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Georgia: Interim Operational Strategy 2008–2009

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 5 January 2008)

Currency Unit	–	Georgian lari (GEL)
GEL1.00	=	\$1.5925
\$1.00	=	GEL0.62793

ABBREVIATIONS

ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
BDD	–	basic data and directions
BEEPS	–	business environment and enterprise performance survey
CDM	–	clean development mechanism
CPS	–	country partnership strategy
EBRD	–	European Bank for Reconstruction and Development
EDPRP	–	Economic Development and Poverty Reduction Program
EU	–	European Union
FDI	–	foreign direct investment
GDP	–	gross domestic product
IDA	–	International Development Association
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
IOS	–	Interim Operational Strategy
JBIC	–	Japan Bank for International Cooperation
km	–	Kilometer
MCC	–	Millennium Challenge Corporation
MDG	–	Millennium Development Goal
MDF	–	municipal development fund
MTEF	–	medium-term expenditure framework
NBG	–	National Bank of Georgia
NGO	–	nongovernment organization
OCR	–	ordinary capital resources
ODA	–	official development assistance
PBA	–	performance-based allocation
SME	–	small- and medium-sized enterprise
Tacis	–	Technical Aid to the Commonwealth of Independent States
UN	–	United Nations
USAID	–	United States Agency for International Development

NOTE

In this report, "\$" refers to US dollars.

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EXECUTIVE SUMMARY

Context. Georgia became a member of the Asian Development Bank (ADB) in February 2007. It has been classified as a B1 developing member country with access to the Asian Development Fund and ordinary capital resources. This interim operational strategy (IOS) for 2008–2009 outlines ADB’s plan for launching country operations in 2008. ADB will support the Government’s development priorities in areas where it has an entry point and can add value.

Economic Performance. Georgia’s economy has been strong in recent years due to far-reaching policy reforms. Annual gross domestic product growth averaged 8.3% during 2004–2006, up from 5.8% during 2000–2003. Attracted by the improved business environment, foreign direct investment (FDI) has surged. Inflation has trended upward in recent years with rising domestic demand and the expansion in net foreign assets. Major fiscal reforms on the revenue and expenditure side in the past 3 years have made Georgia’s public finances more sustainable. A sharp rise in revenue collections has been accompanied by public expenditures to support growth, which have significantly improved the provision of public goods and helped to attract private investment. The current account deficit has widened with the acceleration in import growth (from higher energy prices, FDI-related imports, and higher demand) and the slowdown in export growth (in part due to the Russian trade embargo). However, large FDI inflows have been sufficient to cover the deficit. Debt burden indicators have improved since 2003. Recent growth has not yet translated into a sustained decline in unemployment and poverty rates. Economic diversification is the main development challenge that Georgia faces as a small, open country with a significant share of its population still living in poverty.

The Government’s Development Agenda. The Government has made good governance, particularly rooting out corruption, the cornerstone of its reform agenda. Key elements of the agenda include (i) mainstreaming anticorruption measures into the reform program, (ii) strengthening property rights and the rule of law, (iii) consolidating improvements in public resource management, and (iv) deepening fiscal decentralization reforms. The Government aims to reduce overall poverty incidence by half to 15% and extreme poverty to less than 4% by 2015 through strengthening the social assistance system, improving access of the poor to affordable basic services, and raising net job creation rates. Sustained high growth of more than 7% per year is to be pursued through adherence to macroeconomic prudence, economic diversification, and infrastructure development.

ADB’s Strategy. The IOS for 2008–2009 will focus limited resources on a few priority areas: (i) improving service delivery in municipal infrastructure within the evolving decentralization process, (ii) reducing road transportation constraints on economic activity, and (iii) upgrading and developing energy infrastructure. ADB and the Government have identified two projects that will constitute the core program of the IOS (2008–2009): the municipal infrastructure development project and the regional roads development project. The possibility of introducing ADB’s carbon market initiative will be explored with a view to supporting the development of clean energy, energy efficient, and greenhouse gas abatement projects that are eligible under the Clean Development Mechanism of the Kyoto Protocol. ADB also will pursue opportunities for private sector operations given that Asian Development Fund availability is constrained and the Government is seeking to limit public non-concessional external borrowing.

I. CURRENT DEVELOPMENT TRENDS AND ISSUES

A. Development Context

1. Georgia became the 67th member of the Asian Development Bank (ADB) in February 2007. After the circulation of a country economic report,¹ ADB's Executive Board approved Georgia's classification as a B1 developing member country.² This 2-year interim operational strategy (IOS) will provide the basis for ADB to launch country operations in 2008 and support the Government's development priorities in areas where ADB has an entry point and can add value.³

2. Georgia is a small, lower-middle-income country in the South Caucasus. Geographically, the country is an important link in the oil and gas transit system from the Caspian Sea to international markets. It also has abundant natural resources, such as forests, water sources, and mineral deposits. With its geography, natural endowments, and educated labor force, Georgia has strong economic potential.

3. The administration that assumed office in 2004 set in motion far-reaching structural and institutional reforms that have catapulted Georgia into the upper echelons of reformers in the world. Mikhail Saakashvili was re-elected in the Presidential elections held on 5 January 2008. Georgia's recent economic performance and the Government's commitment to reform have been impressive. Nevertheless, with high unemployment, low net job creation, and about one third of its population still living in poverty, Georgia has an unfinished agenda for achieving broad-based growth with poverty reduction.

B. Economic Growth

4. Georgia's economy has been growing strongly since 2004, following a period of more volatile growth in 1998–2003. Over the past 5 years, growth has accelerated from 5.5% to 9.4% in 2006, and is expected to touch 12.0% in 2007. The economy has shown resilience to the major shock of the trade and transit embargo imposed in 2006 by the Russian Federation, formerly Georgia's largest trading partner. Strong foreign direct investment (FDI) has been a driver of growth. During 2002–2005, FDI inflows were for pipeline construction, but they are now increasingly being channeled to other sectors, particularly banking, manufacturing, and tourism. This trend reflects improvements in the investment climate through structural and sectoral reforms. The sectoral contribution to growth is changing. Compared to 2002, the contribution of trade, manufacturing, transport, and finance had increased in 2006, while the contribution of construction had declined. The service sector accounts for 67.0% of GDP and the industry sector accounts for 21.7%. However, the performance of the agriculture sector continues to be volatile. Its share in nominal gross domestic product (GDP) declined to 11.3% in 2006.

5. Recent growth has been sustained by generally prudent macroeconomic management and a coherent set of structural reforms. However, inflation is accelerating—from 8.8% at the end of 2006 to 11.6% at the end of November 2007. Rapid money supply growth and higher energy prices are the main sources of upward

¹ ADB. 2007. *Country Economic Report: Georgia*. Manila.

² ADB. 2007. *Country Classification of Georgia*. Manila.

³ The guidelines for preparing strategies for new member countries are given in footnote 2 on page 1 of OM Section A2/OP and paras. 38–43 of the 2006 paper on *Further Enhancing Country Strategy and Program and Business Processes*.

pressure on the consumer price index. Accelerating credit growth from a low base has been financed from domestic deposits, with the central bank applying prudential limits for foreign currency borrowing by commercial banks. Strengthened public finances have been achieved through higher revenue mobilization, which has enabled (i) clearance of payment arrears, (ii) increased priority spending on infrastructure and the social sectors, and (iii) reduction in the debt burden. Budgetary revenues have risen from 15.1% of GDP in 2002 to 28.0% (estimated) in 2007. The current account deficit has been widening, although FDI inflows have been sufficient to cover it so far. Reducing the current account deficit and easing competitiveness concerns over the medium term will require (i) generating higher national saving directly through a tighter fiscal policy; and (ii) deepening structural reforms to help stimulate competitiveness of exports. A tighter fiscal policy also will help rein in inflation by containing domestic demand.

6. Sustaining recent high growth rates will depend on maintaining macroeconomic stability, addressing infrastructure bottlenecks, and broadening access to and extending the range of financial services. Over the medium term, Georgia's GDP growth is expected to moderate, but will still be robust at 6.5%–7.5%. Georgia's debt outlook has improved significantly due to the economy's recent strong growth, higher budgetary revenues, increased official development assistance (largely on concessional terms), and prudent debt management strategy. Continuation of these policies is expected to reduce the ratio of public and publicly guaranteed external debt to GDP from 21.9% in 2006 to 12.4% by the end of 2010.

C. Poverty

7. Recent strong growth has not yet translated into a sustained decline in unemployment and poverty rates.⁴ The unemployment rate stood at 13.6% in 2006. Poverty incidence rose by an estimated 5.7 percentage points during 2004–2005 to 32.9%. Although official figures for 2006 have not been released, a recent World Bank document indicates that poverty incidence has fallen to 31.0%.⁵

8. The unemployment rate in urban areas (28.0%) is five times that in rural areas (5.7%). This large difference reflects the open unemployment in urban areas, compared with underemployment in rural areas. The net job creation rate is still low, in part because enterprise restructuring is continuing in Georgia. Moreover, the new private enterprises (as distinct from formerly state-owned enterprises that were privatized), which are a source of labor demand, still constitute a relatively small but growing share of the formal sector. On the supply side of the labor market, skills shortages in emerging growth sectors constrain employment.

9. Georgia has adapted the Millennium Development Goals (MDGs) to its country context. The national objective of reducing extreme poverty to under 4.0% by 2015 is likely to be achieved with the successful reform of the social assistance program that aims to reach the poorest and most vulnerable segments of the population. The MDGs for education and health are also likely to be reached, given the ongoing efforts to reform sector policies, institutions, and financing. The social sectors now account for about a

⁴ ADB. 2007. *Country Economic Report: Georgia*. Manila. A detailed analysis of recent trends in poverty incidence and underlying causes can be found in paras. 9–18.

⁵ International Development Association (2007). *Program Document for a Third Poverty Reduction Support Operation*. May 15. Washington, DC.

third of public spending, and the targeting of pro-poor spending has been enhanced. However, achieving the MDG on access to safe drinking water is likely to be more challenging, as the differences in access to infrastructure services between rural and urban areas, and between the poorer and more developed regions of the country, are significant.

D. Governance and Institutional Capacity

10. The Government has made good governance the cornerstone of its reform agenda. It is pursuing reforms along several dimensions, including policy development, public administration, and public resource management. Administrative structures have been rightsized and streamlined, resulting in more effective mechanisms for policy coordination among ministries and agencies. The national anticorruption strategy adopted in June 2004 was reinforced with an action plan in 2005 and an implementation plan in 2006 that includes provision of a multilayered coordination mechanism headed by the state minister for reforms coordination. The legal framework has been strengthened with a new law on public procurement and the law on conflict of interest and corruption. Accountability mechanisms, such as the Chamber of Control and the Ombudsman, also help promote transparency and integrity in public service. The effectiveness of the Government's anticorruption measures is reflected in the significant drop in the frequency of bribery across all sectors, as reported in the latest round of the European Bank for Reconstruction and Development (EBRD)–World Bank business environment and enterprise performance survey (BEEPS).⁶ Georgia leads all transition countries in terms of reduction in corruption.

11. Major reforms in public resource management are continuing. The first medium-term expenditure framework (MTEF) was introduced in the 2006 budget formulation process to make budget management more strategic and reflective of the Government's policies and priorities. Previously off-budget expenditures have been incorporated into the budget. Budget execution has improved significantly, and payment arrears from past years have largely been cleared. Recent tax policy and administration reforms have boosted tax revenues. There is a single corporate tax rate set at a low rate and a flat rate income tax. The new tax code has simplified compliance with its provisions and reduced the discretion of tax officials. Corruption in tax administration has declined significantly.

12. As part of Georgia's strategy to strengthen local governance and intergovernmental fiscal relations, the following legislative measures have been adopted: (i) the organic law on local self-governance (2005), paving the way for consolidating more than 1,000 local self-government units into 70 units; (ii) the new tax code (2004), which clarifies revenue sources for local governments; and (iii) the law on local self-government budget (2006), establishing a formula-based intergovernmental fiscal transfer mechanism.

13. The legal environment governing the activities of nongovernment organizations (NGOs) is liberal and supportive, limiting the state's control over the sector and allowing NGOs to operate freely. Georgia's overall score on the United States Agency for International Development's NGO sustainability index is 4.0 on a scale of 1 (best) to 7

⁶ Anderson, James H., and Cheryl W. Gray. (2006). *Anticorruption in Transition 3: Who is Succeeding and Why*. Washington D.C.

(worst), the best score in the region.⁷ It has improved its performance on the service provision dimension of the index, reflecting increased demand from the public and private sectors for NGO services, and the expansion of NGO service delivery at the local level. Georgian NGOs offer a variety of services in education, environmental protection, health care, and social services for low-income citizens. The formal mechanisms that integrate civil society into public debates could be strengthened.

E. Private Sector

14. Private sector development has been boosted by wide-ranging business regulatory reforms undertaken since 2003. Licensing reforms stand out as an area that has transformed the business environment in Georgia. Reforms in labor regulations, property registration, and taxes have also been notable. As a result, Georgia's global ranking on the World Bank's ease of doing business index has climbed to 18 (Table 1). Georgia, the top reformer in 2006, was ranked fifth in 2007, and continues to target better rankings each year.

Table 1: Ease of Doing Business in the Caucasus (2008)

Indicator	Georgia	Armenia	Azerbaijan
Ease of Doing Business Rank	18	39	96
Starting a Business	10	47	64
Dealing with Licenses	11	73	159
Employing Workers	4	48	80
Registering Property	11	2	56
Getting Credit	48	36	26
Protecting Investors	33	83	107
Paying Taxes	102	143	141
Trading Across Borders	64	118	173
Enforcing Contracts	42	64	30
Closing a Business	105	42	75

Note: The index ranked 178 countries.

Source: World Bank. 2007. *Doing Business 2008*. Washington, DC.

15. Georgia's trade regime is liberal, with low import tariffs, no quantitative restrictions, and no limits on current and capital account convertibility. Under the law on customs tariff, which took effect on 1 September 2006, the average tariff is 7.8%, the number of tariff bands has been reduced from 16 to 3, and the maximum band is set at 12%. Customs administration reform includes reducing staff and recruiting new employees based on merit. Georgia is seeking to harmonize its trade policies and institutions with those of the European Union. Institutional reforms include the establishment of two agencies, one for standardization and technical regulation and another for accreditation.

16. The finance sector is among the fastest growing sectors of the economy. Private sector credit as a share of GDP is expanding rapidly from a low base. However, credit is concentrated in the retail trade and construction sectors while the agriculture remains underserved. Interest rate spreads are high but coming down. Access of small- and medium-sized enterprises (SMEs) to credit is limited but improving. Reports indicate that only a fraction of potential SME borrowers succeed in accessing credit because of reasons such as lack of collateral, perceived high credit risk, and unaffordable interest

⁷ Available: http://www.usaid.gov/locations/europe_eurasia/dem_gov/ngoindex/2006/

rates. The leasing market, which could attract SMEs, is still in a nascent stage of development.

F. Regional Cooperation

17. Georgia is a member of several regional institutions, including the Black Sea Economic Cooperation Pact and a grouping of Georgia, Ukraine, Azerbaijan, and Moldova. Georgia is facing the following key regional cooperation challenges:

- (i) **Transport and trade facilitation.** Georgia has prioritized its participation in the Eurasian transport corridor project supported by the European Union. The project links Central Asia and Europe through the Caucasus. Development of these corridors will enable Georgia to realize its full transit economy potential. The Government's objective is to combine high-quality transport infrastructure (roads, railways, ports) with trade facilitation, including harmonization of border crossing procedures, transit fees, and tariffs.
- (ii) **Regional energy trade.** Georgia, Azerbaijan, and Turkey cooperate on energy security and energy transportation. The development of a Caucasus regional energy market structure could generate benefits over the longer term.
- (iii) **Transboundary environment issues.** These relate to the use and protection of shared waters, particularly the Black Sea and the Kura-Araks river basin.

G. Environment

18. The key environmental challenges facing Georgia include:

- (i) water quality concerns due to weak infrastructure and contamination from wastewater and hazardous chemicals;
- (ii) coastal and marine pollution due to oil spills from oil transit, and discharge of municipal and industrial waste;
- (iii) air pollution due to emissions from transport, energy, and industry;
- (iv) sustainable commercial exploitation and conservation of forest resources and checking illegal logging; and
- (v) conservation of biodiversity.

19. Georgia has the necessary environmental legislation and policy framework in place, but their implementation and enforcement could be improved. The authorities have developed a framework law on environment (law on environmental protection, 1996), other relevant laws, and policy documents to address priority problems. The national environment action plan was adopted in 2000 with a 5-year time span. The second national environment action plan is being prepared.

H. Gender

20. Gender equality has been achieved in education. Enrollment rates show no gender gaps in primary completion rates, and the small difference in secondary education enrollment is in favor of females. Although health policies and programs give women access to delivery care and family planning services, trends in maternal mortality

rates are of concern. The Government is implementing a reproductive health policy to reverse these trends. Gender gaps are evident in labor force participation and remuneration. In 2006, 45.4% of females 15 years old and over were employed, compared with 59.3% of males in that age range. In addition, women earn less than half of men's salary. The majority of women reported as employed are self-employed, and a significant proportion of the female workforce is employed in agriculture. The Government has recently taken steps to improve and coordinate its anti-trafficking efforts. Recent national initiatives aimed at addressing violence against women include adoption of the law on elimination of domestic violence, and protection and assistance of the victims of domestic violence enacted in 2006.

II. THE GOVERNMENT'S DEVELOPMENT AGENDA

A. Development Goals and Strategy

21. The Government's development agenda is reflected in (i) the Basic Data and Directions (BDD) document;⁸ (ii) annual progress reports on the economic development and poverty reduction program (EDPRP) of Georgia;⁹ and (iii) the MDG targets adapted to the Georgian context.¹⁰ A summary of the Government's development agenda follows.

1. Poverty Reduction

22. The objectives are to reduce, over the period 2006-2015, overall poverty incidence from 31% to 15% and extreme poverty from 11% to 4%, through the following priority interventions:

- (i) **Social assistance system.** The social assistance system is being reformed with (a) improved means-tested targeting to reach the poorest and most vulnerable sections of the population, and (b) increasing protection against poverty in old age through a fiscally sustainable pension system.
- (ii) **Access of the poor to basic services.** Disparities in access to basic services are being reduced by (a) reforming basic education finance to accommodate differences in education costs in poorer areas, and (b) improving equity and access to essential quality health services by strengthening primary health care services and streamlining the universal health benefits package with a supplemental package targeted at the extreme poor.
- (iii) **Employment.** Rapid economic growth is expected to create an enabling environment for creating jobs, and reducing unemployment.

2. Economic Growth

23. The objective is to sustain rapid growth of 7.0%–7.5% per year during 2008–2011. The plan includes strategies for:

⁸ Government of Georgia. 2007. *Basic Data and Directions for 2008–2011*. Tbilisi.

⁹ Government of Georgia. 2006. *Georgia: Poverty Reduction Strategy Paper Progress Report*. Tbilisi.

¹⁰ United Nations Development Programme. 2004. *Millennium Development Goals in Georgia*. Tbilisi.

- (i) **Macroeconomic stability.** Prudent macroeconomic management is to be pursued to reduce the risk of the economy overheating due to significant inflows of foreign exchange, and debt sustainability is to be maintained.
- (ii) **Economic diversification.** Economic diversification is to be promoted through (a) a liberal trade and investment regime, (b) financial sector development, and (c) more balanced regional development.
- (iii) **Infrastructure development.** Infrastructure bottlenecks to growth will be removed. The strategy includes (a) developing transport infrastructure to strengthen market access and to realize Georgia's transit economy potential more fully, (b) securing energy security, and (c) improving municipal and local infrastructure services.
- (iv) **Human resource development.** A well-trained labor force adapted to the needs of a modern economy will be developed through reform of vocational and career education, particularly by designing a training and retraining program targeting SMEs.

3. Governance and Anticorruption

24. The objectives of the governance agenda are to continue reform in public administration and further strengthen the anticorruption framework. Areas being addressed include:

- (i) **Anticorruption framework.** Anticorruption measures will be mainstreamed into the reform process.
- (ii) **Legal and regulatory environment.** Reforms will focus on (a) strengthening property rights and the rule of law, (b) improving corporate governance standards, and (c) reducing regulatory burden and restricting state involvement in economic affairs to the minimum necessary.
- (iii) **Public resource management.** Improvements will be consolidated in (a) revenue mobilization and administration, and (b) strategic medium-term public expenditure management.
- (iv) **Public administration reform.** The reforms will maintain focus on (a) rightsizing government overall and within each ministry/ agency, merit-based hiring and promotion, and improved staff incentives; and (b) improving mechanisms for consulting and reporting on public affairs.
- (v) **Decentralization.** More responsibilities, revenues, and autonomy will be delegated to local governments.

B. Resource Mobilization and Investment

25. Since 2004, Georgia has sought to create fiscal space for growth-oriented spending through tax reform, privatization receipts, and more efficient budget allocation and spending. Reforms in tax policy and tax administration have boosted tax collections; tax revenue is projected at 25.7% of GDP for 2007 and is expected to rise above 27% by 2010. Large privatization receipts have eased financing pressures in recent years. Privatization receipts were equivalent to 4.1% of GDP in 2006 and are projected at 3.6% in 2007. However, this source of capital revenues is expected to decline in subsequent years with the completion of the privatization program. Increased revenue mobilization is being complemented by reforms in budget allocation and spending, particularly by making public expenditure more cost effective (e.g., improved targeting of social assistance system, more efficient service delivery, and smaller government). These

factors, together with a prudent debt management strategy, have contributed to Georgia's attainment of a sustainable primary balance, i.e., the difference between the actual primary balance and the primary balance required to stabilize the public debt ratio is positive.

26. Although the situation is much improved, Georgia has substantial investment needs, particularly for infrastructure for transport, energy, municipal services, irrigation, and drainage. The investment rate was 25.6% of GDP in 2006, of which private FDI accounted for 15.4%. FDI inflows are expected to continue, though not at such a high level. General government investment, estimated at 5.5% of GDP in 2006, is also expected to stabilize at about 7%. Domestic private investment is expected to increasingly fill the gap. The investment–savings gap (resource gap) was estimated at 15% of GDP in 2006 and is expected to remain high in the medium term.

C. Role of External Assistance

27. Net official development assistance (ODA) to Georgia was \$310 million in 2005.¹¹ The top five providers of gross ODA (2004–2005 average) were the United States, the International Development Association, Germany, the European Commission, and the International Monetary Fund (IMF), in that order. ODA to Georgia includes loans (mainly on concessional terms) and grants. In addition to project financing, Georgia has been receiving budget support. The Government is increasingly seeking assistance of this type on the grounds that the medium-term expenditure framework and the credibility of its reform strategy make budget support an effective aid instrument for Georgia. The ODA outlook for Georgia over the medium term remains positive.

D. ADB's Assessment of the Government's Development Strategy

28. **Poverty Reduction.** The recently released BDD 2008–2011 reaffirms the need to reduce poverty and sustain rapid growth. Poverty is expected to be reduced mainly through better targeting of social assistance, improved delivery of basic services needed by the poor, and employment-generating growth.

29. The Government's strategy is to make the social assistance system more effective in reducing poverty by raising the level and efficiency of such assistance. Growth and public sector reforms are enabling higher government spending on social assistance, while improved targeting has enhanced its efficiency. The pension system is one area that needs further reforms to make it more fiscally sustainable.

30. The strategy prioritizes equity and access of basic services needed by the poor, particularly basic education and primary health care. In education, the Government is paying increasing attention to addressing the lagging education attainment levels of minorities. The introduction of the per student financing formula at the basic education level—differentiated by urban, rural, and mountain schools to accommodate differences in education costs in poorer areas—is expected to increase equity, efficiency, and transparency in public spending on education. In health care, the strategy is to move toward private provision of hospital care, while focusing public resources on strengthening primary health care, including a supplemental health services package

¹¹ Available: <http://www.oecd.org/dac/stats/idsonline>.

targeted at the poor. Health care reforms have resulted in increased utilization of health care services by the two poorest quintiles.

31. The strategy documents take the view that unemployment, and in turn poverty, will fall with rapid growth. The underlying rationale is that additional jobs can be generated and unemployment reduced by alleviating labor market constraints on (i) the demand side by improving the business environment for entry of new private sector firms, and (ii) the supply side by addressing skills shortages. The Government has had notable success in business environment reforms. Reform of the education system for skills development is ongoing. These reforms are necessary but not sufficient for broad-based growth and poverty reduction. Taking into account the urban–rural dimensions of the labor market, Georgia has too many underemployed workers in low productivity agriculture and too many unemployed skilled workers in urban areas. Thus, the challenge in reducing poverty incidence is as much to expand high value-added activities in agriculture and the rural economy as to expand job opportunities for skilled labor in urban areas.

32. **Economic Growth.** The central theme of the Government's development agenda is private sector-led growth and macroeconomic stability. The BDD, which includes a more forward-looking macroeconomic framework than the EDPRP, projects GDP growth of 7% during 2008–2011. Private investment is projected to increase in real terms by an annual average of 2.5%, driven by strong business regulatory reforms. However, the scenario for the external sector, where export growth is projected at 7% per year and import growth to decelerate sharply, needs to be supplemented with alternative scenarios that take into account the effect of exogenous shocks.

33. The Government's medium-term expenditure framework for 2008–2011 assumes that the revenue-to-GDP ratio will stabilize at 29% of GDP by 2011, with tax revenues projected at 28% of GDP against a backdrop of further liberalization of tax legislation. Over the same period, the share of expenditure to GDP is expected to be maintained at 30% of GDP, with spending prioritized on infrastructure development, social sectors, defense, and security. Given that a prudent fiscal policy is essential for managing capital inflows in a non-inflationary manner, the strategy needs to elaborate on the consistency between the proposed expenditure levels with inflation estimates.

34. The Government is making good progress in promoting private sector-led growth by reforming the business environment and the financial sector. To further strengthen the business environment, the Government plans to continue streamlining the licensing and permit system, divesting itself of state-owned enterprises, and improving tax administration. More work is required on corporate governance, strengthened capacity of transport and trade-facilitation institutions, and effective implementation of the new law on insolvency. The finance sector is the fastest growing sector of the Georgian economy. However, sectoral lending is highly concentrated. Access to financial services needs to be improved by broadening the types of collateral that can be accepted by banks, reducing costs associated with evaluation of credit information, and establishing effective systems for enforcing repayment. Broadening access to nonbank institutional finance also will help reach underserved sectors and small businesses. Gaps in transport infrastructure are a cost to doing business. Although the Government has increased investment in this sector, sector agencies and the domestic private sector will need to enhance their capacity for planning and management.

35. **Governance and Public Sector Management.** The Government's notable success in addressing corruption, undertaking public finance reforms, and improving service delivery and operational efficiency is widely acknowledged. Further strengthening in some areas could ensure that Georgia's development progress remains on track. The MTEF process can be strengthened by reinforcing the link between policies and resources, performance monitoring, and capital budgeting. Decentralization is another area where the institutional framework and policies are still evolving. Fiscal decentralization can contribute to improved service delivery and improved quality of life. However, local government capacity needs to be strengthened to realize this.

III. ADB'S INTERIM OPERATIONAL STRATEGY

A. Summary of Key Transition and Development Challenges

36. Economic diversification is the main development challenge that Georgia faces as a small, open country with a significant share of its population still living in poverty. Table 2 summarizes the key dimensions of this challenge. The table traces the links between the dimensions of poverty reduction and the challenges for achieving inclusive growth through macroeconomic management, structural and sectoral policies, and governance and public sector management.

Table 2: Summary of Key Development Challenges

	Challenge	Inclusive Growth			
		Macroeconomic Management	Structural and Sectoral Policies	Policies for Inclusion and Equity	Governance and Public Sector Management
	Sustained macroeconomic stability with growth	Private sector competitiveness and economic diversification	Equitable regional growth, access to local services, and social inclusion	Improvement in public institutions, incentives and capacity for effective planning and service delivery at national and subnational levels	
Dimensions of Poverty Reduction	Employment and Income	<ul style="list-style-type: none"> Foreign exchange inflows managed with non-inflationary macroeconomic policy to enable private sector growth Fiscal space for improved public goods provision 	<ul style="list-style-type: none"> Reduce labor market constraints to productive employment on demand side through improved business environment and on supply side through addressing skills shortages Broader and more efficient financial sector Improve investment climate and competitiveness by addressing infrastructure gaps <ul style="list-style-type: none"> Reduced transportation constraints Enhancing energy security, sector efficiency and sustainability 	<ul style="list-style-type: none"> Lagging regions catch up Adoption and implementation of adequate standards for air and water quality, waste management, and nature protection 	<ul style="list-style-type: none"> Rightsizing public sector employment with pay adequacy Effective implementation of the anticorruption strategy to make the investment climate more attractive
	Capability	Limit competitiveness declines from real exchange rate appreciation	<ul style="list-style-type: none"> Gap in skills needs and availability identified and addressed in educational curricula Enhanced business capacity of small and medium sized enterprises through training programs 	<ul style="list-style-type: none"> Reduce disparities in quality of basic education through reform of education finance Improve educational attainment of minorities Improve efficiency and reliability of service delivery of municipal infrastructure Ensure affordable access of the poor to quality health care 	At subnational level, enhanced capacity to comply with law on local self-government budget
	Security	Fiscally sustainable pension program provides protection against poverty for elderly	Adequate legal basis for property rights and its implementation	Social assistance program provides adequate coverage of the poor and vulnerable	Increased public trust in police to maintain security and control criminal activities

B. Focus of Interim Operational Strategy

37. ADB's priorities for the IOS (2008–2009) have been identified based on the following considerations: (i) alignment with the Government's development agenda; (ii) selectivity in focusing limited resources on a small number of priority areas; and (iii) complementarity with other development partners.

38. The IOS will focus on enhancing sustainable economic growth, with the cross-cutting themes of governance, regional cooperation, and environmental protection, by:

- (i) improving service delivery in municipal infrastructure within the evolving decentralization process,
- (ii) reducing road transportation constraints on economic activity, and
- (iii) upgrading and developing energy infrastructure.

ADB will also pursue opportunities for private sector operations given that Asian Development Fund (ADF) availability is constrained and the Government is seeking to limit public non-concessional external borrowing.

1. Improved Service Delivery in Municipal Infrastructure

39. **Context.** In the initial years of transition, the quality and reliability of municipal services deteriorated sharply due to the vitiated policy and institutional environment. In recent years, strong economic performance in a conducive policy environment has reversed the deteriorating trend of service quality, particularly among the larger and more creditworthy municipalities, improving the quality of life for their populations.

40. Georgia's subnational administrative structure has three tiers: (i) regions; (ii) raions and cities; and (iii) sub-raion towns and municipalities. Local governments are responsible for providing municipal infrastructure services at the raion and sub-raion levels. The municipalities' financial and technical capacities to make infrastructure investments vary.

41. In 1997, the Government took an important step, with World Bank support, toward laying the groundwork for financing municipal infrastructure by establishing the municipal development fund (MDF), a legal entity under public law. The MDF provides the legal and operational structure for municipalities to borrow from the fund on relatively concessional terms for municipal infrastructure investments. The MDF does not only serve as a financial intermediary onlending funds to local governments, but also supports them in project appraisal, design, and implementation, blending loans with grants where appropriate, and provides technical assistance to local governments in financial management. Thus far, MDF has lent to the more creditworthy municipalities. Over the years, MDF has developed considerable expertise in financing and enhancing the efficiency of municipal infrastructure investments.

42. **Issues.** The investment costs of improving municipal services, including piped water, sewerage networks, waste treatment, and municipal heating, are significant. While the more creditworthy municipalities have had some success in gaining access to resources for investment, a significant number of municipalities still are unable to provide adequate service delivery, as they lack access to financing for infrastructure investment and rehabilitation. Recently, water and sewage pipe failures in certain areas led to

outbreaks of waterborne diseases, particularly diarrhea and hepatitis. There is also scope for increasing the coverage of water consumption metering, expanding tariff reforms, and improving payments collection.

43. **ADB's Role.** ADB's proposed support for municipal infrastructure is in line with the Government's development agenda, which aims for improved service delivery and decentralization with effective implementation of legal, economic, and financial frameworks for local self-governance. Although other development partners are active in municipal services, the unfinished agenda allows space for ADB to add value. With the recent completion of the second World Bank municipal services project, the Government has requested ADB assistance in continuing assistance in this area. The demand for municipal infrastructure in Georgia is growing due to rapid economic growth and evolving decentralization reforms. By focusing support on financing municipal infrastructure, ADB can contribute to (i) sector reforms for ensuring the sustainability of infrastructure assets by supporting an appropriate long-term business model, (ii) strengthening the link between financing local infrastructure projects and decentralization reforms, (iii) stimulating local economic development, and (v) improving the quality of life of the population in the municipalities covered.

44. In its initial operations, ADB's engagement in municipal infrastructure services will involve channeling funds for cost recovery-oriented investments through the central Government, and in turn from the MDF to local governments. This "wholesale" approach of relying on the MDF's procedures, appraisal, and financial framework will ensure more effective results in ADB's initial municipal infrastructure operations compared with the more traditional "retail" approach of providing project loans to selected municipalities. It is justified because the MDF is a tried and tested model for financing municipal infrastructure. Moreover, a specialized institution such as the MDF is needed to work with selected local governments in applying standards for infrastructure financing. ADB will also undertake a comparative study on approaches to sustainable decentralized basic service delivery that will inform the design and implementation of subsequent projects in this area.

2. Reduce Road Transportation Constraints on Economic Activity

45. **Context.** Georgia's road network consists of 1,495 kilometers (km) of international, 3,354 km of state, and 15,480 km of local roads. The country has five main roads and highways, including the East–West Highway connecting the ports of Poti and Batumi to the Azerbaijan border. The Road Department in the Ministry of Economic Development oversees the construction and maintenance of international and secondary roads. The Government has been encouraging private sector participation in construction and maintenance of highways.

46. **Issues.** Given the country's location, transport sector development is critical to reducing the logistics costs of economic activity and realizing Georgia's full potential as a transit economy. The difficult terrain in some sections and congestion slows traffic, increases vehicle operating costs, and reduces road safety. Road maintenance costs are also high because of the terrain and weather conditions. About 10% of the main roads, 30% of the secondary roads, and 50% of the local roads are in poor condition and need rehabilitation. The Government has prioritized improving conditions of the road network.

47. **ADB's Role.** ADB's operational engagement in this area will involve financing improvements to the highway network, resulting in lower transport costs, better road safety, and reduced traffic congestion and vehicle pollution. These are high-return, in-demand operations, and the Government has requested ADB assistance in this area to help address some of the remaining investment gaps. Further, the Government is committed to continuing highway management reforms. The focus would be on the main East–West Highway and enhancing regional and domestic connectivity.

3. Upgrading and Developing Energy Infrastructure

48. **Context.** Over the past few years, Georgia has made significant progress in energy sector reforms to address the chronic power shortages and the poor financial condition of electricity and gas companies. The reliability of electricity services has improved significantly due to investments in energy infrastructure and maintenance. Financial viability has strengthened with tariff reforms, improved revenue collections, and reduction in the quasi-fiscal deficits in the sector. The privatization of power generation and distribution has improved management of operations. Georgia is well endowed with renewable energy resources, especially hydropower and geothermal resources, and the Government is developing a potential pipeline of renewable energy projects. The Government's priorities for the future are to develop and utilize the country's considerable hydropower potential, to diversify its supply sources for natural gas, and to participate in the Eurasian energy corridor, particularly the East–West and North–South transmission lines.

49. **Issues.** Georgia's energy infrastructure, particularly its hydropower assets, needs rehabilitation. The country still depends on oil and gas imports. In addition, as in other countries that used to be part of the former Soviet Union, Georgia's energy consumption is inefficient and wasteful.

50. **ADB's Role.** ADB's operational engagement in this area will involve support for renewable energy initiatives, including assistance for identifying potential hydropower sites. The Government has suggested that high voltage power transmission should also be considered as an option. The possibility of introducing ADB's carbon market initiative will be explored with a view to supporting the development of clean energy, as well as energy efficient and greenhouse gas abatement projects that are eligible under the clean development mechanism (CDM) of the Kyoto Protocol. These initiatives will be combined with technical assistance to establish an adequate CDM policy framework and infrastructure.

IV. ADB's ASSISTANCE PROGRAM

A. Overall Assistance Level

51. Georgia has been classified as a B1 country (footnote 2), eligible to borrow from the ADF and ordinary capital resources (OCR). For 2008, the ADF component of lending will come from a special allocation of \$40 million for Georgia outside of the performance-based allocation (PBA) system for ADF resources. The special allocation is necessary, because the biennial allocations under the PBA process for 2007–2008 were made before Georgia's membership. From 2009 onwards, allocations will be based on outcomes of the annual country performance assessment exercise. The performance

assessment ratings that will form the basis for the 2009–2010 biennial allocations will be finalized shortly.

B. Indicative Assistance Program (2008–2009)

52. ADB and the Government have identified two projects that they expect to proceed with in 2008–2009 as the core program of the IOS (2008–2009): the municipal infrastructure development project, and the regional roads development project. During 2009, increasing funding for core program activities and for additional projects will be considered provided an agreement is reached on financing amounts from OCR over and above ADF assistance. This could allow more flexibility in the size and composition of the program.

53. ADB will work to develop country knowledge linked to the evolving strategic priorities. An area that ADB will focus on in the near term will be sector capacity diagnosis in municipal infrastructure and roads development with a view to helping target specific capacity development interventions in the future. ADB will make assessments of, and build knowledge about, government policies and practices related to safeguards. ADB will also focus on deepening its knowledge and understanding of core governance issues, such as public financial management, procurement, and anticorruption, including undertaking institutional corruption risk assessments in selected sectors.

Table 3: ADB's Assistance Program (2008–2009)

Core Lending Program	
2008	2009
Municipal Infrastructure Development (\$40 million from ADF)	Regional Roads Development (\$30 million–\$50 million from ADF)
Expanded Lending Program	
	Regional Roads Development –Additional Funding from OCR
Nonlending Activities	
Municipal Financing Study	
Renewable Energy Master Plan	
Institutional Corruption Risk Assessment (selected sectors)	

ADF = Asian Development Fund, OCR=Ordinary Capital Resources

54. **Private Sector Operations.** Private sector operations, particularly in the finance sector, could be expanded. ADB's Board of Directors has already approved one such transaction—a senior loan to the Bank of Georgia for onlending to SMEs. The Government has stated that the real sector should also be considered as a possible area of ADB's private sector operations, along with the finance sector. Since private sector operations are driven by individual transactions, it is difficult to set out, a priori, a pipeline for such projects. Potential transactions that ADB might consider could include loans and equity investments in private banks, as well as equity investments and provision of credit lines to leasing companies and other nonbank financial institutions. ADB's private sector operations will add value by catalyzing foreign investment to bank and nonbank financial institutions. These transactions could be linked to nonsovereign technical assistance for capacity building and institutional strengthening.

C. Complementarity and Coordination with Other Development Partners

55. Among the multilateral development partners in Georgia, the most active are the World Bank group (International Development Association and International Finance Corporation), the European Bank for Reconstruction and Development (EBRD), the European Union (EU) Technical Aid to the Commonwealth of Independent States (Tacis), and the United Nations agencies. Among the bilateral partners, the United States (USAID and Millennium Challenge Corporation), Germany, United Kingdom, Netherlands, and Japan are active.

56. **World Bank.** The World Bank began operations in Georgia in 1994. Georgia is eligible to borrow only from IDA. Over the years, World Bank operations have covered a wide range of areas: (i) macroeconomic management, (ii) fiscal and budget management, (iii) agriculture and rural development, (iv) energy, (v) transport, (vi) education, (vii) health, and (viii) water supply and municipal development. The World Bank's last country partnership strategy (CPS) was approved in 2005, covering 2006–2009, and has the following focus areas: (i) generating growth and job creation by removing barriers to private sector development and improving infrastructure, finance, and markets; (ii) enhancing human development through improved education, health, social protection, and community services; and (iii) strengthening public sector management and budgetary processes. A key component of the CPS is a series of operations to support poverty reduction, complemented by a public sector reform support program. The CPS provided for an indicative IDA resource envelope of \$143 million during 2006–2009.

57. **EBRD.** EBRD's activities have focused on energy, transport, agribusiness, general industry, and banking. Almost 80% of EBRD financing was in the private sector. EBRD's last country strategy, approved in 2006, has the following focus areas: (i) investment climate, (ii) infrastructure, (iii) enterprise sector, and (iv) financial sector. EBRD expects to continue to focus primarily on private sector financing, but will support a few public sector operations.

58. **EU Tacis.** EU assistance has focused mainly on health and judicial and legal reform, with some activity in transport, energy, social protection, and public sector reform. Its latest country strategy paper, covering 2007–2013, identifies the following priority areas of support: (i) democratic development, the rule of law, and governance; (ii) economic development and European Neighborhood Policy Action Plan implementation; (iii) poverty reduction and social reforms; and (iv) resolution of internal conflicts.

59. **UN Agencies.** UN agencies have been particularly active in environment, judicial and legal reform, and community empowerment. The priority areas for 2006–2010 are (i) capacity building for democratic governance, (ii) poverty reduction through policy advice and promotion of employment opportunities, (iii) crisis and conflict prevention and recovery, and (iv) environmental and natural resource management.

60. **Complementarity of Proposed ADB Activities With Other Development Partners.** Other foreign funding agencies have been involved in the areas that IOS proposes to focus on but this is justified given the potential complementarity of ADB's role and value addition. In municipal infrastructure, EBRD and the Millennium Challenge Corporation have ongoing projects in the eastern part of the country. With the World

Bank's Municipal Development and Decentralization Project II drawing to a close, the Government has requested ADB support for building on these earlier projects. In road transport, the World Bank is implementing the East–West Highway project and a secondary roads project. The Japan Bank for International Cooperation (JBIC) is also involved and is examining the possibility of financing the East–West Highway project in the western part of the country. However, given the large scale of investment needs in this sector and gaps in infrastructure, ADB's entry is warranted. IFC and the EBRD have a limited number of technical assistance activities with nonbank financial institutions.

V. RISKS

61. Georgia has been receiving a sizable amount of development assistance from multilateral and bilateral development agencies over the past decade. ADB's recent engagement with Georgia calls for quickly expanding sector knowledge, while minimizing project preparation time to remain responsive and add value. Limiting the IOS to 2 years will allow ADB and its development partners to remain highly selective and focused, while deepening knowledge and understanding of the country constraints and opportunities that can be reflected in the development of a full CPS by 2010.

62. In municipal infrastructure, ADB will not be taking the traditional route for project design and implementation. Instead, it will build on the MDF model, which has proven to be an effective and well-managed financing channel. ADB may experience an initial learning curve in taking this new route, and the municipalities benefiting may be among the more creditworthy rather than the poorer and relatively underserved municipalities. However, the traditional route could entail project delays and significant oversight effort by ADB.

63. In road transport, ADB's focus on improving the highway network would complement activities of JBIC and the World Bank in assisting the improvement and upgrading of the East–West Highway. Moreover, the highway sector provides a good entry point from which ADB can extend support for designing and implementing trade and transport facilitation projects.

PROGRESS TOWARD THE MILLENNIUM DEVELOPMENT GOALS AND TARGETS

Georgia Adjusted Goal	Current Status
Goal 1. Eradicate extreme poverty	<p>Trend. The proportion of the population in extreme poverty is trending downward, with estimates at 16.9% in 2004 and 16.1% in 2005. A solid trend has not been established for overall poverty incidence. Using a new methodology, the World Bank estimates that overall poverty incidence declined from 30.0% in 2003 to 27.2% in 2004 and then rose to 32.9% in 2005. Preliminary estimates for 2006 indicate an overall poverty decline to 31.0%.</p> <p>Likelihood of achieving goal. It is likely that the goal of reducing extreme poverty to 4%–5% by 2015 will be achieved. A new social assistance database has been developed to identify who the poor and needy are. It aims to improve targeting of the poor by moving from categorical targeting to a purely means-tested targeting system, moving from in-kind to monetary benefits, and adjusting the coverage to different types of assistance. As of 1 January 2007, 100,000 households were regularly receiving assistance, and the coverage is expected to have increased to 120,000 households by the end of 2007, a figure that corresponds to the estimated number of poorest households in Georgia. Adequate provision for this has been made in the 2007 budget.</p>
Goal 2. Ensure coherence of Georgia's education systems with educational systems of developed countries through improved quality and institutional setup	<p>Trend. Primary education is almost universal. The primary school gross enrollment rate was 94% in 2005. Secondary school gross enrollment rate was 83%.</p> <p>Likelihood of achieving goal. The Government's objectives are to (i) maintain primary education enrollment rates, (ii) switch from a 10-year to a 12-year school cycle, (iii) integrate students' achievements into an international assessment system, and (iv) modernize the school education system. These goals are likely to be achieved. The Government has significantly increased public spending on basic education, and has launched a major program for rehabilitation of school buildings. Other key educational reforms undertaken include curriculum reform, a national system for assessment and examination, reform in text book production, teacher training and incentives, and per capita financing. Georgia is a candidate country for the Education for All fast track initiative, a global partnership between foreign funding agencies and developing countries to ensure accelerated progress towards the Millennium Development Goal of universal primary education by 2015.</p>
Goal 3: Promote gender equality and empower women	<p>Trend. Education shows no gender disparities in education, but gender gaps can be found in the labor market. The ratio of female to male enrollment in secondary education is 1.01 (2005). Georgia's labor laws provides for gender equality in the right to work, equal remuneration, and equal retirement age for men and women. However, gender imbalances exist in the labor market. Women's representation in parliament is low at 9.4%.</p> <p>Likelihood of achieving goal. The goal is likely to be met.</p>

Georgia Adjusted Goal	Current Status
Goal 4. Reduce child mortality	<p>Trend. Infant mortality rate in Georgia shows a decreasing trend from a high of 28.6 per 1,000 live births in 1994 to 19.7 in 2005.</p> <p>Likelihood of achieving goal. This goal is likely to be achieved. The Government has introduced some initiatives for reducing child mortality, including first- and second-level free medical service for children up to 3 years and 20% cost-sharing for children between 3 and 5 years, child immunization program, child-age disease management program, infant development program, and other programs.</p>
Goal 5: Improve maternal health	<p>Trend. Maternal mortality is trending downward. After peaking at 68.5 deaths per 100,000 live births in 1997, the maternal mortality rate started falling and was 42.4 deaths per 100,000 live births in 2004¹. The main cause of maternal mortality continues to be bleeding and septicemia.</p> <p>Likelihood of achieving goal. This goal can be achieved if the reproductive health policy continues to be effectively implemented. Health policies and programs give access to delivery care and family planning services, and the Government is implementing a reproductive health policy to reduce maternal mortality. Skilled health personnel attend 97.5% of births.² Family planning services to reduce unintended pregnancies are available. Georgia's Ministry of Labor, Health, and Social Affairs has prepared a draft law on reproductive health care, and an associated regulatory and policy framework for quality reproductive health services.</p>
Goal 6: Combat HIV/AIDS, malaria, and other diseases	<p>Trend. The cumulative reported cases of HIV/AIDS has risen from 20 in 1996 to 395 in 2005, with 119 cases reported in 2005 alone mainly due to drug use. The prevalence of malaria and tuberculosis is trending downward. Tuberculosis incidence, in particular, improved from a high of 119.8 in 1996 to 89.7 in 2004.</p> <p>Likelihood of achieving goal. The goal can be met provided surveillance and prevention efforts are stepped up. Policies for the prevention and treatment of HIV/AIDS are in place, and coverage of treatable cases is adequate. However, surveillance and prevention need more effort and resources. Georgia has a relatively high tuberculosis burden, but policies for prevention and treatment are in place. The quality and coverage of DOTS, the internationally recommended strategy for TB control, could be increased further. Policies for malaria prevention are in place and are being successfully implemented.</p>
Goal 7: Ensure environmental sustainability. Reduce by half the proportion of people without sustainable access to safe drinking water	<p>Trend. The coverage of water supply and sanitation has gaps, particularly in rural areas. According to one source, 82% of the population was using improved drinking water sources (2005).</p> <p>Likelihood of achieving goal. The likelihood of achieving this goal is unclear.</p>

¹ Source: TransMONEE database, UNICEF Innocenti Research Center, Florence

² Source: Health For All (HFA) in World Health Organization (2007). Making Pregnancy Safer. Georgia Country Profile.

COUNTRY ECONOMIC INDICATORS, 2002–2006

Item	2002	2003	2004	2005	2006
A. Income and Growth					
1. GNI per Capita (Atlas method, current \$)	730	860	1,050	1,300	1,560
2. GDP Growth (% , in previous year=100)	5.5	11.1	5.9	9.6	9.4
B. Saving and Investment (current and market prices, % of GDP)					
1. Gross Capital Formation	25.5	27.7	28.3	28.6	28.0
2. Gross National Saving	19.3	18.3	21.5	17.8	13.0
C. Money and Inflation (annual change)					
1. Consumer Price Index (average annual % change)	5.6	4.8	5.7	8.2	9.0
2. Reserve Money	9.9	13.9	44.3	19.7	19.2
3. Broad Money (M3)	18	22.7	42.6	26.4	39.3
D. Government Finance (% of GDP)					
1. Revenue (including grants)	16.7	16.2	22.0	23.4	26.7
2. Expenditure and Onlending	17.8	17.5	19.7	25.0	28.7
3. Overall Fiscal Balance (cash basis)	(1.0)	(1.6)	(0.3)	(2.5)	(2.2)
E. Balance of Payments					
1. Merchandise Trade Balance (% of GDP)	(14.4)	(16.0)	(17.7)	(18.9)	(26.0)
2. Current Account Balance (% of GDP)	(6.2)	(9.4)	(6.7)	(10.8)	(14.9)
3. Merchandise Exports (\$) Growth, annual % change	9.0	37.4	37.9	32.8	11.5
4. Merchandise Imports (\$) Growth, annual % change	2.0	33.1	39.2	32.5	38.7
F. External Payments Indicators					
1. Official reserve assets (\$ million)	202	196	387	479	931
in Months of Current Year's Imports of Goods	1.70	1.30	1.89	1.77	2.56
2. External Debt Service Ratio (% of exports of goods and services)	23.4	12.6	11.6	7.2	6.7
3. External Public and Publicly Guaranteed Debt (% of GDP)	53.3	46.4	35.7	27.0	21.8
G. Memorandum items					
1. GDP (GEL million)	7456	8564	9824	11621	13784
2. Exchange Rate (end of period)	2.09	2.075	1.825	1.7925	1.7135
3. Population (million)	4.6	4.6	4.5	4.5	

() = negative, GDP = gross domestic product, GNI = gross national income.

Sources: Government of Georgia, International Monetary Fund, World Bank, and Asian Development Bank estimates.

SUMMARY OF RECENT ECONOMIC DEVELOPMENTS

1. **Background.** Georgia's economic growth has gone through several phases since independence: transition recession (1991–1994), stabilization and structural reforms (1995–1996), uneven growth with deteriorating policy environment (1997–2003), and growth with improving policy environment (2004 to date). The structure of the Gross Domestic Product has also changed significantly since transition, with the share of services rising above 60% of GDP (Table A3.1), reversal of the downtrend in industry's share that followed the breakup of the Soviet Union, and a continuing decline in the share of agriculture. This appendix discusses recent trends in growth and the underlying factors.

Table A3.1. GDP Structure and Growth Rate, by Sector

Sector	Average		
	1997–1999	2000–2003	2004–2006
GDP Growth (annual %, 1996 = 100)	5.4	5.9	8.9
Agriculture			
Value Added (% of nominal GDP)	26.2	20.0	14.2
Value Added (annual % growth, 1996 prices)	1.4	1.3	(1.8)
Contribution to Real GDP growth	0.4	1.2	0.6
Industry			
Value Added (% of nominal GDP)	21.7	22.1	23.2
Value Added, (annual % growth, 1996 prices)	3.5	8.4	13.0
Contribution to Real GDP Growth	0.8	1.8	2.7
Services			
Value Added (% of nominal GDP)	52.1	57.9	62.6
Value Added (annual % growth, 1996 prices)	9.4	7.0	11.4
Contribution to Real GDP growth	4.2	2.9	5.6

() = negative, GDP = gross domestic product.

Source: Government of Georgia, Department of Statistics, staff estimates.

2. **Factors Driving Recent Growth Acceleration.** Since 2004, growth has accelerated. Georgia's economy grew by 12.4% year on year in H1 2007, and is expected to post full-year GDP growth of 12.0%, outpacing the annual average growth in 2004–2006. The sectors that have made the largest contribution to growth are (i) services, led by trade (16% year on year), transport (19.8%), and financial intermediation (26.1%); and (ii) industry, led by manufacturing (14.1%) and mining (15.0%). The construction and commissioning of an oil and gas pipeline has been an important factor driving growth. While this was reflected initially in the expansion of construction sector activity, after pipeline commissioning it resulted in higher exports of services. An increase in other oil transit activities, i.e., Georgian railways carrying Azeri oil to the Black Sea coast, has also contributed to growth. The agriculture sector showed signs of recovery in the second quarter of 2007 from the slump in 2006. The sector is less significant in terms of contribution to growth (agriculture's share in value added is dwindling) than food prices.

3. Domestic demand has been the main driver of growth expenditure growth, underpinned by a consumption boom and strong investment activity. Rising real wages and remittance inflows support consumption growth. Investment has been buoyed by foreign direct investment (FDI). Net FDI, including privatization receipts, has risen from \$163 million in 2002 to \$1,094 million in 2006 and are expected to reach \$2 billion in 2007. Attracted by the improved business environment, FDI is now extending beyond pipeline-related activity to more subsectors, including banking, tourism, and manufacturing. FDI inflows have had a strong reciprocal effect on the economy, promoting higher productivity and industry restructuring. However, they have

made macroeconomic management more challenging (para. 4). The increasing negative contribution of net exports to GDP growth, reflected in the widening saving–investment gap, has been largely covered by FDI.

4. **Management of Domestic Demand.** In an environment of strong foreign exchange inflows, the task of managing domestic demand using a consistent macroeconomic policy mix is especially challenging. In addition to price stability, the National Bank of Georgia (NBG) aims at maintaining the purchasing power of the national currency. NBG does not directly target inflation, but it does target reserve money, an intermediate policy instrument. It also intervenes in the foreign exchange market to smooth fluctuations, using unsterilized and sterilized interventions. The authorities recognize that the scope for sterilized interventions is limited, because the financial markets are shallow and interest costs of sterilized interventions could be high.

5. As foreign exchange inflows began to surge in 2004, NBG responded by intervening in the foreign exchange market to limit appreciation of the lari. The nominal exchange rate of the lari against the US dollar appreciated by 1.8% in 2005 and 3.5% in 2006, while the real effective exchange rate (REER) based on Georgia's trade with its 12 major partners appreciated by 3% in 2005 and 0.09% in 2006. However, the nominal effective exchange rate had depreciated by 2.8% year on year as of November 2007, and the REER depreciated marginally by 0.7%. The International Monetary Fund (IMF) has suggested that the slowing export growth and the rising current account deficit indicate that the real exchange rate may be overvalued.¹ Inflation has trended upward, reaching 11.6% year on year in November 2007. The recent introduction of two new monetary policy instruments—certificates of deposit and securitized government debt—is expected to pave the way for some flexible liquidity management. However, given the limitations in using monetary policy instruments to contain inflation in Georgia (shallow financial markets and high interest costs of sterilized interventions), the onus is on fiscal policy. Fiscal tightening can help alleviate the problem of excess liquidity, but this is predicated on resisting pressures for higher public spending in an environment where revenue collections are increasingly significantly and there are pressing needs for raising social sector and infrastructure spending (para. 7).

6. **Creation and Allocation of Fiscal Space.** Major fiscal reforms on the revenue and expenditure side in the past 3 years have made Georgia's public finances more sustainable. Reforms in tax policy and tax administration have been mutually reinforcing, resulting in a significant upward trend in the revenue-to-GDP ratio from 15.8% in 2002 to an estimated 28% in 2007.

7. The increasing share of revenue to GDP has created the fiscal space for priority public spending. This has been reinforced by expenditure reforms that have significantly raised the efficiency and effectiveness of public spending. At the same time, the expenditure-to-GDP ratio has risen from 17.8% in 2002 to 28.7% in 2007. The higher spending has improved the provision of public goods. Further, with its focus on infrastructure development and social sectors, public spending supports medium-term growth. However, higher public spending has also raised domestic demand and inflationary pressures. The challenge for the authorities is to balance (i) the need for adequate provision of public goods that support growth, and (ii) fiscal prudence essential for managing capital inflows in a non-inflationary manner and for generating higher national saving.

¹ International Monetary Fund (2007). *Georgia: Sixth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility*. August. Country Report 07/299. Washington D.C.

8. Debt burden indicators have improved since 2003. The debt-reducing factors include the effect of higher GDP growth on the debt–GDP ratio, debt reduction operations, and a conservative external borrowing strategy. Total government debt has fallen from 59.7% of GDP in 2003 to an estimated 25% in 2007, while public and publicly guaranteed external debt has declined from 45% of GDP to 21.8% of GDP (2006 figures). Public and publicly guaranteed debt accounted for 88% of total gross external debt in 2005. The authorities’ external borrowing strategy is conservative. An IMF–World Bank assessment of Georgia’s debt sustainability² found that the country is only at moderate risk of debt distress and accordingly has been classified as a “green light” country under the IMF–World Bank debt sustainability framework. Stress tests for worst-case scenarios, however, indicated vulnerability to adverse shocks to exports and GDP growth that could lead to deteriorating debt sustainability.

2. **Structural Reforms to Stimulate Productivity Growth and Competitiveness.** To increase resilience to shocks and enhance productivity growth and competitiveness, the Georgian authorities have been pursuing structural reforms on a number of fronts, including enterprise, business regulatory, and institutional reforms; trade liberalization; and reform in the finance sector, infrastructure and utilities, and public sector management. Evidence is strong³, that these reforms have transformed the investment climate, but areas of reform backlog remain. The latest Global Competitiveness Index 2007–2008⁴ highlighted Georgia’s reduced regulatory burden and educated labor force as sources of competitive advantage. Among the sources of competitive disadvantage are financing constraints, particularly for small enterprises; limited financial market sophistication; and small market size (foreign and domestic).

9. Structural reforms are resulting in the restructuring and/or exit of old, inefficient, state-owned firms and the entry of new firms in the private sector. One study found that in 2006 the firm exit rate was 10.4%, while the entry rate was 8.4%.⁵ An ongoing process of intensive enterprise restructuring is raising productivity growth, with the labor productivity of expanding firms significantly above the median.

10. **Boosting Net Job Creation Through Encouraging Small Enterprises.** While enterprise restructuring is raising productivity growth, the high rate of job turnover associated with this process is generating frictional and structural unemployment. The unemployment rate in 2006 was 13.6%. Unemployment rates are highest in Tbilisi, almost twice the nationwide rate. Recent estimates of rural underemployment are not available, but are likely to be high as indicated by the high rates of self-employment in agriculture. The relatively high rates of urban unemployment and of rural underemployment contribute to the persistence of poverty. Net job creation rates have been found to be highest in small private firms, as the large privatized enterprises are downsizing and shedding labor. However, privatized large enterprises still dominate output and employment. Greater focus is needed on creating an enabling environment for the development of small firms to boost net new job creation. This calls for addressing the constraints that such enterprises face. For example, small- and medium-sized enterprises face bigger hurdles in accessing finance than larger firms. In addition to strengthening the institutional environment, the access of such enterprises to capital also can be improved by (i) diversifying financial services offered, (ii) broadening the types of collateral that can be accepted by banks, (iii) reducing costs associated with evaluation of credit information, and (iv) establishing effective systems for enforcing repayment.

² <http://siteresources.worldbank.org/INTDEBTDEPT/Resources/DSAFY07Georgia.pdf>

³ World Bank. 2006. *Anticorruption in Transition 3: Who Is Succeeding and Why?* Washington, DC. World Bank. 2007. *Doing Business 2008*. Washington, DC.

⁴ World Economic Forum (2007). *Global Competitiveness Report 2007-2008*.

⁵ Rutkowski, Jan. 2007. *Labor Market in Georgia: Lack of Jobs or Structural Mismatches?* Washington DC.

11. **Prospects for Sustained Strong Growth.** Georgia has good prospects for sustaining strong growth (above 7%) over the medium term by exploiting its competitive advantages, including its transit economy potential, and overcoming some vulnerabilities, such as susceptibility to exports shocks. A key challenge is to expand high value-added activities in agriculture and the rural economy and to expand job opportunities for skilled labor in urban areas. Continued adherence to prudent macroeconomic policies, together with delivering on reform commitments, should ease competitiveness concerns, raise the rate of net job creation, and keep the economy on a high-growth trajectory.

**COUNTRY COST-SHARING CEILING AND OTHER FINANCING PARAMETERS
(2008–2009)**

Item	Parameter	Explanation
Cost-sharing ceiling for loans, 2008–2009	Up to 99%	Proposed projects have been aligned with national priorities, ensuring Government commitment and ownership. The 99% country cost-sharing ceiling will be applied selectively considering the context for the project. Counterpart funding will be encouraged, to promote ownership, particularly in projects where the executing agencies have their own sources of revenue generation. ADB will also seek cofinancing with other development partners. Types of projects that may be financed close to the 99% ceiling include renewable energy projects, community-driven initiatives, and governance capacity building.
Cost-sharing ceiling for TA for 2008–2009	Up to 99%	The Government will be encouraged to meet the in-kind costs associated with TA assistance.
Recurrent cost financing	No country limits	Although no country limit has been set for recurrent cost financing, such financing is not expected to be significant. It will only be considered in individual cases after a careful consideration of sustainability issues at the sector and project levels, including implied future outlays.
Taxes and duties	None	Taxes and duties are considered reasonable and nondiscriminatory. ADB may finance taxes and duties associated with project expenditures, taking into account whether the taxes and duties account for an excessively high share of project costs.

TA = Technical Assistance.

ACTIVITIES OF OTHER DEVELOPMENT PARTNERS

Sector/ Thematic Area	ACTIVITIES
Agriculture and Natural Resources	<p>World Bank: Rural development, forest development, irrigation and drainage community development, agricultural research, extension and training</p> <p>UNDP: Capacity Building for the Ministry of Environment of Georgia; Regional Partnership for Prevention of Transboundary Degradation of the Kura-Aras River Basin, Recovery, Conservation and Sustainable Use of Georgia's Agro-Biodiversity</p> <p>USAID: Support for agricultural policy reform</p> <p>MCC: Support for agribusiness development activity</p>
Education	<p>World Bank: Support for education system realignment and strengthening</p> <p>European Commission through TEMPUS/TACIS: Higher Education Cooperation Program</p> <p>UNICEF: Support to increase access to and quality of maternal and child health and nutrition services; and improved protection for the most vulnerable children and young people from violence, abuse, and exploitation</p>
Energy	<p>World Bank: Small hydropower rehabilitation, energy transit institution building, and electricity market support</p> <p>UNDP: Renewable energy resources for local energy supply</p> <p>EBRD: Baku–Tbilisi–Ceyhan Oil Pipeline; Enguri Hydropower Plant Rehabilitation; Georgian State Electrosystem; South Caucasus Gas Pipeline</p> <p>MCC: Rehabilitation of the North–South Gas Pipeline, and implementation of Georgia's Energy Sector Strategy</p> <p>German development cooperation through KfW: Rehabilitation of power transmission, debt restructuring in the electricity sector, transmission line Tbilisi–Alaverdi (Armenia), promotion of renewable energy, rehabilitation of the electricity distribution system</p> <p>European Commission: Improve the accountability of gas transit, and address issues of pipeline network security</p>
Governance and Public Sector Management	<p>World Bank: Public Sector Financial Management Reform Support Project. Note: Pooled funding is arranged to support this project, with the World Bank, DFID, and the governments of Netherlands and Sweden contributing funds.</p> <p>DFID: Support civil society public policy reform and reform of civil registration</p> <p>UNDP: Public Service Bureau, strengthen transparency and effectiveness of the parliament, national human rights education and information dissemination strategy, protection and promotion of human rights, capacity within the public defender's office</p> <p>EU Tacis: Institutional, legal, and administrative reform in the areas of rule of law, PCA implementation, and institutional capacity building in tax and customs administration</p> <p>German development cooperation GTZ: Support legal and justice reform and Georgian Chamber of Control</p> <p>USAID: Reform national governance; empower communities for local decision making; improve justice sector, strengthen parliament project; strengthen political parties; improve tax and customs administration systems; business climate reform</p>

<p style="writing-mode: vertical-rl; transform: rotate(180deg);">Health, Nutrition, and Social Protection</p>	<p>World Bank: Avian Influenza Control and Human Pandemic Preparedness and Response; Primary Health Care Development; Social Investment Fund</p> <p>UNDP: Prevent the spread of HIV/AIDS</p> <p>EU Tacis: Addressing the social consequences of transition, with a focus on primary health care, social assistance, and child welfare reform</p> <p>German development cooperation through KfW: Support fight against tuberculosis</p> <p>United Kingdom (DFID): Support primary health care, building capacity in key ministry departments and associate structures, support to health and social policy development</p> <p>USAID Increase immunizations (health sector); support for promoting women’s health program (reproductive health); strengthen health systems (health sector)</p>
<p style="writing-mode: vertical-rl; transform: rotate(180deg);">Infrastructure/ Transportation (Roads and Highways)</p>	<p>World Bank: First East-West Highway Improvement, Secondary and Local Roads</p> <p>EBRD: Tbilisi International Airport, modernization of equipment and systems at Batumi Airport, Poti Port, Trans-Caucasian Rail Link, Tbilisi Public Transport</p> <p>MCC: Samtskhe–Javakheti Road Rehabilitation, Regional Infrastructure Development Activity</p> <p>EU Tacis: Transport Cooperation Program</p> <p>German development cooperation through KfW: National Park Borjomi-Kharagauli, rehabilitation of municipal infrastructure, rehabilitation works in the water supply systems of the municipalities bordering the Borjomi National Park, rehabilitation of communal infrastructure in Batumi, rehabilitation of water supply and sewerage systems in Batumi</p> <p>German development cooperation GTZ: Ongoing project in the Frame of the Caucasus Initiative of BMZ: Cities’ Network Caucasussupporting municipal infrastructure and public services; strengthen NGOs and intensify their cooperation with the population</p>
<p style="writing-mode: vertical-rl; transform: rotate(180deg);">Municipal Development</p>	<p>World Bank: Second Municipal Development and Decentralization; Social Investment Fund</p> <p>German development cooperation GTZ: Fund to support civil society and municipal democracy</p> <p>EBRD: Poti Water Supply Project; Tbilisi Public Transport Project</p> <p>USAID: Cities’ Network Caucasus supporting municipal infrastructure and public services; strengthen NGOs and intensify their cooperation with the population.</p>
<p style="writing-mode: vertical-rl; transform: rotate(180deg);">Poverty Reduction</p>	<p>World Bank: Poverty reduction support operations</p> <p>UNDP: Implementation of the Economic Development and Poverty Reduction Program of Georgia; Integrated Employment Generation; SME Development Program</p>

Private and Finance Sector Development	<p>EBRD: SME credit line, equity investment and syndicated loans and mortgage loan to banks, support for financial sector strategy</p> <p>IFC: Georgia Corporate Governance Project, business enabling environment</p> <p>KfW: Equity Participation Credit Guarantee Fund for SMEs</p> <p>USAID: Small- and medium-sized enterprise growth: (ii) increasing access to credit, (iii) developing land market, (iv) increasing agribusiness productivity, (v) promoting Georgian exports, and (vi) economic livelihood and local economic development</p> <p>UNDP: Modernization of Financial System of Georgia (First Phase and Second Phase)</p> <p>MCC: Georgia Regional Development Fund activity</p>
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BMZ = Federal Ministry for Economic Cooperation and Development; DFID = Department for International Development; EBRD = European Bank for Reconstruction and Development; EU = European Union; GTZ = Deutsche Gesellschaft für Technische Zusammenarbeit; IFC = International Finance Corporation; KfW = Kreditanstalt für Wiederaufbau; MCC = Millennium Challenge Corporation; NGO = non governmental organization; SME = small and medium enterprise; TACIS = Technical Aid to the Commonwealth of Independent States; TEMPUS = Trans European Mobility Programme for University Studies; UNDP = United Nations Development Programme; UNICEF = United Nations Children's Fund; USAID = United States Agency for International Development