The external sector

Trade in goods

Poor data complicate the analysis of trade

Foreign trade turnover increased considerably as major international investment projects and energy and communications rehabilitation programs implemented successfully. This vigorous foreign economic activities simulated positive trends in economy of the country.

Foreign Trade

	January-August. 2004		January-August 2005	
	(US $ m)	%	(US $ m)	%
Exports of goods	407.7	100.0	525.2	100.0
of which:				
Scrap Black Metals	56.2	13.8	65.4	12.5
Ferrous Metals	26.4	6.5	52.6	10.0
Wine	29.1	7.1	47.7	9.1
Other Aircrafts	66.4	16.3	38.7	7.4
Copper Ores and Concentrates	23.7	5.8	28.2	5.4
Gold Unwrought or in Semi-Manufactured Forms	13.8	3.4	23.1	4.4
Sugar	26.2	6.4	22.5	4.3
Mineral Waters	10.6	2.6	19.7	3.7
Other Nuts. Fresh or Dried. Whether or not Shelled or Peeled	1.5	0.4	19.0	3.6
Fertilizers	13.5	3.3	18.0	3.4
Other	140.2	34.4	190.3	36.2
Imports of goods	1095.5	100.0	1390.8	100.0
of which:				
Crude Oil and Petroleum Products	107.2	9.8	181.2	13.0
Automobiles	60.3	5.5	97.7	7.0
Medicines	46.4	4.2	63.4	4.6
Petroleum Gases and Other Gaseous Hydrocarbons	48.5	4.4	57.1	4.1
Sugar	29.5	2.7	43.6	3.1
Other Aircrafts	7.7	0.7	30.6	2.2
Wheat or Meslin Flour	25.4	2.3	28.5	2.0
Wheat	52.2	4.8	25.3	1.8
Electric Power	22.0	2.0	21.0	1.5
Transmission Apparatus for Radio & TV	11.0	1.0	18.9	1.4
Other	685.2	62.5	823.5	59.2
Trade Balance	**-687.8**		**-865.5**	

Source: State Department of Statistics

Georgia remains primarily dependent on low value-added exports

The export composition has illustrated big share of metals, including scrap metals. Turkey imports almost 90% of Georgia's ferrous-alloys and ferrous scrap. Wine and mineral water are also important export items, and are mainly exported to Russia. The share of these two categories increased, stipulated by significant increase in production of these goods. The highest growth was in category of *Other Nuts, Fresh or Dried, Whether or not Shelled or Peeled*. The aircraft repair export decreased by 40% and constituted only 7.4% of total export (rather then 16.3 percent in 2004).

Oil and oil products and electricity remain the largest import commodities, accounting almost 15% of total import expenditure. Their share increased by 2.8% for the previous year, probably caused by the increasing prices of oil and oil products. Georgia continues to import electricity from Russian and Azerbaijan to meet most of its energy requirements. However Georgia has considerable potential for the generation of hydroelectric power. Realization of such useful possibility is highly depends on implementation of successful investments in this sector.

Main trading partners. (January-August. 2005)
(% of total)

Exports to

Russia	16.9
Turkey	17.7
Azerbaijan	11.4
Ukraine	2.9
Germany	2.2
Turkmenistan	7.9
Bulgaria	4.9
USA	2.1
UK	4.4
France	1.1

Imports from

Russia	15.8
Turkey	12.7
Azerbaijan	9.5
Ukraine	8.9
Germany	8.3
Turkmenistan	3.2
Bulgaria	3.5
USA	4.0
UK	2.8
France	3.5

Source: State Department for Statistics

Geographical proximity determines trade partners

Some changes were observed in geographic orientation of Georgian export. Export share to CIS decreased from 44.5% to 39% for this year. After CIS. the EU constitutes major export market with a share of over 20% (instead of 15.6% in the first three quarter of 2004). Although it is notable that EU primarily imports raw materials from Georgia. The main factor explaining Georgia's export patterns is therefore geographical proximity, with Turkey and Russia remaining the country's leading trading partners.

In 2005 import share from CIS increased till 37% instead of 34.4% during the first three quarters of the previous year. due to the growing import expenditures on oil and oil products. However, the composition of ten largest trade partner countries remained the same.

Current account

(US$ m)	2003	2004	2005*
Goods : exports (FOB)	830.6	1092.5	281.8
Goods : imports (FOB)	-1466.6	-2008.6	-497.2
Trade balance	**-636.0**	**-916.0**	**-215.4**
Service balance	54.0	56.1	20.0
Income balance	32.3	96.8	31.1
Current transfers balance	183.0	413.8	451.0
Current account balance	**-366.7**	**-349.3**	**-107.2**

Source: State Department for Statistics of Georgia.

*for the first quarter

Current-account deficits decreases

Since independence Georgia has had a large current-account deficit, which shows slightly improving tendency. Services exports dropped rapidly after independence, largely because of the collapse of tourism, but service exports recovered in 1998. The service sector development was primarily stimulated by transit infrastructure. An improvement in the goods and services balances in 2004 resulted in a fall in the current-account deficit to 6.7% of GDP in that year (instead of 9.2% in 2003).

Balance of Service could have a potentially increasing effect on the Balance of Payment. However, due to the underdeveloped infrastructure, the scale of realization of the country's tourism and transit potential is far from the needed.

Current transfer balance displayed surplus. Georgian citizens' remittances from abroad more than doubled in 2004. It is notable, that the volume of remittances grows every year.

The trade deficit increased but current account balance remained roughly stable in year-on-year terms in 2004.

Capital flows and foreign debt

Capital and financial accounts are improving

The net inflow of foreign capital to Georgia has influenced the capital and financial account of the country, which equaled to US$525.4m (10.02% of GDP) instead of US$399.7m (9.8% of GDP). Such impressive growth trend of capital inflows starting from 2002 when capital and financial account was 5.8% in GDP terms is the result of the implementation of international investment projects. According to the State Department of Statistics capital and financial account to GDP ratio decreased slightly for the first quarter of this year amounting US$112.8m or 9.3% in GDP terms. However according to the privatization plan of the large scale state owned enterprises high capital flows is expected till the end of this year.

As trading links destroyed after breaking down Soviet Union, export of the country fell and import costs (mainly for grain and energy) rose, by end-1994 Georgia's foreign debt had reached almost US$1bn.

Debt restructuring made in 1995 brought down the debt-service ratio from 58% in 1995 to 23.4% in 1998. Since 1995 Georgia has borrowed from multilateral and bilateral sources, mainly on concessional terms. In July 2004 Paris Club creditors agreed with the government of Georgia to a restructuring of its external debt. This agreement followed the IMF's approval of Georgia's arrangement under the Poverty Reduction and Growth Facility in June 2004 in support of the Government ambitious reform program. This agreement is expected to reduce debt service from US$169m to US$46 m. This debt restructuring will make an important positive contribution to Georgia's economic outlook.

The Paris Club has restructured Georgia's debt

According to the Ministry of Finance of Georgia the external debt stock of the country was US$1.77bn at the end of August 2005 up from US$1.5bn a year earlier. The rise was attributable almost entirely to an increase in public-sector medium- and long-term debt. Low growth and stable inflation over this period insured the decreasing trend of debt/GDP ratio that was 44% at the end of 2004 instead of 54% in 2003.

FDI inflows increase slightly

Foreign direct investment (FDI) has been low with occasional rises primarily a result of pipeline construction or expansion. FDI was 2.5 times higher in 2003 compared to 2002. In 2004 it reached US$500m, while in 2002 it was US$122.5m. FDI is expected to rise rapidly over the next few years as a result of the improvement of investment climate in the country. Foreign investment has been inhibited by predatory tax enforcement, a lack of adequate legal protection. pervasive corruption and the arbitrary application of rules and regulations. Another obstacle for private business development in Georgia is the poor state of the infrastructure particularly energy sector.

Foreign reserves and the exchange rate

The lari has remained stable since 1999

A stabilization program supported by the IMF in mid 1994 brought an end of hyperinflation, and introduction of a new currency in 1995 replacing the coupon – old currency- boosted demand for money. Since then, the National Bank of Georgia (NBG) has conducted a prudent monetary policy, focusing on maintaining price stability. The Lari was pegged de facto to the US dollar until December 1998 and price stability helped to remonetized economy.

Owing to low inflation the lari was initially extremely unstable. This remained the case until the Russian crisis combined with a fiscal crisis to produce devaluation in December 1998, when after running foreign reserves down to the equivalent of three weeks imports the National Bank of Georgia stopped intervening in the currency markets to defend it. Georgia has adopted a managed floating exchange rate regime. The lari/dollar exchange rate immediately dropped by 20 percent and monthly inflation soared to 12 percent.

According to the National Bank of Georgia, gross international reserves were US$444.2m at the end August 2005 US$100m higher than a year before. Some of the reserves had been used to service the country’s foreign debt. Given Georgia’s high debt and its vulnerability to regional economic stability, the low level of reserves, that is only three months of import cover, is a cause for concern.

Economic policy

Structural reforms in fiscal sector were introduced in 2003

Georgia made some progress in implementing economic reforms began in 1993. Notable achievements include high GDP growth starting from 2003, maintaining low inflation, and introduction further reforms in tax policy, administration, and financial sector. However, the progress was slow in some key areas, caused by weak governance and corruption. Poor investment climate and regional instability have diluted prospects for foreign investment. Severe problems in the energy sector remains unsolved that substantially raises a significant risk to macroeconomic stability and growth. However structural reforms in the fiscal sector advanced in 2003. The new budget low for 2003 provided a useful framework for improved public expenditure and policy. The revenue-neutral tax policy measures introduced to ease the tax burden on small farmers; the number of taxes was reduced from 21 to 8 rates of the VAT; and payroll taxes were cut. To offset the revenue loss from the tax cut, excise tax rates were raised, several exemptions were abolished and efforts to improve revenue administration were intensified. A major drive to strength tax and customs administration played a key role in improvement of fiscal performance in 2004 and 2005.

The NBG continued strengthening supervision policy and rationalizing the banking sector. FDI to Georgian banks increased. Important steps towards combating money laundering were made.

The government has been meeting budget targets from 2004

Despite the fact that the economic growth was higher than expected in 2003, the government was unable to fulfill the core budget parameters, constrained by inefficient work of fiscal authorities and deficiency in the tax legislation. Like collection of revenue, financing the deficit also encountered problems: Due to the failure to fulfill budget parameters external sources become unavailable. Financing of the deficit by T-bills and privatization proceeds was not adequate. So the state expenditure remained under-financed and arrears accumulated, leaving pension liabilities, other protected and priority items of the budget partially unpaired.

The revenues collected by the state in 2004 almost doubled compared to the previous year. Nonetheless, the funds were attracted, under the funding item, both from internal and external sources. The large part of the external funding was the directed privilege credits, intended to finance particular social, energy or agricultural projects. They were earmarked under the respective expenditure items. As to internal funding, GEL 122.0 million T-bills were sold at the T-bills auction in 2004, and the last year's respective liabilities already redeemed amounted to GEL 130.9 million. As a result, the net indicator of funding from this source was negative, GEL-8.9 million. The development of the T-bills market in 2004 and the reduction of interest rates was a priority for the Ministry of Finance's financial policy. From the internal sources of financing, the National Bank's long-term loan of GEL 21.5 million was disbursed. As a result, the net domestic funding indicator amounted to GEL 17.8 million.

Except the said GEL 178.4 million earmarked credits, the external sources also helped repay the principal of the GEL 150.4 million external debt.

Despite the new financial liabilities assumed by the state budget in 2004, its external and domestic debt, excluding guaranteed credits, reduced by 7.7%, which resulted from the appreciation of the exchange rate of lari. In the US dollar expression, the volume of external debts increased by 2.1%, domestic debt rose by GEL 6.2 million. In a situation of augmented state budget, total debt at the year-end amounted to 43.9% of GDP, while 54.4% in the previous year. The volume of the debt was still high, exceeding the state budget 2.4 times.

63.4% of the state budget was represented by long-term external liabilities, amounted GEL 2730.8 million, i.e. USD 1469.3 million, being by USD 31 million more than the respective 2003 indicator. Together with the restoration of the IMF program, Paris Club restructured a number of Georgia's debts, leading to the redemption of the principal of USD 92 million from the state budget.

In 2005 state budget runs proficite (US$27.6m as for August 2005) caused by improved revenue collection and moderate expenditure fulfillment.

Tax revenue is improving

The first sign of improvement revenue collection appeared and tax revenues were 25.6% more than in 2002, and 12.3 more than considering the economic growth rate. In terms of tax collection, problems were severe in the VAT and excise sphere. The actually collected VAT to GDP ratio equaled only 4.5%. The customs tax was the exception, collected at 10% higher level than planned. This outcome caused mainly by significant growth of imports, rather than by increased performance of customs agencies.

In 2004, the Georgian economy was greatly affected by the budget policy of the new authorities, based on the extraordinary measures to bring the financial order in the country. Much tighter tax and customs administration collected the revenues more than planned by the law, for the first time over the last few years, and allowed the government to improve the social status of the budget-dependent population. Tax revenue of the general government increased by 49.9% year-on year during 2004, well in excess of expectations, 18.2% in GDP terms. Much of this successful performance was used to accelerate clearance of arrears by 2.6% of GDP.

Revenue collection in 2005 (according to the data for the first eight months) increased by 63% on year base that could be positive sign to fulfill budget commitments.

The country receives external assistance

The International Monetary Fund (IMF) has extended Georgia the third tranche of a loan for 14 million SDR, or $20.4 million under a three-year Poverty Reduction and Growth Facility (PRGF) program. Georgia is expected to receive another PRGF loan by the end of 2005 after fulfilling its responsibility to advance economic and structural reforms in the economy.

The United States and Georgia have signed a $295.3 million aid agreement financed through a development fund designed for countries committed to political and economic reforms.

The Georgia agreement aims to reduce poverty and stimulate economic growth in regions outside the country's capital of Tbilisi. Also it focuses on rehabilitating regional infrastructure and promoting private sector development. The funding will support improvements to roads, a gas pipeline and other infrastructure; an investment fund to provide risk capital for small and medium-sized enterprises; and grants and technical assistance for farmers and agribusinesses.

Privatization process is accelerating

Privatization of State owned enterprises is a crucial component of the reform process in the country. Recently initiated phase of privatization will play a distinctive role in the economic development of the country. Since 1992 over 15.000 enterprises have been privatized. Now there are approximately 1,800 enterprises with state participation with over 180,000 persons employed. Small, medium and strategically important enterprises are among them. This privatization process, which is expected to be maximally impartial and transparent, will be exercised for 18 months.

During 2005 privatization of Batumi and Poti ports have been completed and the total proceeds from privatization amounted GEL 245m as for August 2005. In 2004 one of the large enterprise Tbilaviamsheni was privatized, that brought the state budget around 90% of the revenues from capital operations. In total, as a result of privatization operations, GEL 67 million was collected in 2004, while in 2003 almost no revenues were derived from this source.