in tetri/kWh, in 2020



Source: IEA (2020) Energy Policy Review, EBRD calculations.

Note: TPP stands for thermal power plants.

Heavily subsidised gas prices are inconsistent with the liberalisation of the electricity market.

According to the International Energy Agency's analysis of the price-gap approach, these implicit gas subsidies for the residential sector amounted to 4.6% and for the electricity sector to 2.1% of total budget spending in 2017. As further explained, the gas price subsidies were therefore equivalent to around 43% of total government expenditure on education and more than 5.7 times its expenditure on research and development.¹⁵⁵ Reviewing the current subsidy system and tackling these market distortions would deliver a more efficient use of resources and uphold the principles of a competitive market environment, in line with the EU regulations.

¹⁵³ IEA (2020). "Georgia 2020 Energy Policy Review."

¹⁵⁴ Thermal power plants receive the fixed price for electricity generated as well as guaranteed capacity compensation to cover the fixed costs during periods of inactivity when they are in stand-by mode, ready to operate on call when necessary.

¹⁵⁵ IEA (2020). "Georgia 2020 Energy Policy Review."

7.5 Long-term business opportunities offered by decarbonisation

The potential harboured by renewable energy sources is vast and, with the exception of hydropower, largely untapped. Potential hydropower generation capacity is estimated upwards of 15 000 MWh per year, more than three times the size of total power generation at the moment, and the potential of wind power is estimated at an additional 1 500 MWh. Solar photovoltaic (PV) and solar thermal potential is considerable with an average of 250 to 280 sunny days a year in most regions¹⁵⁶, translating into a photovoltaic power potential (PVOUT) of around 2.67-4.10 kWh/kWp.¹⁵⁷ The potential of wind power is enormous, estimated at 4 TWh annually by the government.¹⁵⁸ At the same time, the Law On Promoting the Production and Use of Energy from Renewable Sources, approved in 2019, has an ambitious goal of 35% of total final energy consumption to come from renewable energy by 2030, not taking into account the sustainability of fuelwood consumption¹⁵⁹. Developing an appropriate support scheme to attract investors to the new and untested market will be the key challenge ahead.

With abundant renewable energy sources and fast progress on adopting the EU acquis, Georgia is well-positioned to reap the benefits of decarbonisation. The deployment of renewables offers more than just clean energy and reduced air pollution¹⁶⁰; the benefits vary from economic growth and job creation to catalysing major infrastructure projects and expanded energy resilience. Georgia is lacking a solid long-term strategy that would reflect state policy, a long-term vision and objectives for carbon neutrality.

Expanding renewable energy generation capacity would also help reduce total greenhouse gas emissions (GHG). Georgia is committed to the United Nations Framework Convention on Climate Change (UNFCCC) and ratified the Paris Agreement in 2017. In May 2021, Georgia submitted its enhanced nationally determined contribution (NDC), in which it raised its ambition while aiming to support the sustainable and balanced development of the country, taking climate change, environmental and socioeconomic challenges into equal consideration. As per this enhanced contribution, Georgia has unconditionally committed to reducing greenhouse emissions by 35% and conditionally by 50-57% by 2030, compared to 1990 levels.¹⁶¹ This is more ambitious than the previous version which had an unconditional target of 15% below the business-as-usual growth projection by 2030 and a conditional target corresponding to a 40% reduction below 1990 levels. In 2017, greenhouse gas emissions in the energy sector accounted for 60% of total emissions of Georgia. Emissions for the energy sector currently consist of fuel combustion activities (energy industry; manufacturing and construction; transport and other sectors), accounting for 87% in 2017, and fugitive emissions from fuels (solid fuels; oil and natural gas), accounting for 13% in 2017 (Figure 7). Decreasing the reliance on natural gas in favour of renewables would help decrease the sector's greenhouse gas emissions.

¹⁵⁶ IEA (2020). "Georgia 2020 Energy Policy Review."

¹⁵⁷ Global Solar Atlas (2021). "Georgia."

¹⁵⁸ Ministry of Energy of Georgia (2021). "Wind Power Potential."

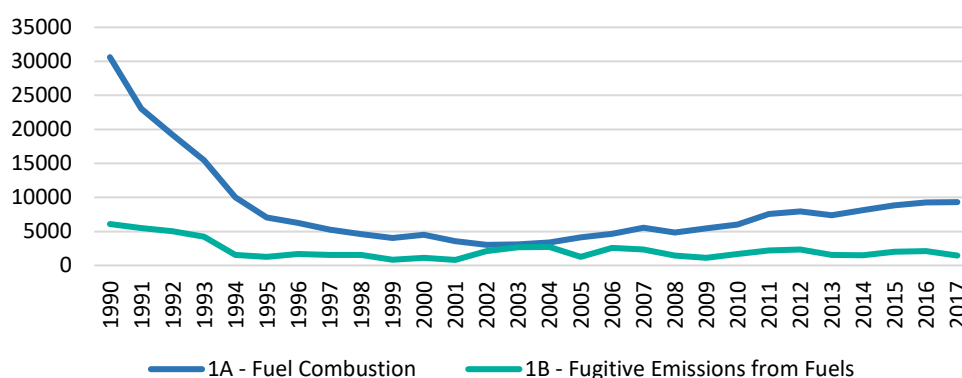
¹⁵⁹ All fuelwood used in the country is counted as renewable energy even though not all of it meets the EU Renewable Energy Directive's sustainability criteria for biomass.

¹⁶⁰ Between 2009-2019, air pollution remained in the top six health risk factors in Georgia (see <http://www.healthdata.org/georgia>) and Georgia ranks 14th in the world according to the indicators showing burden of disease attributable to ambient air pollution (WHO (2021) Ambient air pollution attributable daly).

¹⁶¹ UNFCCC (2021). "Georgia's Updated Nationally Determined Contribution (NDC)."

The implementation of energy efficiency measures would bring significant gains. Georgia's energy intensity is about 46% higher than the EU average.¹⁶² As an Energy Community member, Georgia is required to introduce energy efficiency obligation schemes (or alternative policies) across all sectors, including industry, buildings and transport, and the government is in the process of establishing the regulatory framework. The Law on Energy Efficiency and the Law on Energy Performance of Buildings were adopted in May 2020, which will help to improve energy performance standards for new builds and building retrofits, in line with EU standards. A national action plan on energy and the climate as well as on energy efficiency is being developed.

*Figure 7: Greenhouse gas emissions in the energy sector have been on the rise
In gg CO₂ eq.*



Source: Ministry of Environment and Natural Resources Protection of Georgia (2020), National Inventory Report of Georgia "GHG Inventory 1990-2017."

¹⁶² IEA Data Services (2021).

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GEORGIA

Country Diagnostic

October 2021