Georgia diagnostic

This report, based on the EBRD-EIB Georgia diagnostic, was prepared by Dimitar Bogov, Ana Kresic and Lia Alscher, with significant contributions from EBRD colleagues.

All assessments and data are based on information as of late August 2021.

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This report was prepared by Dimitar Bogov, Ana Kresic and Lia Alscher, with contributions from Oleksandr Pavlyuk, Hester Coutanche, Christine Hagedorn, Giuseppe Grimaldi, Keti Sandroshvili, Damin Chung, Konstantine Kintsurashvili, Federica Foiadelli, Meryem Uyar, Marko Stermsek, Ines De la Pena, Idil Bilgic-Alpaslan, Marcel Schlobach, Jinrui Liu, Polyxeni Pentidou, Borbala Siklos, Florian Lalanne and George Welton, with feedback, comments and additional input from other colleagues. It is based on the EBRD-EIB Georgia diagnostic.

The report benefited from the work of the winners of the 2020 EBRD in Georgia student challenge – Archil Chapichadze, Gocha Kardava and Nino Sarishvili from the International School of Economics at Tbilisi State University – on the main obstacles to the development of agriculture in Georgia, as well as that of runners up Nino Siradze and Nino Shanidze from the Caucasus University and Ani Kheladze from the Free University of Tbilisi.

Country diagnostics are an EBRD tool for identifying the main obstacles to entrepreneurship and private-sector development and shaping the Bank's strategic priorities and project selection for new country strategies. Each diagnostic informs the EBRD's policy engagement with the authorities in that country.

Country diagnostics assess the progress and challenges of developing a sustainable market economy in the economies where the EBRD invests. Private-sector development and entrepreneurship are at the heart of the Bank's mandate in the regions where it operates, but the private sector faces a range of problems and obstacles in all of the economies where it invests. The diagnostic identifies the key challenges facing private companies and shows where each country stands with regard to its peers in terms of the Bank's six qualities of transition – competitive, well-governed, resilient, integrated, green and inclusive – as well as the main deficiencies and gaps in each.

The diagnostics draw on a range of methodologies and best practices for assessing how big certain obstacles are. Extensive use is made of in-house expertise across the EBRD, along with surveys such as the Business Environment and Enterprise Performance Survey (BEEPS) and the Life in Transition Survey (LiTS), other cross-country surveys and reports from institutions such as the World Bank, World Economic Forum and Organisation for Economic Co-operation and Development (OECD). For some larger countries, the diagnostics also draw on specially commissioned studies of selected issues that are critical to private-sector development in the country.

The country diagnostics are led by the EBRD's Country Economics and Policy team. They draw substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and involve wide consultation with experts across the EBRD in preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

The views expressed in the diagnostic papers are those of the authors only and not of the EBRD or its members.

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Glossary of key terms

AA	Association Agreement
ATQ	Assessment of Transition Qualities
BEEPS	Business Environment and Enterprise Performance Survey
CAGR	Compound annual growth rate
CGS	Credit guarantee scheme
CIS	Commonwealth of Independent States
DCFTA	Deep and Comprehensive Free Trade Area
EBRD	European Bank for Reconstruction and Development
EEC	Eastern Europe and the Caucasus
EIB	European Investment Bank
ESCO	Electricity system commercial operator
EU	European Union
EUR	Euro
EPG	Economics, Policy and Governance (EBRD)
FDI	Foreign direct investment
FX	Foreign exchange
GCI	Global Competitiveness Index
GCR	Global Competitiveness Report
GDP	Gross domestic product
GEL	Georgian lari
GHG	Greenhouse gas
GII	Global Innovation Index
GNERC	Georgian National Energy and Water Supply Regulatory Commission
GSE	Georgian Stock Exchange
GSP	Generalised Scheme of Preferences
GVA	Gross value added
GVC	Global value chain
HPP	Hydroelectric power plant
IFI	International financial institution
IMF	International Monetary Fund
LiTS	Life in Transition Survey
LLC	Limited liability company
LPI	Logistics Performance Index
LSE	London Stock Exchange
MFN	Most favoured nation
MSME	Micro-, small and medium-sized enterprise
NBG	National Bank of Georgia
NEAP-3	Third National Environmental Action Programme of Georgia
NEET	Not in education, employment or training
NDC	Nationally Determined Contribution
NPL	Non-performing loan
NRI	Network Readiness Index
OECD	Organisation for Economic Co-operation and Development
PIACC	Programme for the International Assessment of Adult Competencies
PISA	Programme for International Student Assessment
PPP	Purchasing power parity
SIGMA	Support for Improvement in Governance and Management
SME	Small and medium-sized enterprise
SOE	State-owned enterprise
SSO	Sectoral skills organisation
TANAP	Trans-Anatolian Gas Pipeline
TAP	Trans-Adriatic Pipeline
TFC	Total final consumption
TIMSS	Trends in international mathematics and science
TIBR	Tbilisi Inter-Bank Rate
TPES	Total primary energy supply
TPP	Thermal power plant
TVET	Technical and vocational education and training
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States of America
WEF	World Economic Forum
WGI	Worldwide Governance Indicators
WJP	World Justice Project
WPP	Wind power plant

1. Executive summary

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Georgia has pursued wide-ranging reforms, underpinned by its European aspirations and, more recently, its commitment to implementing its Association Agreement with the European Union (EU). While these reforms have slowed significantly in recent years, they have transformed the Georgian state and economy, lifting its potential growth rate and improving its standard of living. With gross domestic product (GDP) per capita still considerably below that of the EU, strong private sector-led economic expansion remains paramount to bring the economy in line with that of its European neighbours. The Covid-19 pandemic has underscored the need to reinvigorate the structural reform agenda, as Georgia's overreliance on a buoyant hospitality sector, the main driver of its robust economic growth in recent years, became a key source of vulnerability. To advance its economic convergence with the EU economies, Georgia needs to address the following private-sector constraints:

- Despite widely recognised successes over the past 15 years, the transformation and application of Georgia's public-sector governance framework has been uneven and remains incomplete, emphasising the need to keep **governance** standards high on the reform agenda. Political volatility is the most widely identified business challenge influencing immediate investment decisions, as well as the country's long-term reform progress. Strengthening judicial independence, accountability and capacity and increasing the efficiency of the court system are key to improving Georgia's investment climate. Weaknesses in its public administration, public procurement and corporate governance standards should be addressed too, also by introducing further digital solutions.
- The skills of the labour force increasingly fail to match the evolving needs of businesses and are becoming one of the most pressing obstacles to private-sector **competitiveness**. Improving the skills of the workforce requires tackling weaknesses in the education system and eliminating skills mismatches, including by strengthening national technical and vocational education and training (TVET) and advancing digital skills. Georgia's productivity growth would also be boosted by addressing persistent **inclusion** issues, such as gender disparities and territorial imbalances.
- Because of the small and open nature of the Georgian economy, the continued pursuit of **integration** with global markets through export-driven growth and the diversification of exports to higher value-added goods are the fastest route to greater prosperity. Fully utilising the opportunities presented by the Deep and Comprehensive Free Trade Area (DCFTA) with the EU, Moldova and Ukraine requires addressing a number of challenges. Foreign investment could facilitate the penetration of European and other markets if the declining trend in greenfield investments can be reversed. Advancing logistics and infrastructure, both physical and digital, remains crucial to boosting Georgia's external competitiveness.
- Better access to finance would improve the **resilience** and competitiveness of Georgian companies, especially small and medium-sized enterprises (SMEs). The banking sector is well managed and regulated, comfortably capitalised, consistently profitable and relatively efficient in channelling credit to the real sector. However, dollarisation is traditionally high, making the banking sector susceptible to economic crisis and transferring foreign-exchange risk to credit risk. Micro-, small and medium-sized enterprises (MSMEs), particularly those in the regions, face difficulties in accessing financing, while underdeveloped local capital markets are limiting corporate growth.
- Traditionally one of the largest recipients of foreign investment thanks to consistent regulatory and policy transformation, Georgia's energy sector plays a prominent role in the economy. More recently, reforms have been focused on harmonisation with EU regulation, including the country's ongoing power-market liberalisation. However, ensuring a free and competitive electricity market is at odds with the growing role of gas in the economy and the preferential conditions conferred on the sector, as this distorts the market for other types of electricity. This is a particular constraint on renewable energy sources other than hydropower, which are nearly non-existent despite the country's vast potential. Clarifying the regulatory framework for renewables, in particular non-hydro technologies, would be conducive to further investment. The focus should be on advancing the **green** transition in a decisive manner, as Georgia is in a prime position to take advantage of the long-term business opportunities offered by decarbonisation.

2. Political economy

2. Political economy

Georgia has European ambitions, but suffers from political polarisation and geopolitical challenges

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Georgia has pursued wide-ranging political and economic reforms over the years, aimed at transforming the country into a modern European state. Its reform agenda is underpinned by its commitment to implementing its Association Agreement with the EU, including the DCFTA, which took full effect in July 2016. A visa-free regime for short-term stays by Georgian citizens in the Schengen area was established in March 2017. Political association and economic integration with the EU enjoy broad public support (up to 80 per cent of the population, according to surveys by the National Democratic Institute.

Despite progress on implementing the Association Agreement and reforms, major challenges remain, particularly with regard to the rule of law and justice-sector reform. Georgia is the highest-scoring country in eastern Europe and the Caucasus on transparency, ranking 45th out of 180 countries in the 2020 Corruption Perceptions Index (Transparency International, 2021). Nevertheless, allegations of high-level corruption persist and anti-corruption efforts are seen as having stagnated. Strengthening the independence, transparency and accountability of the judiciary is a significant outstanding task in the development of Georgia's democratic institutions, improving the business and investment climate and ensuring sustainable economic growth. The government needs to re-energise reforms to deliver the economic and social improvements people want.

Following the adoption of constitutional amendments in 2017-18, Georgia has completed the evolution of its political system towards a parliamentary model. The powers of the president have become largely representative and, as of 2023, the president will be elected by parliament. Under the new system, the government holds the executive power to implement Georgia's domestic and foreign policy. Parliament is the overarching representative body that defines policy direction and holds the government to account.

Georgia's reform and development efforts are suffering amid polarised and personalised politics, which often fuel political volatility. The last, disputed parliamentary elections in October-November 2020 triggered a six-month political stalemate that risked undermining the country's democracy and stability. A compromise agreement (entitled "A way ahead for Georgia") was reached on 19 April 2021 after several rounds of negotiation, mediated by the EU with the support of the United States of America. While the agreement defused immediate political tension, the ruling Georgian Dream party declared it "annulled" three months after signing it, citing the refusal of the opposition United National Movement (UNM) to participate in it (the UNM later signed it). Although certain provisions of the political agreement have been implemented, its annulment has raised the risk of a return to political crisis.

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

3. Overview of economic growth and the private sector

3. Overview of economic growth and the private sector

Georgia needs persistently strong economic growth to catch up with its European peers and increase real incomes

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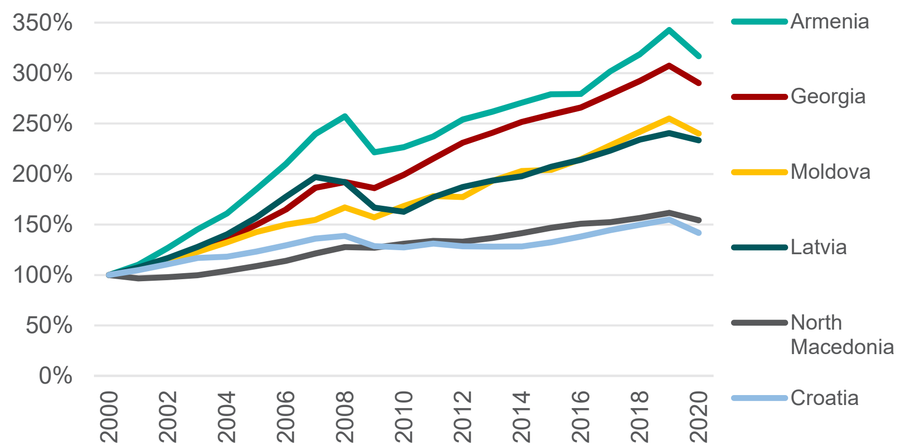
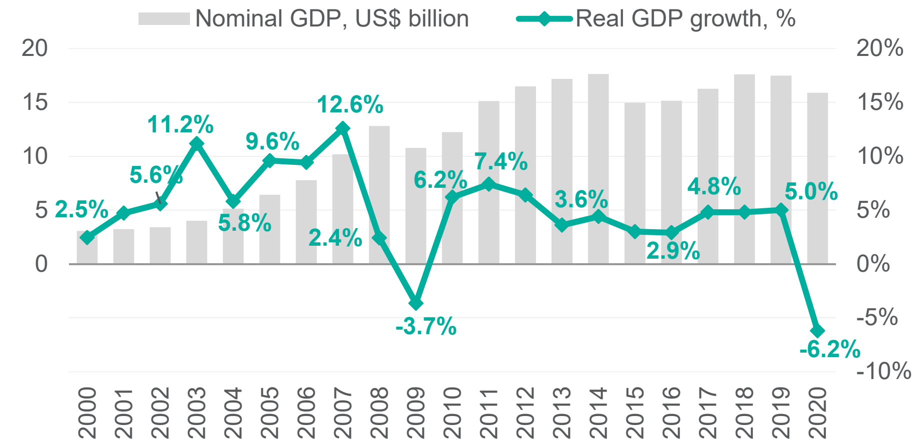
Georgia has seen rapid growth over the past two decades …

Cumulative real GDP growth (%, 2000=100)



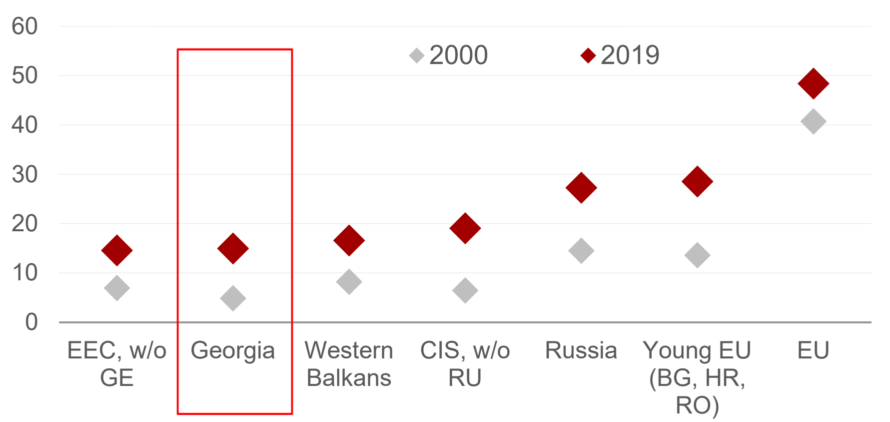
… but it was hit hard by the Covid-19 pandemic in 2020

GDP at current prices



Because of their low base, Georgian real incomes remain at relatively low levels

GDP per capita, US$ 000, constant prices, PPP-adjusted, weighted average



Note: EU excluding Luxembourg, which is an outlier

The Covid-19 pandemic has temporarily stopped the convergence process.

- Strong business environment reform efforts over the past 15 years have lifted the potential growth rate of Georgian economy.
- However, the increased openness of the economy makes it more susceptible to adverse external shocks, such as the global financial crisis in 2008 and the Covid-19 pandemic in 2020. While its openness also puts Georgia in a better position to benefit from the recovery in global demand, the economy's high dependence on tourism adds uncertainty to the speed of its recovery.

Stronger economic growth is needed to close the prosperity gap and rectify regional imbalances.

- Georgia is a small and fast-growing economy hamstrung by its very low level of development at the start of its transition. Despite tripling income per capita since then, it still has much to do to catch up with more advanced economies, such as the EU Member States.

Source: IMF (2021a), National Statistics Office of Georgia, EBRD calculations.

3. Overview of economic growth and the private sector

Georgia's economy and growth model are relatively diversified and service oriented

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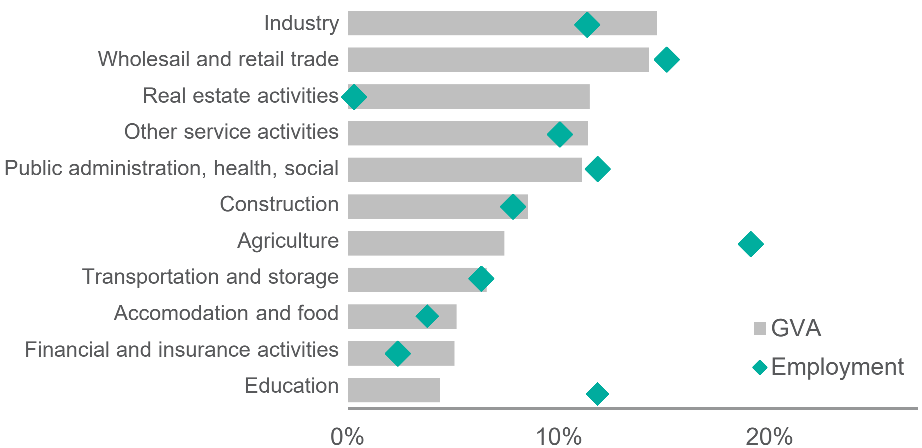
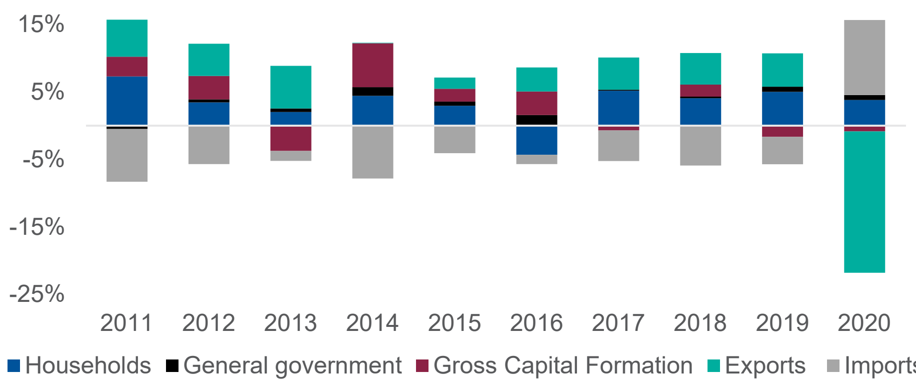
Agriculture's dominant role in employment and modest contribution to value added indicate a high dependence on subsistence farming and a lack of job opportunities

Percentage of total, 2019



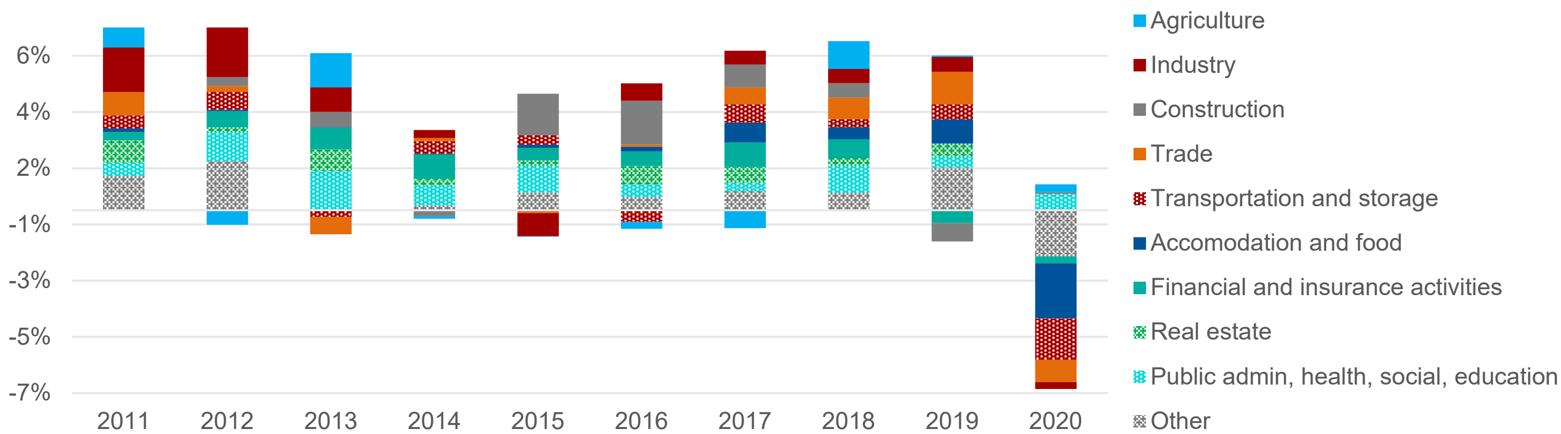
Growth has been relatively balanced, though consumption is growing in importance, largely thanks to rising remittances

Contributions to GDP growth



On the production side, growth is fairly diversified, though the importance of industry has been waning while the contribution of services, including domestic trade, has been on the rise

Contributions to GDP growth



Source: National Statistics Office of Georgia, National Bank of Georgia (NBG), EBRD calculations.

3. Overview of economic growth and the private sector

Dependence on foreign financing reduces Georgia's resilience to adverse shocks

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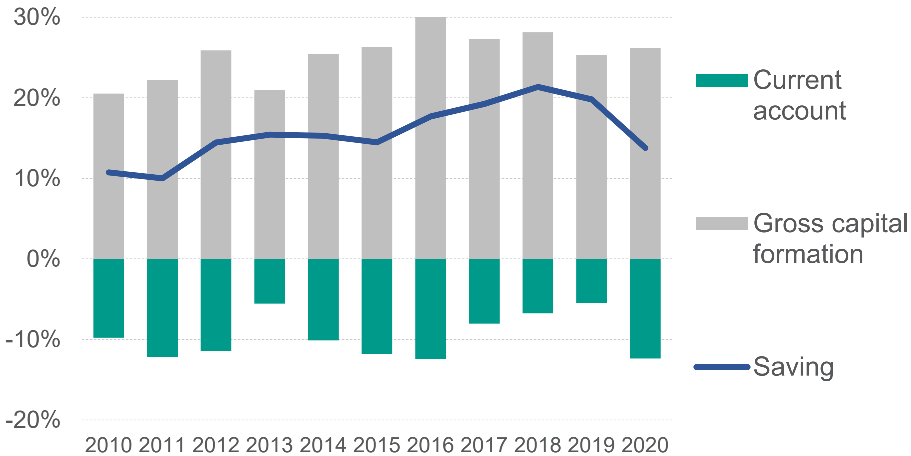
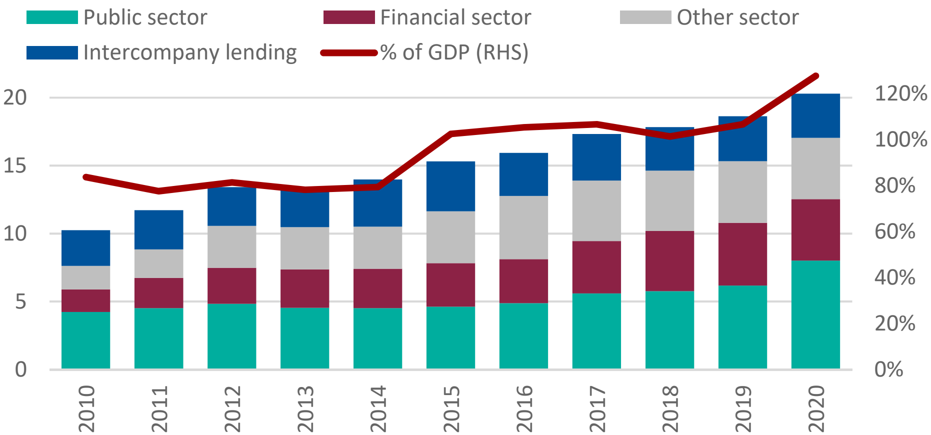
Georgia's rising savings rate has been shrinking its external imbalances and may reduce its reliance on foreign financing for investment

Share of GDP, current prices



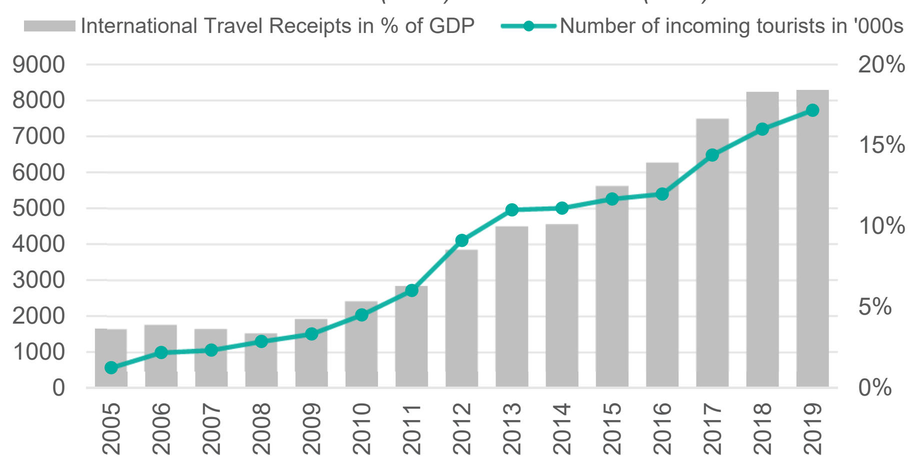
External debt is relatively high and increases with every adverse economic shock

Gross external debt, US$ billion



The number of incoming tourists and tourism revenues as a share of GDP had increased rapidly prior to the Covid-19 crisis

Share of GDP (RHS) and thousands (LHS)



Exchange-rate dynamics reflect the weaknesses of the external sector

Official daily exchange rates, indices (31 December 2012 = 100)
Decline = GEL depreciation

Source: National Statistics Office of Georgia, NBG, World Bank (n.d.), Georgian National Tourism Administration, EBRD calculations

3. Overview of economic growth and the private sector

Strong foreign direct investment (FDI) has underpinned Georgia's rapid economic growth

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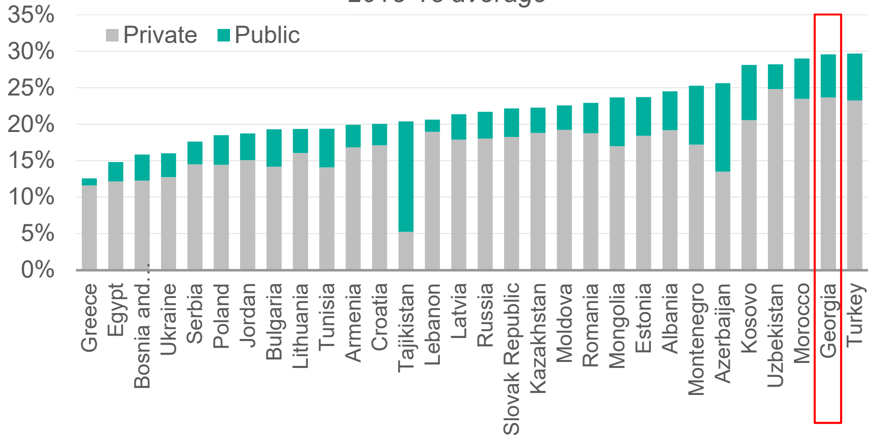
Capital accumulation is at a high level …

Gross fixed capital formation, current prices, percentage of GDP, 2015-18 average

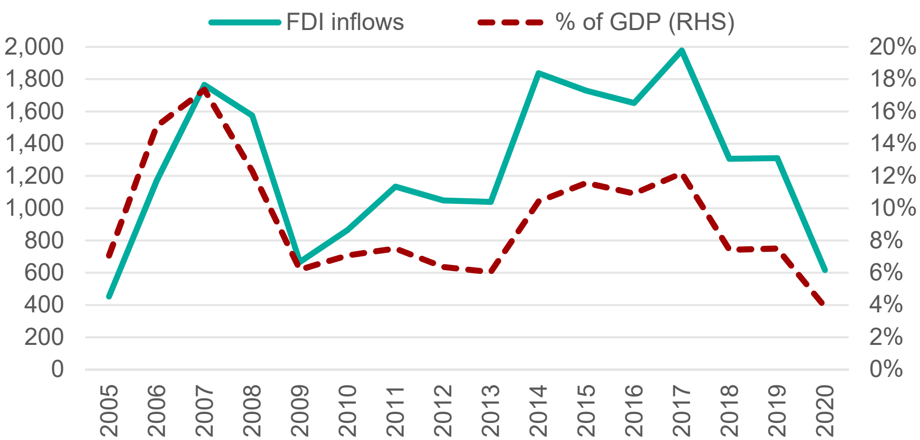


Georgia's high investment rate is largely driven by FDI inflows.

- Georgia investment-to-GDP ratio is one of the highest of the economies in which the EBRD invests. While most investments originate in the private sector, public-sector investment as a share of GDP is also among the highest of its peers.
- FDI inflows as a share of GDP have remained high (6-12 per cent of GDP) for most of the past 12 years, confirming that the business environment is conducive to investment.
- Since Georgia adopted the Estonian corporate tax model in 2017, the composition of FDI has shifted somewhat from new equity investment to reinvested earnings.
- FDI in flows are quite diversified, with most going to higher-value-added sectors, such as transport, communications, finance, energy, manufacturing, construction and real estate.

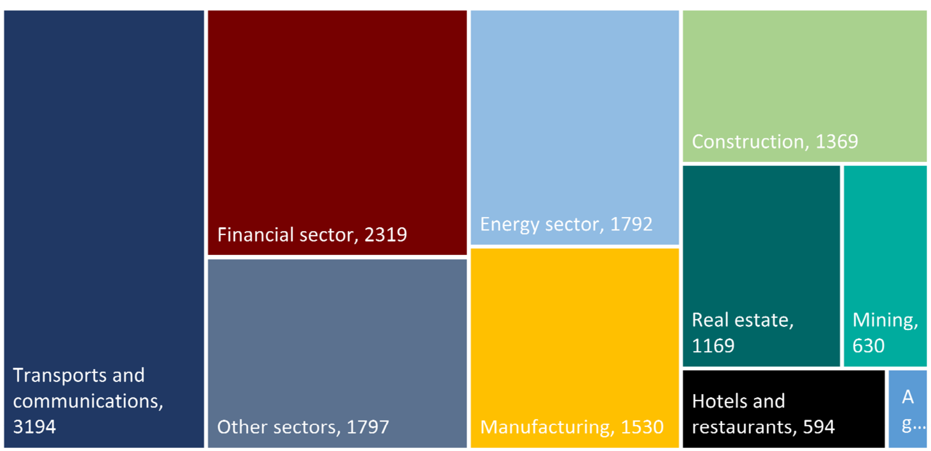
… underpinned by strong FDI as a result of significant improvements in the business environment …

FDI inflows in million US$ (current prices) and as a percentage of GDP



… which is relatively diversified, from energy and pipeline infrastructure to higher value-added sectors

Total FDI inflows by destination from 2010 to 2020 (US$ million)



Source: IMF (2019), National Statistics Office of Georgia, EBRD calculations

3. Overview of economic growth and the private sector

The private sector dominates, characterised by a strong entrepreneurial spirit, but lags when it comes to digitalisation

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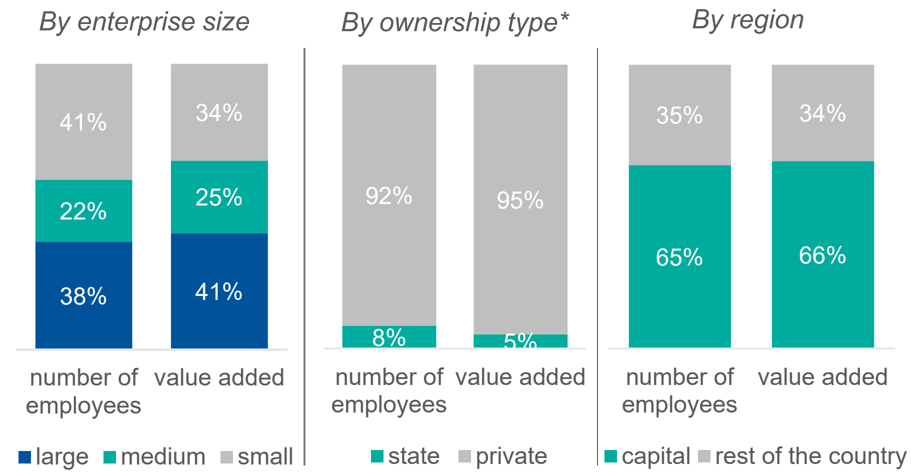
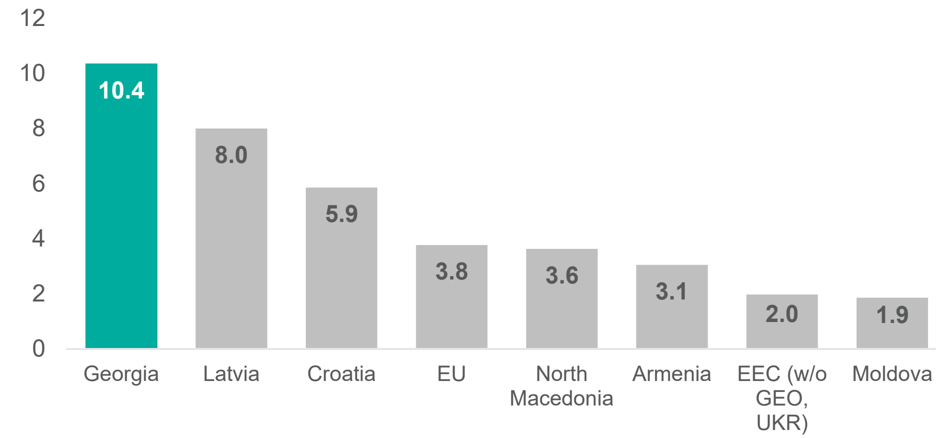
Georgia's economy is dominated by the private sector and its value creation is highly concentrated in the capital, Tbilisi



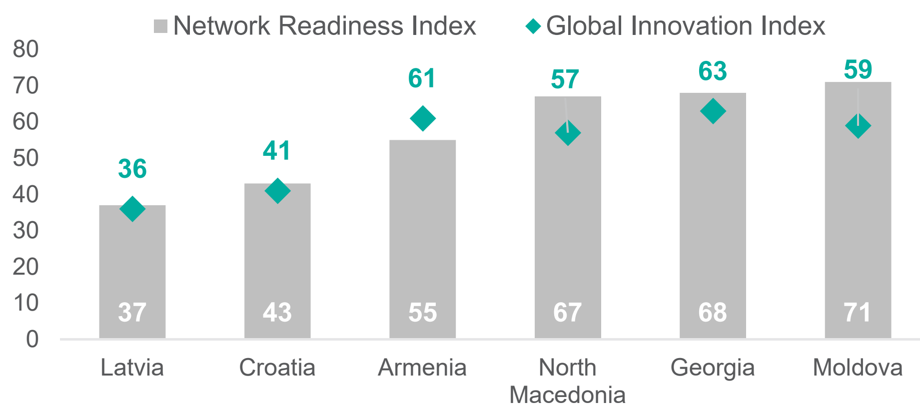
The country's good business environment is matched by a strong entrepreneurial spirit …

Number of newly registered LLCs per 1,000 working-age people, 2018



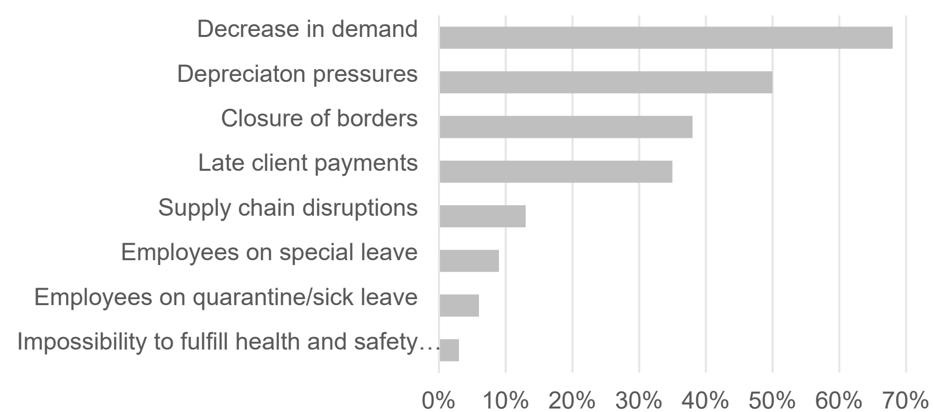
… but it has relatively low digital preparedness and lags on innovation

Rank out of 131 (Network Readiness Index) and 134 (Global Innovation Index) countries, 2020



Companies are facing myriad difficulties due to the pandemic

Share of respondents interviewed for PwC/IC survey, September 2020



Source: Portulans Institute (2020); WIPO (2020); PwC (2020a); National Statistics Office of Georgia; World Development Indicators

**Note: Based on the business survey. According to employment data by ownership, 23 per cent are employed in the public sector (PwC, 2020b).*

4. Obstacles to private-sector development

4.1 Good governance for a better business environment

4.1 Good governance for a better business environment

Governance standards need to remain high on Georgia's reform agenda

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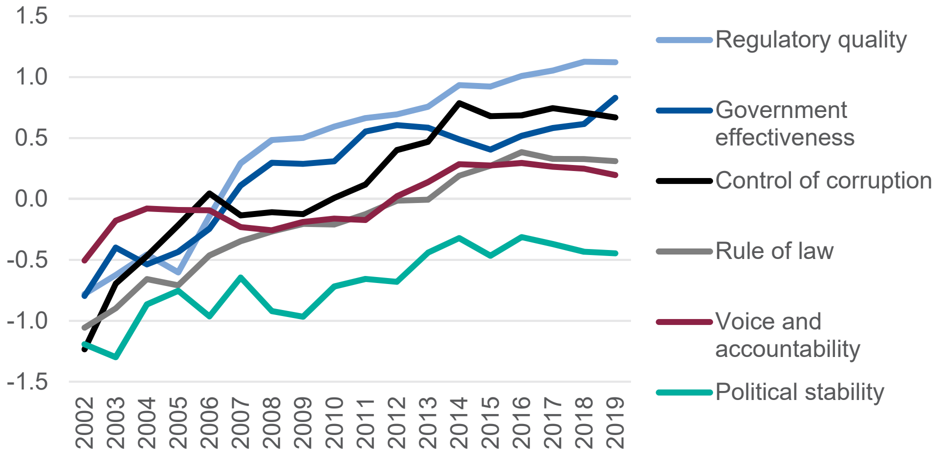
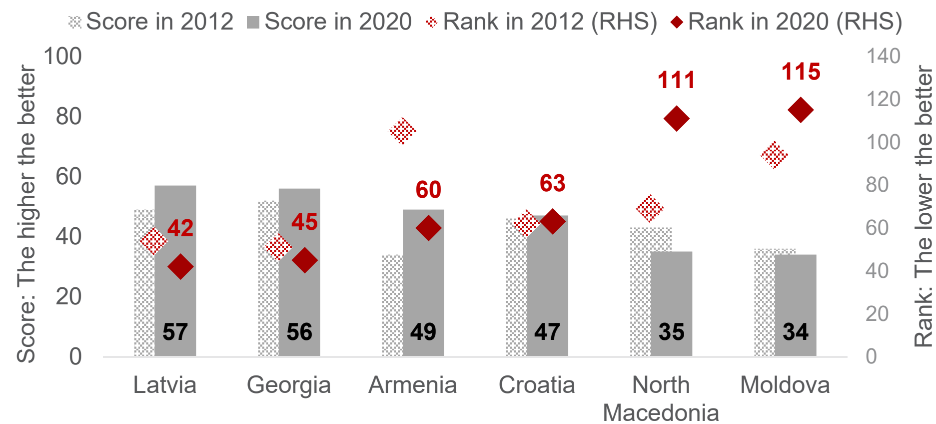
Georgia has launched a series of reforms over the past two decades to improve its public-sector governance

Worldwide Governance Indicators, score [-2.5 (worst) to 2.5]



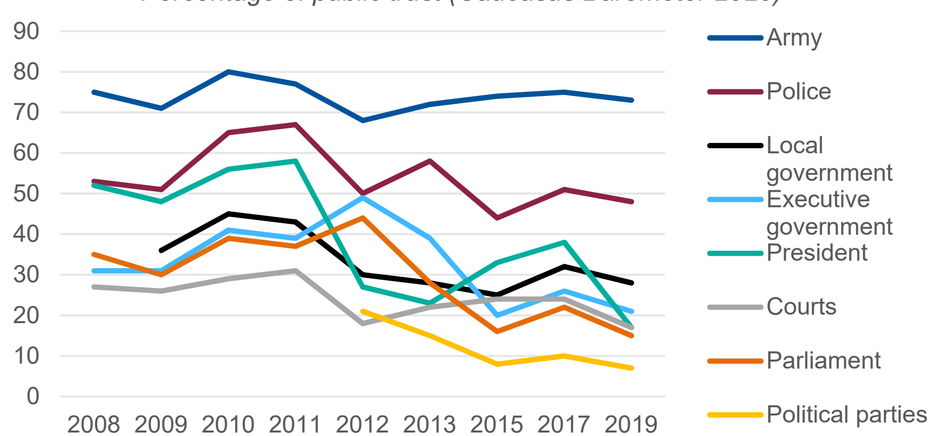
Georgia ranks alongside its regional peers on perception of corruption, though there is room for progress and continued vigilance is needed

Corruption Perceptions Index, scores 1-100, ranking out of 180 countries in 2020 and out of 176 in 2012



Low and declining public trust in most government institutions suggests a need for continued governance reform

Percentage of public trust (Caucasus Barometer 2020)



Georgia has been hailed as a success story and overhauling the regulatory environment is yielding significant economic gains.

- The ambitious reform agenda that started with the Rose Revolution and continued with Georgia's commitment to implementing the EU Association Agreement has resulted in intensive state-building and generated improvements in all dimensions of public governance and the business environment.
- This progress is also reflected in Georgia's scores in the Worldwide Governance Indicators and Corruption Perception Index, especially for regulatory quality, governance effectiveness and control of corruption.

However, significant weaknesses remain in the public governance system.

- These include political instability, accountability in need of strengthening, rule of law challenges, vested interests, institutional capacity and unfinished justice reform. Most recently, the need to improve the governance of state-owned enterprises (SOEs) has become evident.

Source: World Bank (n.d.); Transparency International (2021); CRRC (2020); EBRD calculations

4.1 Good governance for a better business environment

Persistent political volatility is disruptive for the private sector

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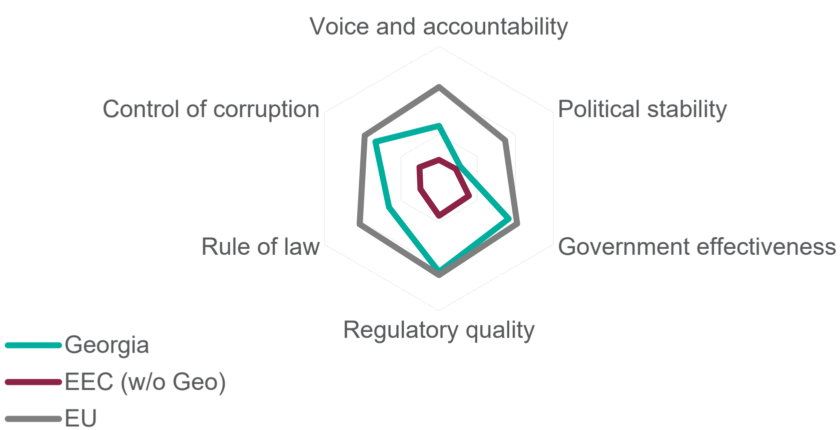
Political volatility is the most often identified governance shortfall in Georgia.

- According to the 2020 Worldwide Governance Indicators (World Bank, n.d.), Georgia lags the EU in most areas, particularly on political stability, where it ranked lowest in the six good governance indicators.
- The private sector repeatedly cites Georgia's political instability as the main hurdle to investment. Thirty per cent of respondents in the latest BEEPS survey (EIB, EBRD and World Bank Group, 2019) and 42 per cent of respondents in the 2013 survey (EBRD and World Bank Group, 2013) said political instability was the single biggest obstacle to doing business in the country.
- The 2019 WEF Global Competitiveness Report (WEF, 2019) ranks Georgia 86th out of 141 countries on "government long-term vision".
- Greater political polarisation is threatening to undermine Georgia's parliamentary pluralism, stability and democracy, as evident in the six-month political stalemate that followed the parliamentary elections of October-November 2020. After several rounds of negotiation, mediated by the EU with support of the United States of America, in April 2021, a compromise agreement was reached that defused immediate tensions.
- The polarised political arena, plagued by personalised attacks and strong mutual mistrust, has helped to fuel the excessive centralisation of power and a lack of continuity and predictability in policymaking. This is partly down to the frequent turnover of the government staff and the presence of vested interests. Transparency International has identified the ruling party's control over a majority of public institutions as a key cause for concern (Transparency International, 2020).

Political instability is the weakest dimension of Georgia's public governance

Worldwide Governance Indicators 2020, score [-2.5 (worst) to 2.5]



Political instability has significant implications for the private sector, in particular, consumer and business confidence and investment decisions.

- Investors that do not expect a quick payout or easy exit (for example, in manufacturing) need political and business environment stability in the medium to long term.
- Political instability in Georgia often translates into increased volatility in the macroeconomic environment. While macroeconomic stability has been maintained by and large through prudent management, political incidents in recent years have dented confidence, with an immediate effect on the exchange rate.

Source: World Bank (n.d.); EEAS (2021a; 2021b); PACE (2021).

4.1 Good governance for a better business environment

Strengthening judicial independence, accountability and capacity and increasing the efficiency of the court system are key to improving Georgia's business environment

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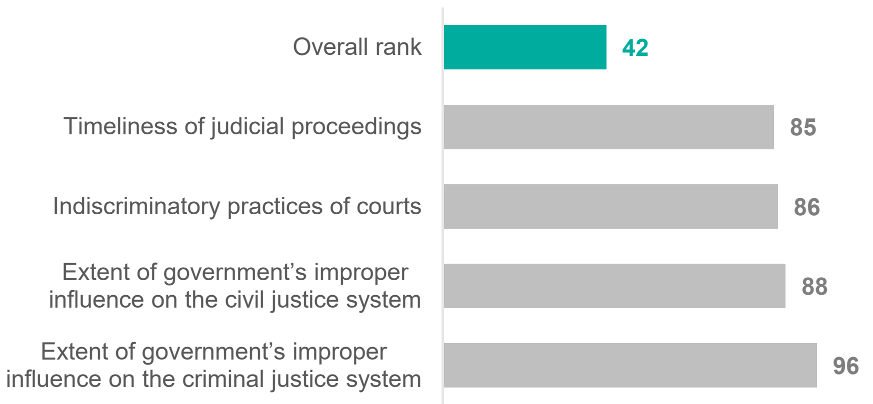
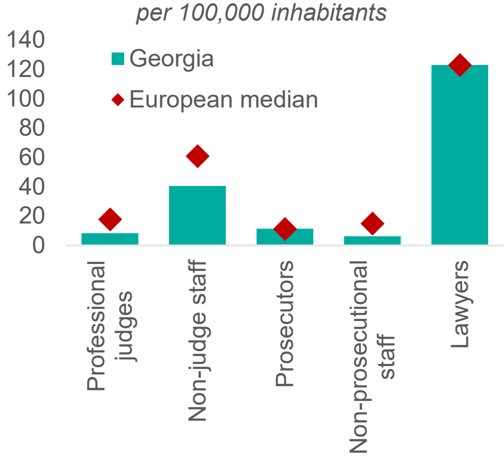
Government influence, discriminatory court practices and the timeliness of judicial proceedings drag down Georgia's Rule of Law Index ranking

Rule of Law Index 2020 overall and lowest rankings, out of 128 countries

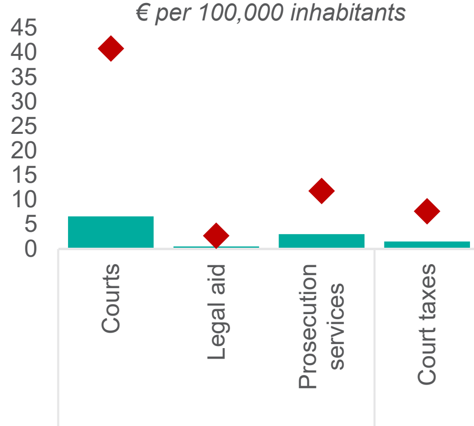


Judicial resources are far lower than the European median

Human resources
per 100,000 inhabitants



Financial resources
€ per 100,000 inhabitants



Georgia's judicial system has undergone four major waves of reform in recent years. Still, considerably stronger independence, transparency and accountability of the judiciary is needed.

- While the constitution provides for the independence of the judiciary, a perceived lack of institutional independence persists, with Georgia's judiciary and institutions at federal and national level considered susceptible to political interference (Transparency International, 2020).
- Allegations of judicial partiality and a lack of accountability in large and politically sensitive cases remain a concern.
- As high-profile court cases receive significant media coverage, even prior to judgment, the negative demonstration effect is significant, fuelling mistrust in the judiciary and discouraging investment, particularly by international investors (Council of Europe, 2020).

Confidence in the judiciary is further undermined by inefficiencies in the court system.

- There is supposedly a large backlog of cases, leading to long delays in judicial proceedings and judgments. The average case clearance rate is 91.1 per cent in courts of first instance (below the European median of 100.7 per cent) and 79 percent in the highest courts (compared with the European median of 98.8 per cent). The disposition time is 273 days in the courts of first instance (above the European median of 201 days) (Council of Europe, 2020).*
- In addition to the need for greater capacity both in terms of human and financial resources, Georgia's judicial capability needs to be boosted, particularly in the areas of commercial and business law.

Introducing e-courts for administrative processes and promoting the broader use of alternative dispute resolution mechanisms could help alleviate the judicial burden on the private sector.

Source: World Justice Project (2020); Council of Europe (2020).

**Note: Clearance rate = (resolved cases/incoming cases)*100*
*Disposition time = (pending cases/resolved cases)*365*

4.1 Good governance for a better business environment

The capacity, effectiveness, accountability and transparency of Georgia's civil service could be enhanced

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Weaknesses in public administration persist.

- The high turnover of personnel, particularly at senior level, due to frequent political change has compromised institutional memory and capacity in recent years.
- Relatively low levels of compensation for civil servants make it challenging for the government to attract and retain qualified professionals, particularly in areas where private-sector experience is required.
- The 2018 Support for Improvement in Governance and Management (SIGMA) baseline assessment of policy development highlighted the importance of further strengthening policy planning, coordination, monitoring and reporting, in particular (SIGMA, 2018).

The Covid-19 pandemic has highlighted the need to re-energise efforts to digitalise government services.

- Georgia ranked 65th out of 193 countries in the United Nations E-Government Survey 2020 (UNDESA, 2020), which captures the scope and quality of online government services, the status of telecommunications infrastructure and existing human capacity. It also ranked 80th in the E-Participation Index, a supplementary index to the E-Government Survey (Chapter 5) on the use of online services to facilitate the provision of information by governments to citizens, interaction with stakeholders and engagement in decision-making processes (e-decision making).
- A lack of e-governance initiatives at local level has resulted in a challenging digital divide between central and local administrations.

To successfully tackle the aftermath of the pandemic, Georgia must put its new insolvency framework into practice.

- Ensuring an efficient insolvency resolution regime would facilitate the "creative destruction" process in the aftermath of Covid-19, enabling economic recovery.
- Good progress is being made, with new legislation on banking resolution and corporate insolvency and the protection of creditor rights, as well as a framework for timely insolvency processes and effective rehabilitation, operational since early 2021.
- Ensuring the effective implementation of this new legislation will be crucial, along with the establishment of a new profession of insolvency practitioners. Focus should now shift to sorting out the system for personal insolvency.

Increasing the transparency of public procurement would enhance competition and create a level playing field.

- Public procurement processes were moved online a decade ago and digital procurement has fully replaced the previous paper-based system.
- While e-procurement should enhance competition and increase the number of firms bidding for government contracts, the average number of bids for open tenders in 2019 was just 1.8-2.6, heightening concerns about unfair competition.
- Covid-19 has further exacerbated this concern, with an increased number of simplified, direct procurement procedures now being used.

4.1 Good governance for a better business environment

Corporate governance reform could give additional impetus to improvements in the business environment while reducing fiscal risk

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Building on improvements in corporate governance standards would boost performance and investment opportunities, especially for SOEs.

- The EBRD's 2016 Corporate Governance Assessment (EBRD, 2016) highlights Georgia's lack of a unified corporate governance code, including the absence of board composition rules. The country also needs to strengthen the functioning and independence of audit committees and enhance the use of codes of ethics, including a whistleblowing framework. Appointing professionals to supervisory board positions would help address concerns about the structure and functioning of company boards and help instil confidence in potential investors.
- Further governance concerns about Georgia's SOEs include the absence of a state ownership policy and clear performance objectives, the limited regulation of SOE board composition, the limited responsibilities of SOE boards, the pervasive role of the state in taking key SOE decisions, rudimentary internal control frameworks and the scant and poor reporting of SOE performance and financial data.
- A number of steps have been taken in recent years to strengthen corporate governance and transparency, including (i) the passage and implementation of a new Accounting, Reporting and Audit Law on company transparency disclosures, which places audit and financial reporting obligations on companies according to their size, and (ii) the adoption of a new Company Law in August 2021. In addition, the integration of environmental, social and governance (ESG) considerations into corporate governance regulations and practices, in line with the country's roadmap for sustainable finance, would enhance the sustainability of company operations.

Motivated by the recent deterioration in the financial performance of SOEs, the government is preparing a comprehensive SOE governance reform programme to limit fiscal risk and increase efficiency.

- According to the International Monetary Fund (IMF), Georgia's SOE sector is relatively large compared with the otherwise lean public-sector balance sheet. With consolidated public-sector assets at 149.3 per cent of GDP in 2018 and liabilities at 81.3 per cent of GDP, the net worth of the entire public sector is estimated at 68 per cent of GDP, placing Georgia in the top third of countries analysed by the IMF (IMF, 2020). The assets of state-owned enterprises amount to nearly one-fifth of all public-sector assets, standing at 27.9% in 2018. A recently completed SOE sectorisation exercise disaggregated government units and public corporations so as to place the non-market activities of SOEs into the appropriate fiscal oversight frameworks. According to the IMF, 196 out of 241 SOEs should be classified as government units, meaning that they are operationally dependent on the government, while 50 companies are inactive (IMF, 2020).
- The SOE sector has been a net draw on the budget in recent years, amid growing leverage and government on-lending, decreasing the average return on assets and equity value despite large equity injections by the government. This has also led to significant upcoming financing requirements for the largest SOEs. The deteriorating financial landscape for Georgian SOEs exposes the underlying need for the reform of SOE commercialisation, the strengthening of corporate governance and greater exercise of the state ownership function.
- The authorities have embarked on discussions to develop a state enterprise reform strategy to bring the management of SOEs closer to the highest standards of corporate governance. This strategy is expected to result, among other things, in a new SOE governance law.

4. Obstacles to private-sector development

4.2 Enhancing human capital to boost competitiveness

4.2 Enhancing human capital to boost competitiveness

Georgia's labour-market characteristics reveal underlying structural issues

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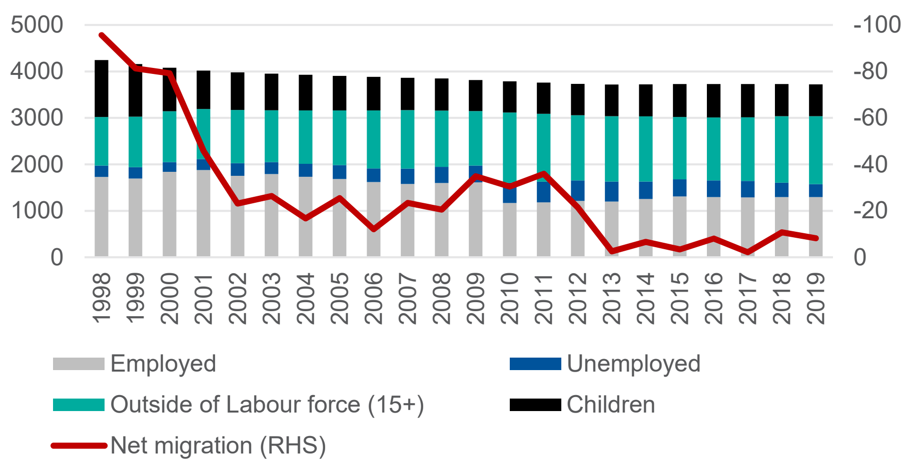
Population decline and net migration have moderated over the past decade (000s)



Economic activity and employment outcomes vary by urban-rural location and gender, 2020

Georgia's total population is declining gradually.

- The population has decreased from roughly 5 million residents at the time of independence to 3.7 million today, mainly due to mass outward migration during the 1990s.
- Outward migration has been consistent, but relatively modest in recent decades. Migrant flows comprise slightly more men (55-60 per cent) than women and are mostly made up of individuals in their 20s and 30s.
- The labour force has shrunk over time, also in reaction to episodes of economic hardship. Economic activity is likely to be sustained due to relatively slow pace of population ageing (a projected increase in the median age from 38.3 to 40.9 years by 2050) and rising labour productivity.

While overall labour productivity is growing gradually, a large proportion of employment is still concentrated in traditional sectors with low productivity.

- This could suggest that the Georgian economy has limited ability to create highly skilled jobs in more productive sectors or lacks the skills needed for higher-value-added jobs.

The activity rate is higher among men and in urban areas.

- Employment rates and economic activity in 2020 were considerably higher in rural than in urban areas. Such results are influenced by large-scale self-employment outside of the capital, in large part through subsistence farming activities.
- Women tend to have lower unemployment rates, but are also significantly less active in the labour market.

Unemployment has increased since the outbreak of Covid-19.

- Unemployment increased from 16.6 per cent in Q4 2019 to 18.3 per cent as of end June 2020 and again to 20.4 per cent at the end of 2020.
- According to a national survey of businesses in October 2020, 22 per cent of respondents had to reduce their workforce and 15 per cent had to grant unpaid leave to employees in response to the pandemic.

Informal employment remains stubbornly high, accounting for slightly over one-third of employees in the non-agricultural sectors.

Source: National Statistics Office of Georgia, EBRD calculations

4.2 Enhancing human capital to boost competitiveness

Labour-force skills do not match the evolving needs of businesses

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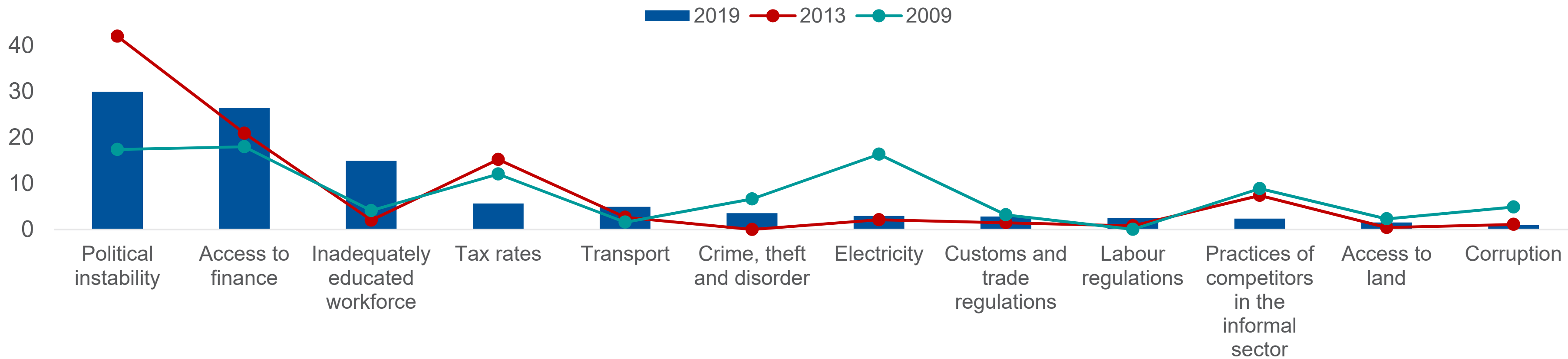
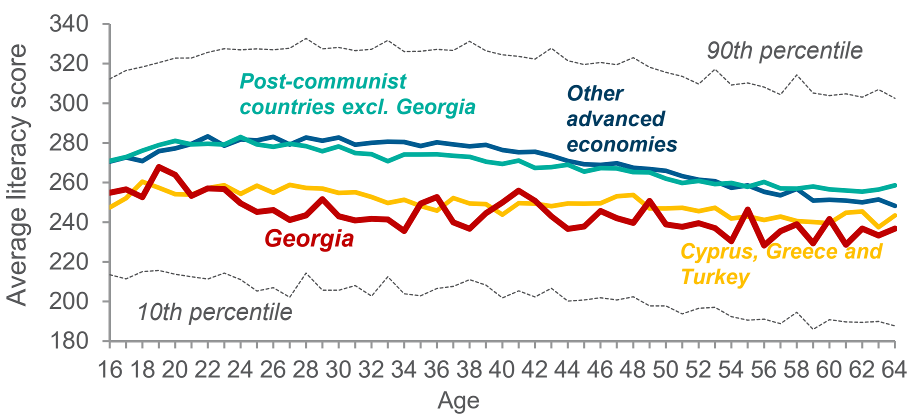
A rapidly growing share of Georgian firms reports poor labour-force skills as one of the main constraints on business, likely reflecting the evolving needs of companies in the wake of Georgia's economic development

Share of respondents identifying a particular area as the biggest constraint on their business



Skills of the Georgian workforce fare poorly in an international comparison across all age groups

Average PIACC scores



Poor workforce skills are among the top constraints on the private sector.

- Nearly 15 per cent of private firms consider Georgia's inadequately educated workforce the single biggest obstacle to doing business, according to the latest BEEPS survey. The skills shortage is particularly constraining for large companies and those in the service sector.
- Among Georgia's worst performances of the 2019 Global Competitiveness Index (WEF, 2019) were skills of the current workforce and ease of finding skilled employees, at 125th and 120th out of 141 countries, respectively.
- The trend of skills shortages is exacerbated by trends in the outward migration of skilled workers, as most Georgian nationals residing abroad have attained an educational level beyond secondary schooling.

The skills of the Georgian population lag those of its comparators.

- According to the Programme for the International Assessment of Adult Competencies (PIACC) (OECD, 2019), Georgia's workforce skills lag in all age groups. Moreover, the quality of digital skills in the active population ranked 107th out of 141 countries 2019 (WEF, 2019).

Source: EIB, EBRD and World Bank (2019); OECD (2019); EBRD calculations.

4.2 Enhancing human capital to boost competitiveness

Improving workforce skills requires tackling weaknesses in the educational system

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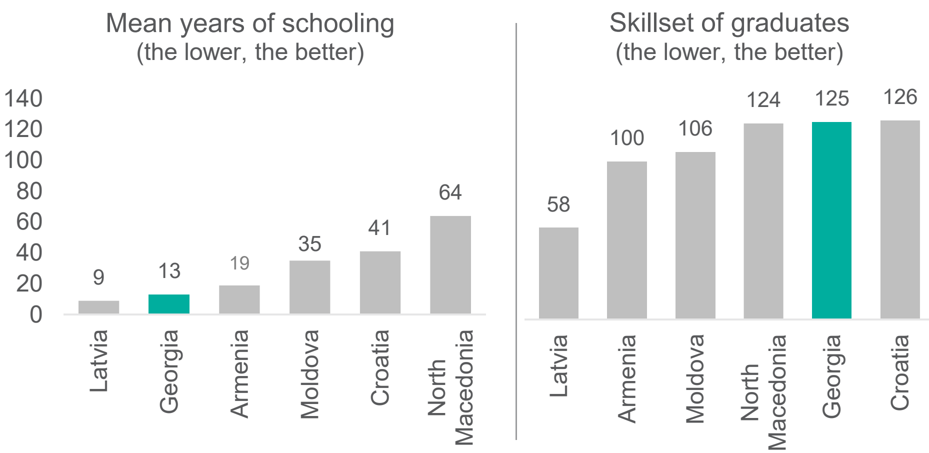
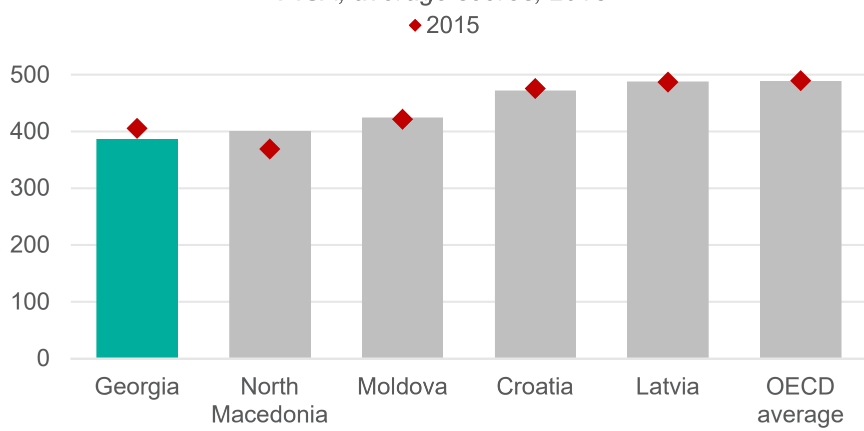
High educational achievement levels are at odds with the poor quality of graduate skillsets

Global Competitiveness Index, rank out of 141 countries in 2019



Georgia's students lag those of comparator countries on international tests of knowledge and skills

PISA, average scores, 2018



The quality of the educational system needs improvement.

- With an average 12.8 years of schooling, Georgia ranked 13th among the 141 countries in the 2019 Global Competitiveness Index (WEF, 2019).
- At the same time, the quality of its graduate skillset lagged that of most comparators. The OECD Programme for International Student Assessment (PISA) (OECD, 2018) ranked Georgian 15-year-old students 71st out of 79 countries on their ability to use their reading, mathematics and science knowledge and skills to meet real-life challenges.
- Georgian students also scored consistently lower than international and regional averages on elements of the Trends in International Mathematics and Science (TIMSS) Study 2019 (Mullis et al., 2019).

There is scope to increase access to and equality of education.

- According to the OECD (2018), the PISA results are down to:
  - students' socioeconomic situation, as disadvantaged students tend to perform more poorly
  - geographic location, as students from rural areas score lower than their urban peers
  - mother tongue, as students from minority groups who do not speak Georgian at home score lower
  - educational track, with those enrolled in general education scoring significantly better than those in the vocational sector.

Efforts to revamp the education system need to be reinvigorated.

- A number of gradual reforms in the educational sector have been implemented over the years. Most recently, the authorities started to work on a comprehensive reform of the education system, including curriculum standards, a new teacher policy framework and more effective vocational training and adult learning.
- In 2019, the authorities placed a floor of 6 per cent of GDP on educational spending from 2022, subject to the implementation of the comprehensive education reform and improvements in spending efficiency. The reforms were never finalised, however, partly because of a government reshuffle the same year.

Source: WEF (2019); OECD (2018).

4.2 Enhancing human capital to boost competitiveness

Eliminating skills mismatches would also help to resolve youth-inclusion issues

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Shortcomings in terms of matching the supply of skills, education, training and life-long learning to employer needs is a long-standing obstacle to Georgia's labour-market development.

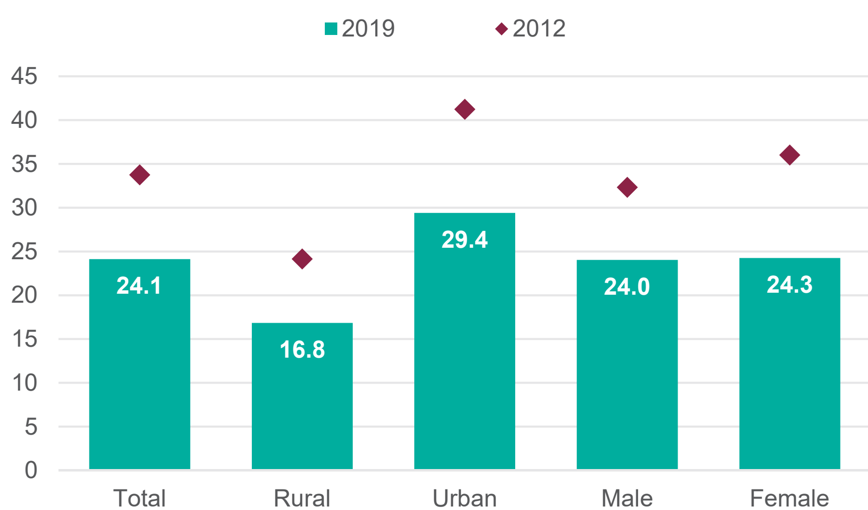
- Higher education has a relatively low economic return in Georgia, as it does not lead to a significant uplift in employability or remuneration.
- For example, more than 60 per cent of young people in Georgia attend higher education, while less than 40 per cent of entry-level positions require a degree. World Bank estimates suggest that a third of Georgia's population is over-qualified (ILO, 2019). Stakeholders point to a lack of systemic national mechanisms for private-sector skills development, which should be reflected in education and training.

Skills mismatches often translate into discouragement and inactivity for young people.

- Youth unemployment remained high, at 24.1 per cent, in 2019. While there are no apparent gender disparities, the difference between urban and rural youth unemployment is significant. This can be partially explained by the widespread self-employment of rural youth in subsistence farming activities.
- The proportion of young people aged 15-24 years in Georgia who are neither in education, employment nor training – the NEET rate – stood at 26 per cent, on aggregate, in 2019 and was higher still among young women. Although the ratio has come down in recent years, worries remain about a "lost generation" of Georgian youth, unprepared for accessing educational and economic opportunities.

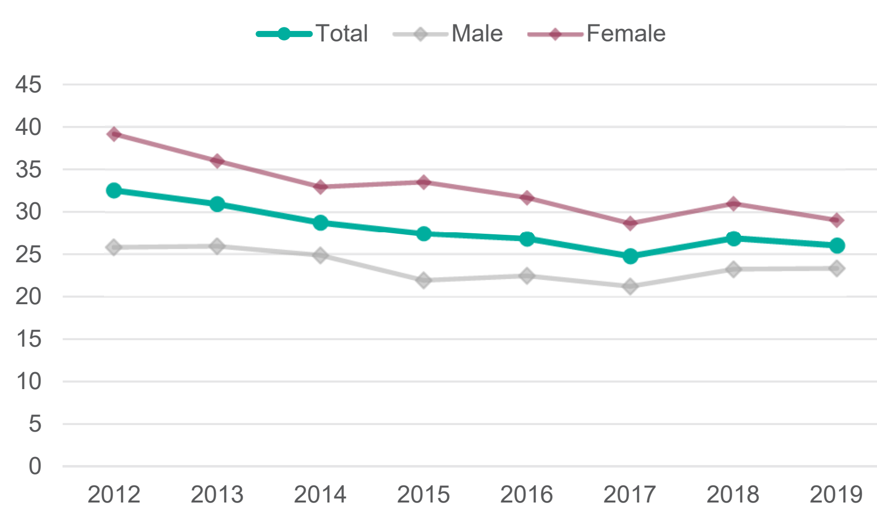
Youth unemployment is very high, especially in urban areas, though it has been decreasing

Youth unemployment rate (per cent)



Share of youth not in employment, education or training (NEET) is high

NEET rate (per cent)



Source: ILOSTAT, EBRD calculations

4.2 Enhancing human capital to boost competitiveness

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

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In recent years, Georgia's government has made significant and systemic efforts to reform the national TVET framework.

- The National Agency for Vocational Skills (or Skills Georgia) was established in 2019 from a multi-stakeholder effort to improve skills standards and secure better co-ordination across the private sector.
- This has led to the creation of a dedicated sectoral skills organisation (SSO) for the agricultural sector, called Agro-Duo, and more are expected to follow in the coming years.
- The SSO's primary objective is to promote public and private collaboration by establishing educational programmes with the private sector to foster the timely supply of competitive skills that meet labour-market demand.

Efforts to improve TVET are needed in light of Georgia's high unmet demand for professionals with technical skills, such as technicians and craft workers, and under-education in medium-skill occupations.

- It is particularly difficult for companies to fill blue-collar vacancies in some sectors, including food processing and related occupations and those requiring stationary plant and related operators.
- According to a survey conducted by Georgia's Ministry of Education, there is a disparity in the levels of employment of female (54 per cent are employed) and male (70 per cent are employed) graduates (Ministry of Education, Science, Culture and Sport of Georgia, 2018).
- Among the survey's unemployed respondents, 22 per cent said they had been unable to find a job as their profession was not in demand, highlighting that the skills mismatch in the labour market is also present in TVET programmes.

The Covid-19 pandemic has caused setbacks in the delivery of TVET, as many enterprises have stopped offering placements due to market uncertainty, changing work patterns and health and safety concerns.

Key TVET development challenges in Georgia

Low and declining levels of enrolment	• 6 per cent of the eligible age group was registered as of 2019
Relatively low state expenditure on vocational education	• 3.2 per cent of total spending in 2019 was on education
Regional disparities in access to TVET	• 46 per cent of Georgia's TVET institutions are based in Tbilisi

TVET employment outcomes
Sixty-two per cent of TVET graduates are employed, while around 10 per cent are self-employed about a year after graduation

Source: Galt & Taggart (2020); ETF (2018); Ministry of Education, Science, Culture and Sport of Georgia (2018)

4.2 Enhancing human capital to boost competitiveness

Gender disparities persist, damping the country's potential productivity growth

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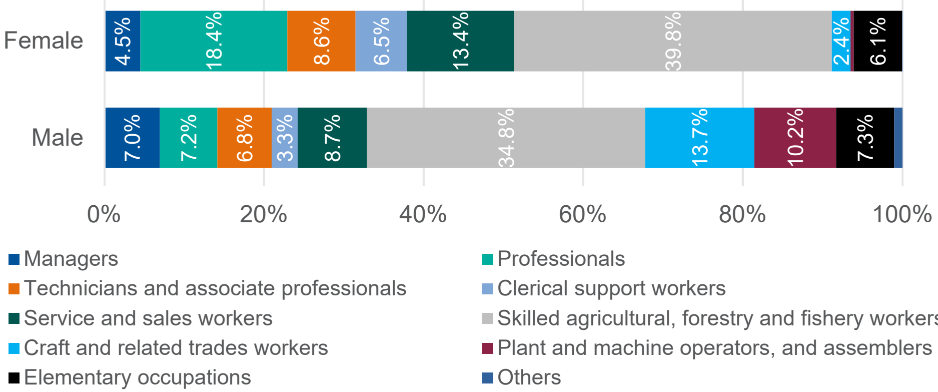
Women are very active in highly skilled occupations in Georgia …

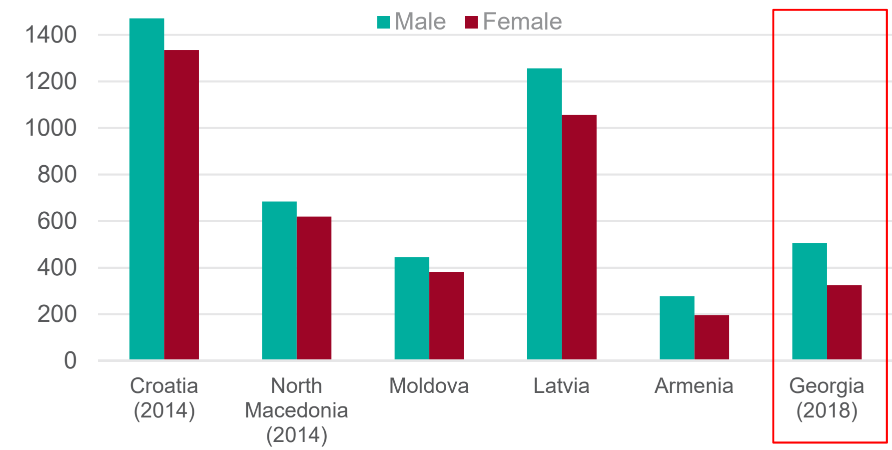
Distribution of employed women and men in Georgia by occupational category, 2019 (%)



Note: These are survey data, so the share of employed persons in agriculture is higher than in official figures.

… but this does not translate into higher earnings, as sizeable gender pay gaps persist in nearly every sector

Mean monthly nominal earnings of employees by sex, by size of pay gap, US$, 2019 and before



Women are very active in highly skilled occupations in Georgia, but a considerable gender pay gap persists.

- Highly skilled occupational categories (managers, professionals and associate professionals) account for roughly one-third of women's economic activity, compared with about one-fifth of men's.
- The average male employee earns about 56.7 per cent more per month than their female counterpart (the figure is lower when adjusted for working hours, education, experience and other factors).
- On a sectoral level, the biggest gaps can be found in financial and insurance services, manufacturing and scientific research. The sectors closest to gender earnings parity are utility supply, public administration and education.
- Conservative attitudes to gender roles remain common in Georgia and continue to damp women's economic and political inclusion (for instance, the burden of household tasks is disproportionately placed on women and does not decrease when a woman is in full-time work).

Access to finance is one of the main barriers to women's economic empowerment in Georgia.

- Men in Georgia are 80 per cent more likely than women to own a non-agricultural company.
- One of the most significant reasons for the difficulties in accessing finance is a lack of collateral, as women in Georgia own significantly less property than men.

Source: National Statistics Office of Georgia; ILOSTAT; EBRD calculations.

4. Obstacles to private-sector development

4.3 External competitiveness and integration with foreign markets

4.3 External competitiveness and integration with foreign markets

Exports have grown rapidly, helped by the boom in the tourism sector

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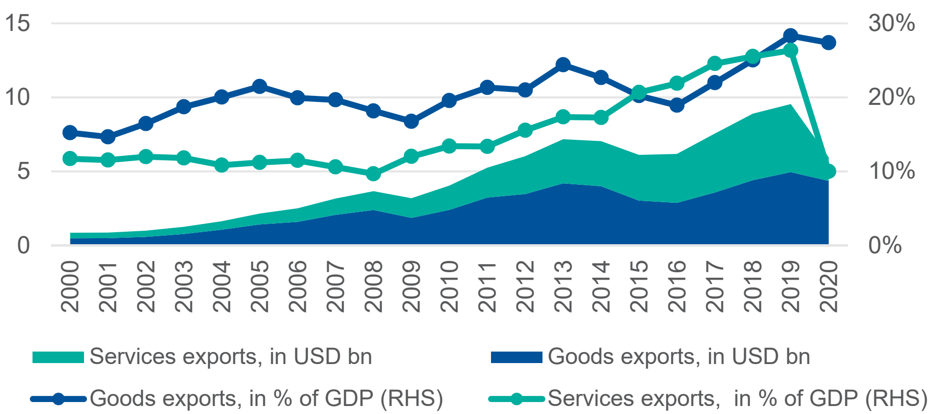
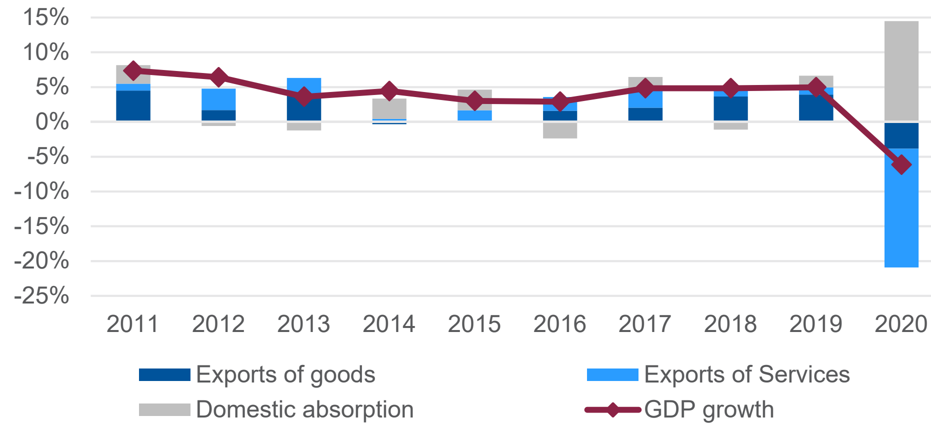
Goods and service export growth has been outpacing GDP growth in recent years

US$ billion (LHS) and real growth rate (RHS)



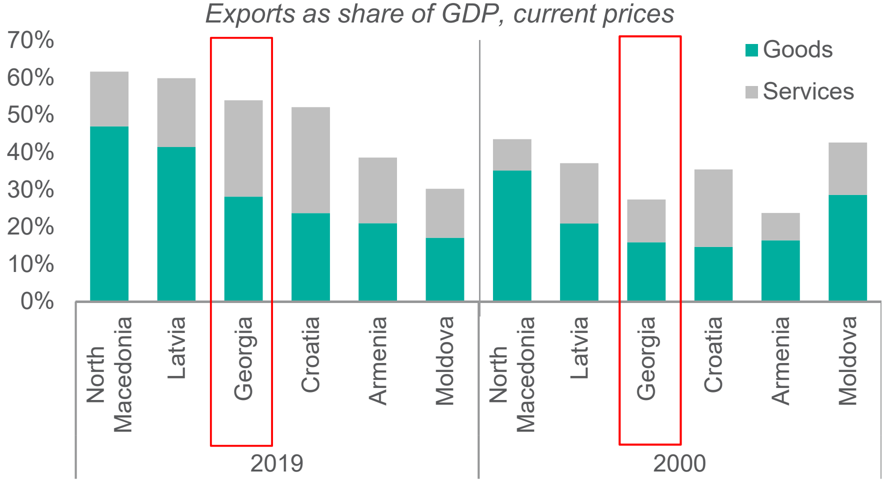
Exports have been a key driver of GDP growth

Contribution to GDP growth



Exports as a share of GDP has been catching up with peers

Exports as share of GDP, current prices



Exports are a major driver of growth for the small and open Georgian economy, though they have significant room to grow.

- Exports have recorded remarkable growth since the start of the reforms and the opening of the economy in the mid-2000s.
- Prior to Covid-19, thanks to tourism, service exports had been gradually taking the leading role from goods exports. Tourism took a huge hit from the pandemic, however, and will need several years to return to 2019 levels.
- There is space to grow. The size of Georgia's exports – in particular, goods and domestically produced goods (not taking into account re-exports) – relative to economic output is below that of some of its comparators, despite significant progress over the past two decades or so.

Source: National Statistics Office of Georgia; NBG; IMF WEO Extended database (October 2020); EBRD calculations

4.3 External competitiveness and integration with foreign markets

Maintaining its CIS markets while trying to diversify goods exports to the EU

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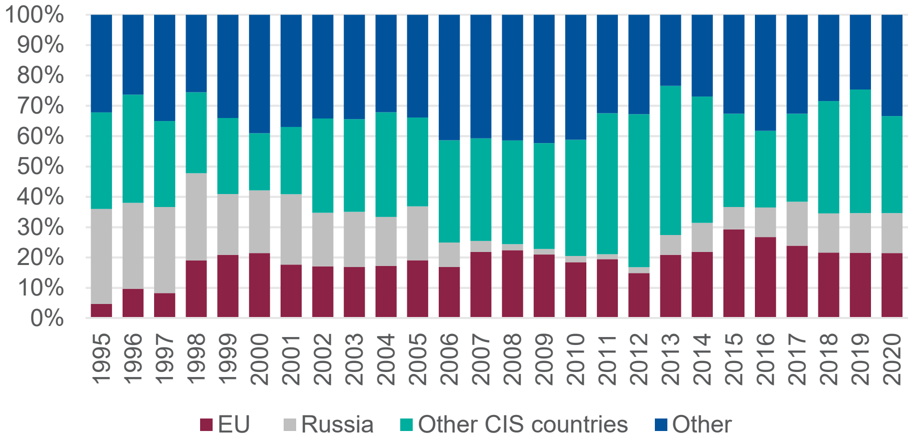
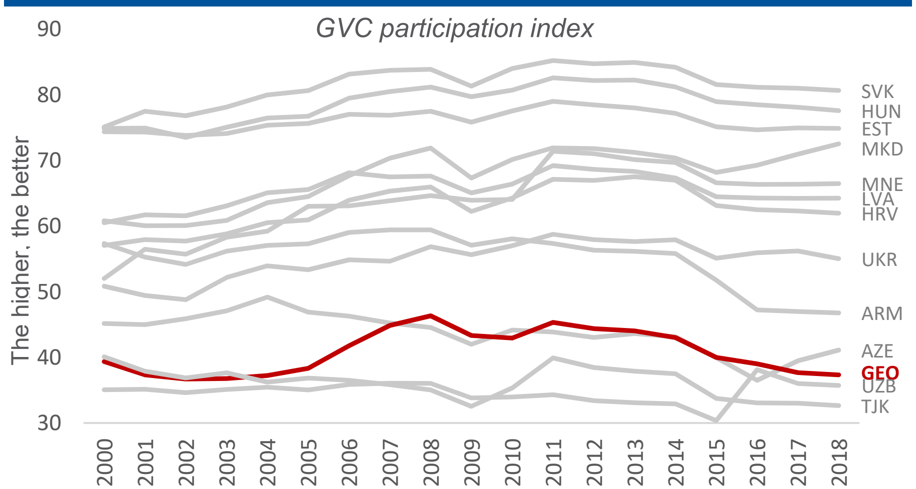
Export markets are getting more diversified



Georgia remains towards the bottom of the league on global value-chain participation, however



Over the past decade, Georgia's trade patterns have been shaped largely by trade with Commonwealth of Independent States (CIS) countries, while the increase in exports to the EU has been modest.

- The trade embargo imposed by Russia in 2005-06 was removed in 2012-13, spurring a strong recovery in exports to Russia. Following the regional economic crisis in 2014-15, exports from Georgia to the CIS declined significantly, but have been recovering ever since. EU trade has been the inverse of the broader picture to some extent, with its share increasing as the share of exports to the CIS declined, and vice versa.
- Georgia currently has 13 bilateral free trade agreements with Turkey, China and its neighbouring countries, in addition to the DCFTA with the EU.
- Exports to China have increased significantly, from 1.1 per cent of total exports in 2012 to 14.3 per cent in 2020, driven largely by minerals. The share of exports to Turkey – mainly intermediary goods such as metals and textiles and clothing – have decreased, falling from 19.9 per cent in 2009 to 5.7 per cent in 2020, though absolute levels remained relatively stable.

Georgia is not highly integrated into global value chains (GVCs).

- Based on backward (total of foreign value added in Georgia's exports) and forward (value added used in the exports of other countries as a share of Georgia's gross exports) GVC participation rates for 2000-17, Georgia is one of the economies in the EBRD regions least integrated into global production chains (UNCTAD-Eora Global Value Chain Database, n.d.).

Georgia's participation in global value chains is further constrained by the low level of digital transformation.

- Georgia faces particular barriers to access and the effective use of digital technologies, also due to the availability of infrastructure.
- Within the framework of its Association Agreement, Georgia has to adopt e-commerce legislation. Currently, there is no unified law on consumer protection. Private entities are not regulated in terms of cybersecurity and the activities of online platforms are not regulated either.
- Company investment in emerging technology is low and few local marketplaces sell across borders. As of January 2020, prior to the pandemic, only 18.4 per cent of enterprises had their own website (National Statistics Office of Georgia (2020). As of 2019, only 2.6 per cent of firms took orders for their goods and services through a website (National Statistics Office of Georgia, n.d.a).

Source: National Statistics Office of Georgia; GeoWel (2020); EU; UNCTAD-Eora Global Value Chain Database (n.d.); EBRD calculations.

The export basket is dominated by low value-added products

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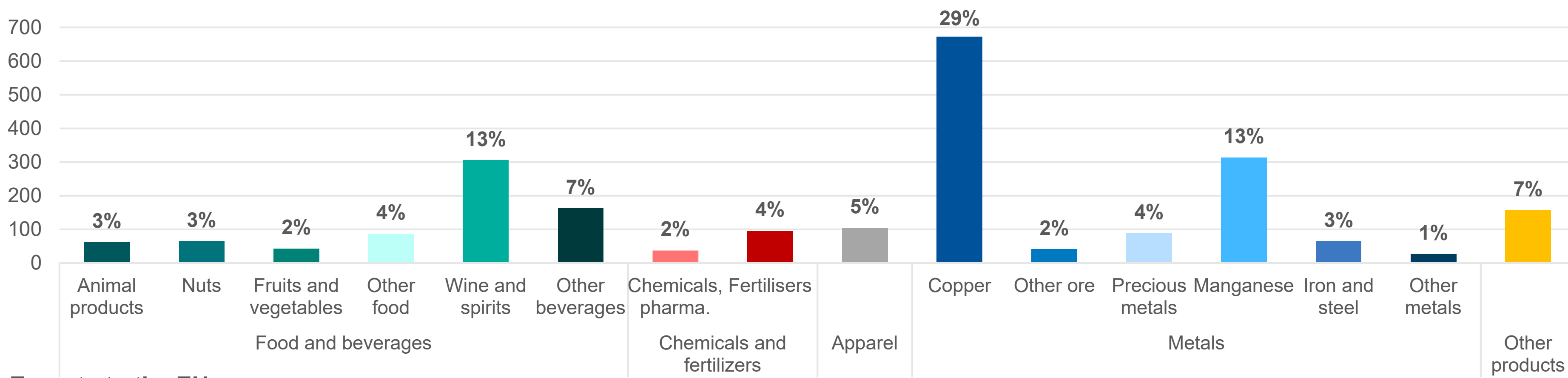
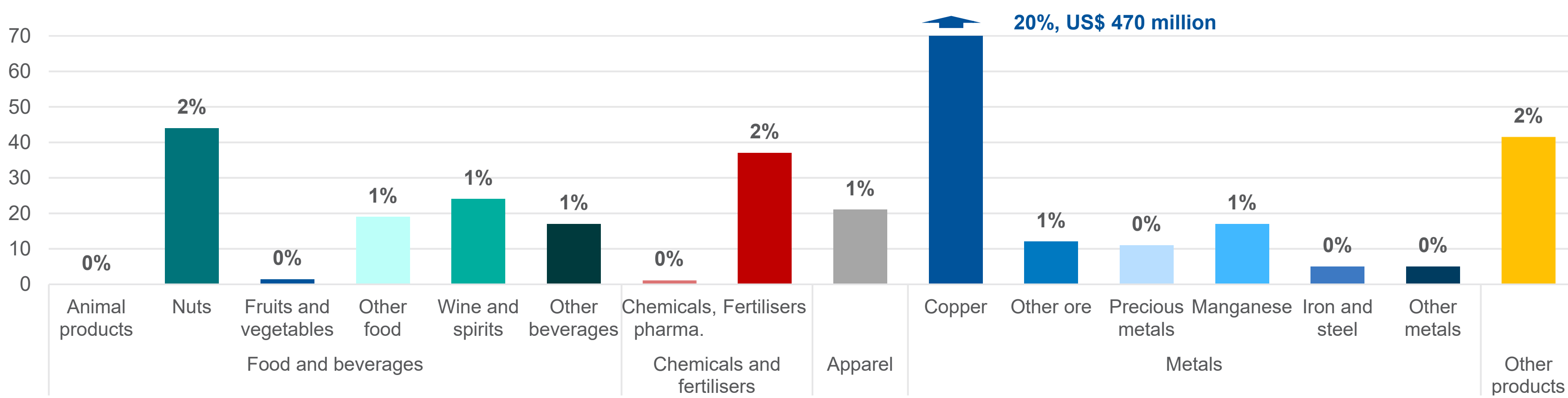
The export basket is dominated by commodities and other low-value-added goods; in addition to ores, (processed) food and beverages are among the most developed exports to the EU

US$ million, current prices, as a percentage of total exports to the world; domestic exports only (excluding re-exports)

Exports to the world



Exports to the EU



Source: National Statistics Office of Georgia; GeoWel (2020); EBRD calculations.

4.3 External competitiveness and integration with foreign markets

The EU DCFTA presents a significant opportunity that has yet to be fully utilised

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Georgia's EU Association Agreement and the DCFTA component, in particular, are aimed at deepening the country's integration with the EU and its US$ 18 trillion, 500 million-strong market.

- The Association Agreement between Georgia and the EU was signed in June 2014. The agreement entered into force in July 2016 (though most of the agreement was provisionally applied from 2014). The increase in Georgian exports to the EU and in foreign direct investment (FDI) to Georgia as a result of the agreement was expected to offer Georgia a pathway to accelerated economic growth.
- The push to bring Georgia into alignment with EU standards has become the biggest driver of legislative reform in the country, particularly in relation to business environment issues. However, the implementation of the agreement has raised the regulatory burden in many areas, ultimately becoming a constraint on private business.

The effect of the Association Agreement on the volume of Georgian goods exported to the EU has been more modest than anticipated, despite underlying positive trends, such as the gradual diversification of exports to the EU. This reflects the fact that the DCFTA has not significantly changed Georgia's terms of trade with the EU.

- The EU maintains a common external tariff regime that applies to most countries outside the EU and these tariffs can be onerous in some areas. Georgia was a member of the EU's Generalised System of Preferences (GSP), a trade agreement that removes tariff and quota barriers on most industrial goods. The EU maintains a GSP regime with countries it wants to support, giving them preferential access to the EU market. Georgia's trade agreement is referred to as GSP+, as it gives even greater access than the GSP.
- Looking at the trade restrictions on 220 product categories for Georgia (all export categories with more than US$1 million in exports), compared with GSP access, only 20 products have seen an improvement, all of them in the agricultural sector. Wine is the only major export product that had seen a significant tariff reduction under the arrangement.

The main reason for the slow realisation of the expected benefits is the inherent challenges of producing for the EU market, combined with Georgia's broader structural issues (as we discuss elsewhere in this report).

- **Lack of business networks.** Traditionally focused on the CIS region, Georgian producers find it very difficult to re-orient production towards the EU market. They are competing with a well-developed ecosystem of existing companies that understand particular national tastes and have already developed networks of clients for their products.
- **Requirements for significantly higher product and production standards.** To enter the EU market, Georgian companies must align their standards with those of the EU. This involves a significant financial and time burden, while the benefits may not be immediately observable. Companies generally do not want to adopt standards unless they are being enforced, as Georgia is a price-sensitive market and the adoption of such standards fuels cost increases that put them at a price disadvantage to their competitors. The government does not want to enforce standards if few companies have adopted them, as this would result in many companies closing. Unlike EU accession hopefuls in the early to mid-2000s, Georgia does not have access to structural funds to finance the cost of upgrading companies to bring them into alignment with EU standards.

4.3 External competitiveness and integration with foreign markets

Foreign investment could facilitate the penetration of the EU and other export markets, provided it is structurally skewed towards the tradable sector

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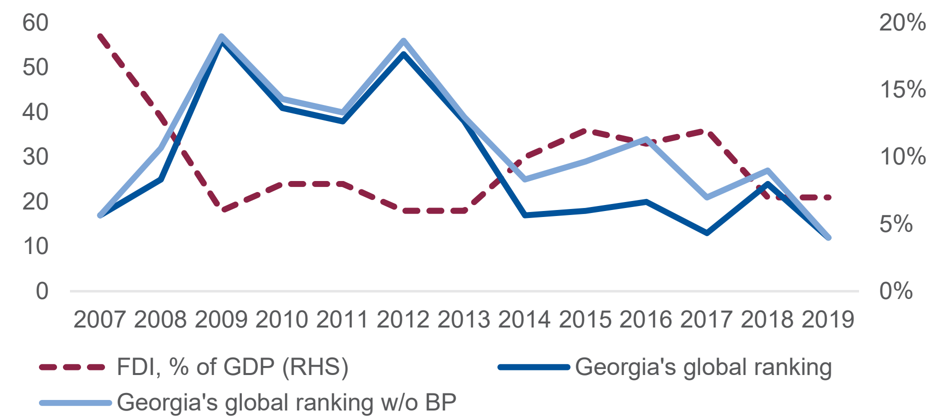
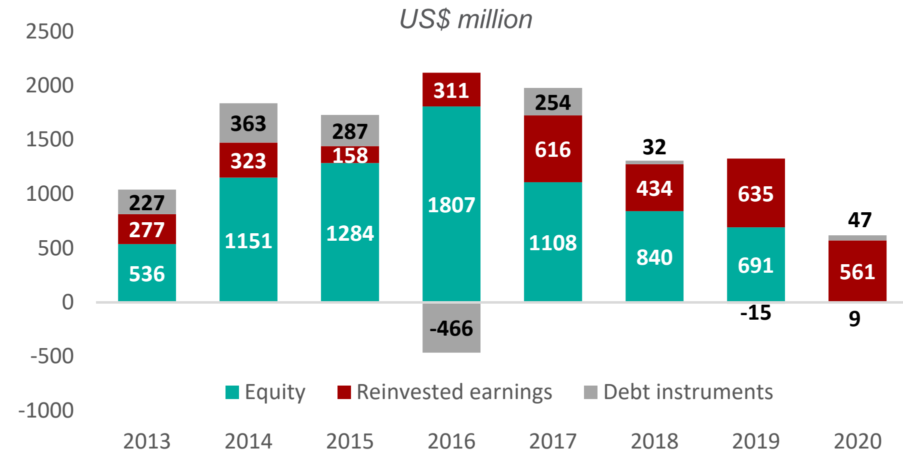
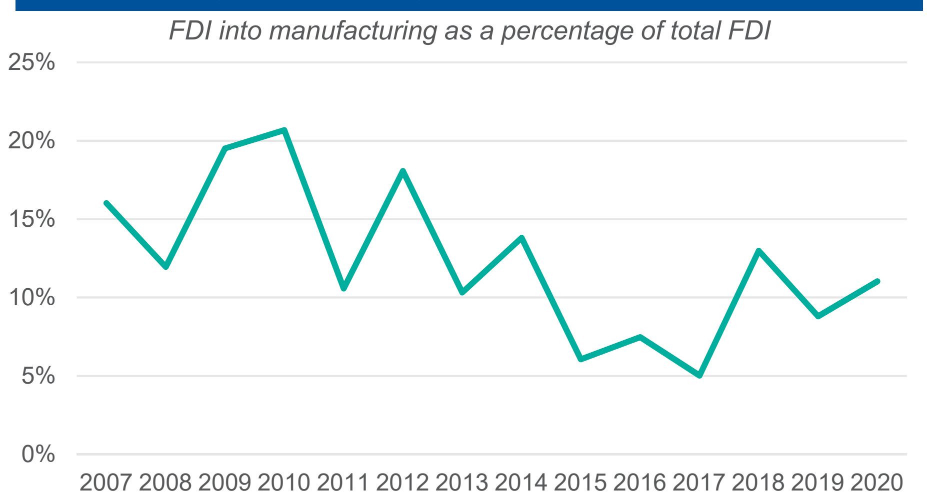
The declining headline FDI ratio, from 19 per cent in 2007 to 7 per cent in 2019, largely reflects lower investor appetite globally



The composition of FDI has been changing



Share of FDI to the manufacturing sector has been low and declining for the past 10 years and mostly concentrated in old Soviet sectors



FDI inflows remain relatively large, though the composition has been changing.

- Even without oil giant BP's large investment in the South Caucasus Pipeline Extension in recent years (about US$ 2.1 trillion), Georgia's percentile ranking compared with other countries based on FDI as a share of GDP has remained below 15 per cent since 2014.
- New equity investments seem to be largely in decline, potentially also reflecting global trends, while the share of reinvested earnings has been increasing – in part due to tax changes – since 2017. Corporate earnings are currently only taxed when they are distributed as dividends.
- Low and declining investment in Georgia's tradable sectors does not bode well for future economic growth.

FDI inflows into tradable sectors are low. The most often cited constraints include:

- Investments in manufacturing are not expected to yield a quick payout or involve an easy exit, so need political and business environment stability in the medium to long term.
- Georgian banks and venture capitalists have been resistant to providing capital for greenfield investments, while the banks have high collateral requirements.
- Such investments need partners with existing supply chains that can also bring production expertise, standards and access to clients/customers.
- Investor aftercare is in need of improvement, including when it comes to dealing with local administration.

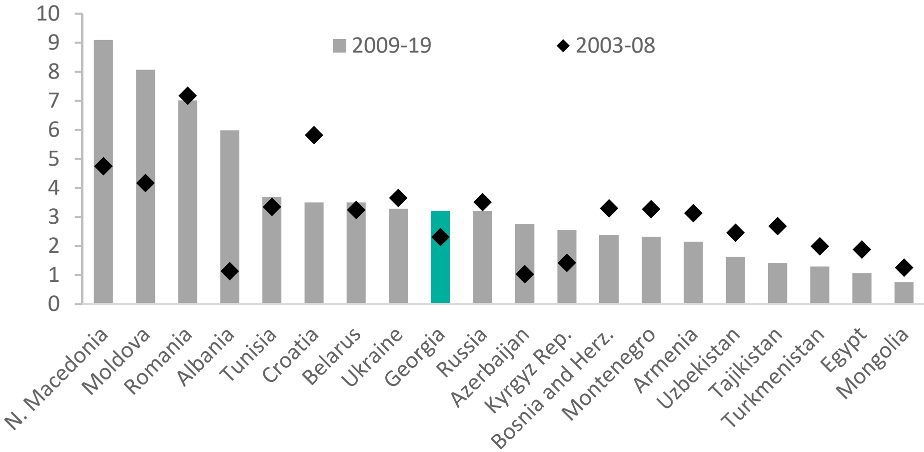
Source: National Statistics Office of Georgia; GeoWel (2020); EBRD calculations

The bulk of greenfield FDI is directed towards low-skilled and low- to medium-digital intensity sectors

European Bank
for Reconstruction and Development

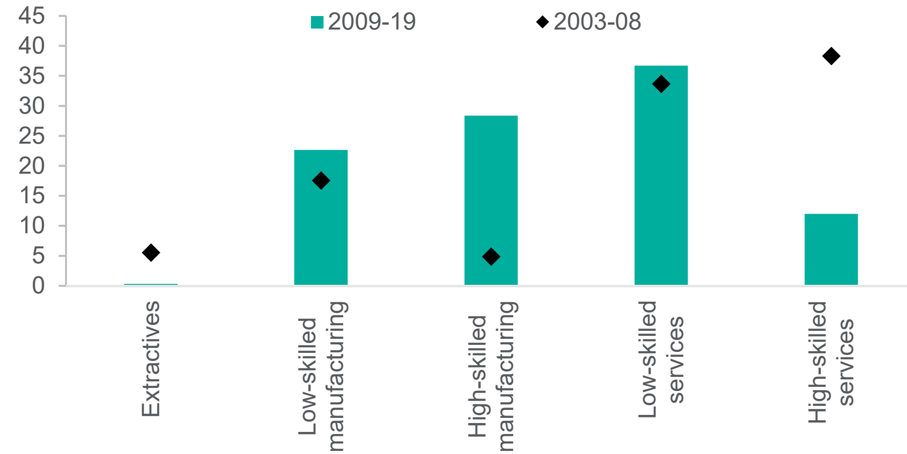
The average labour intensity of greenfield FDI has risen over time …

Number of jobs generated per US$ 1 million invested



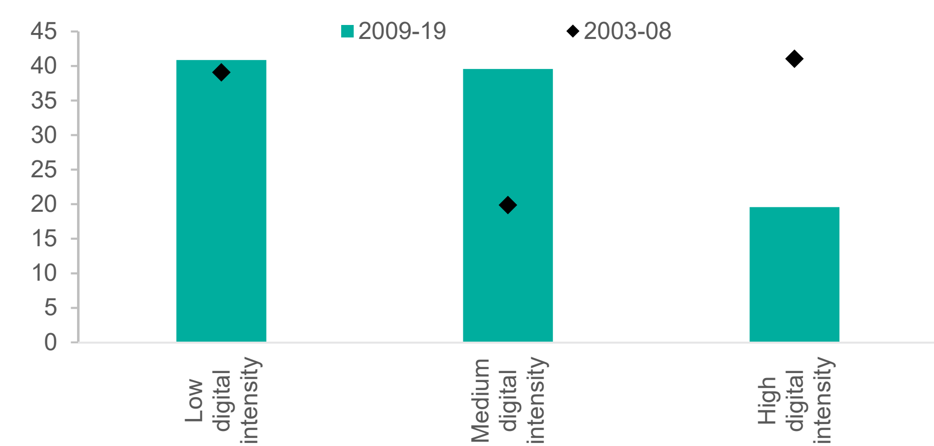
… and shifted away from highly skilled services towards highly skilled manufacturing …

Share of total FDI employment generated, by skills intensity of sector, per cent



… and away from more digitally intense sectors, largely due to the waning importance of financial services

Share of total FDI employment generated, by digital intensity of sector, per cent



- The median project in Georgia created 64 jobs in 2003-19, compared with 80 across the EBRD regions, on average. Around a third of projects created 40 or fewer jobs; only 7 per cent created more than 600 jobs (compared with 10 per cent in the EBRD regions, on average), according to EBRD calculations.
- In 2003-19, Greenfield FDI inflows generated the most jobs in manufacturing, especially in 2008-10. The role of services has increased sharply in recent years. At subsector level, greenfield FDI projects generated most jobs in retail banking, the production of household appliances, clothing, construction and transportation.
- Labour intensity has increased as services have grown in importance. While low-skilled services (such as construction, transportation and storage) still account for the bulk of employment, there has been a shift away from highly skilled services (especially financial services) towards highly skilled manufacturing (such as computer equipment and, to a lesser extent, motor vehicles).
- Greenfield FDI inflows had a significant environmental footprint in 2003-19. Environmental costs are estimated at more than US$ 14,000 per greenfield FDI job generated, compared with around US$ 10,000 for the EBRD regions as a whole, reflecting significant employment creation in transportation in recent years.

Source: EBRD (2021).

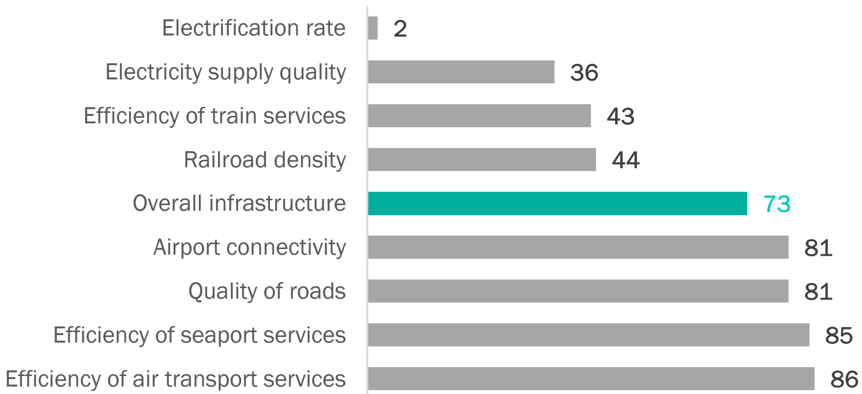
4.3 External competitiveness and integration with foreign markets

Advancing infrastructure and logistics could generate new growth opportunities

European Bank for Reconstruction and Development

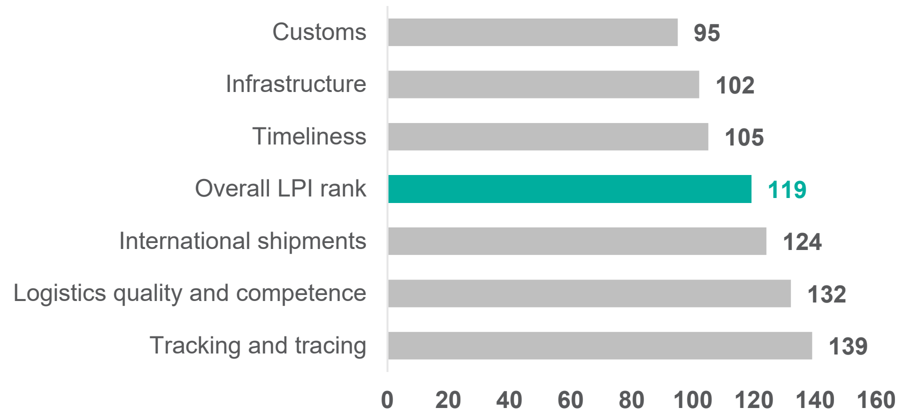
Overall quality of infrastructure ranks 73rd on the World Economic Forum's Global Competitiveness Index …

Rank out of 140 countries, 2019



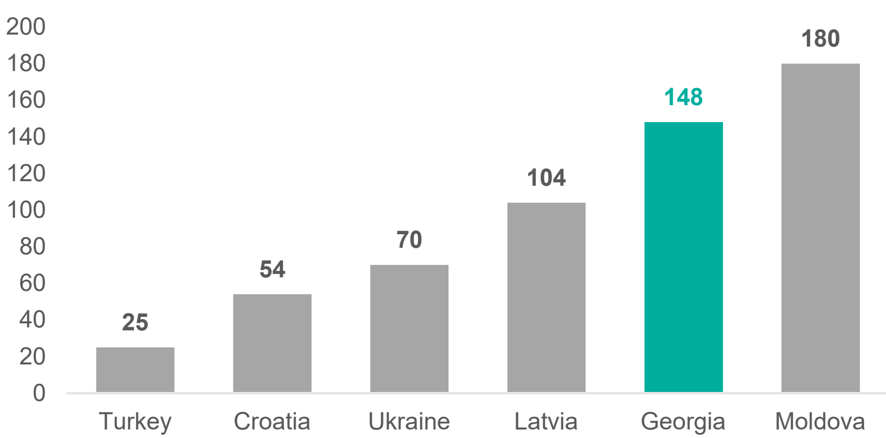
… 119th on the World Bank's Logistics Performance Index …

Rank out of 160 countries, 2018



… and 148th on the UNCTAD Liner Shipping Connectivity Index, which gauges integration into global liner shipping networks

Rank out of 181 countries, Q3 2020



In contrast to its business environment rankings, Georgia ranks low when it comes to infrastructure, logistics quality and connectivity.

- Georgia's geographical location and underdeveloped infrastructure undermine the growth potential created by its successful improvement of the business environment.
- The government has focused on building a good road network rather than taking a strategic approach.

Weak starting point offers greater growth potential.

- The externally driven Trans-Anatolian Natural Gas Pipeline (TANAP) demonstrates how the country could benefit by being a link between the Caucasus, Central Asia and Europe.
- A holistic approach to and investment in road, railway and port infrastructure, as well as a network of logistical centres, could open up new trade and business opportunities.

Source: WEF (2021); World Bank (2018); UNCTAD (2019).

4. Obstacles to private-sector development

4.4 Financial- and private-sector access to finance

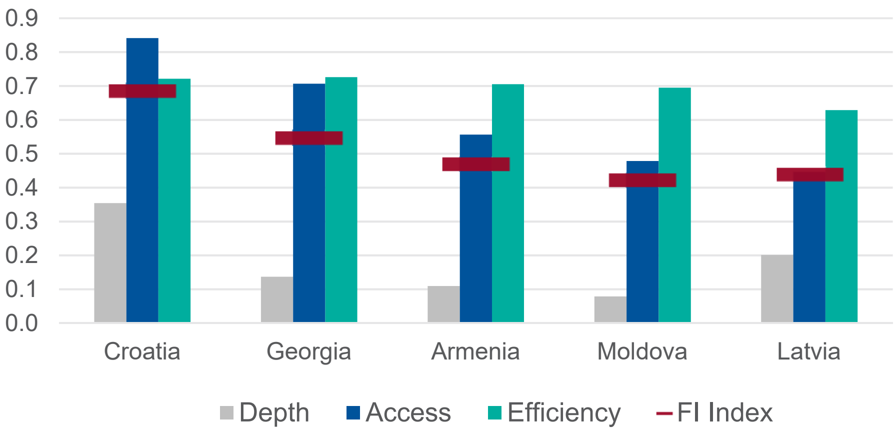
4.4 Financial- and private-sector access to finance

Stable and fast-growing financial system dominated by banks

European Bank for Reconstruction and Development

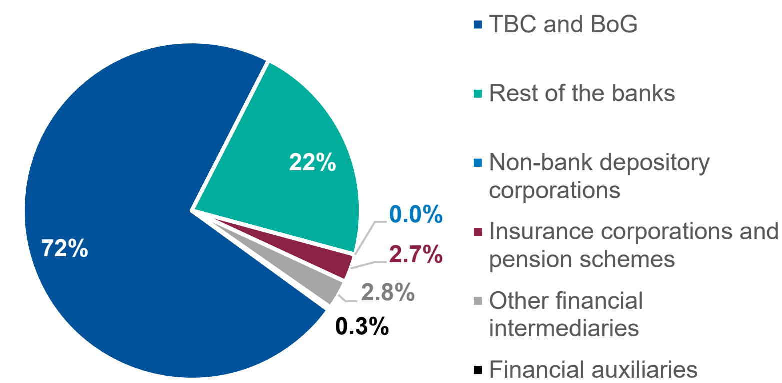
Georgia's financial sector is the clear leader in the region, ranking strongly on access and efficiency

IMF Financial Development Index, financial institutions, 2018



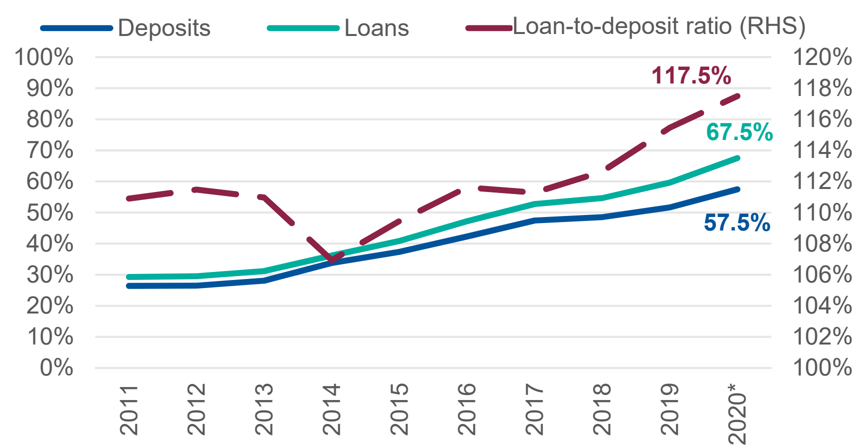
Commercial banks dominate the financial sector, with the two largest accounting for nearly 77 per cent of all banking assets

Financial institutions' share of net assets (percentage share of total financial-sector assets)



Loans and deposits have increased steadily over time, though leverage has increased of late

Monetary aggregates as a share of GDP (per cent)



Financial intermediation in Georgia has grown rapidly in recent years.

- Account ownership and loan penetration indicators attest to the expansion of financial intermediation. From an inclusion perspective, women and the rural population have considerably more access than regional peers (World Bank, 2017).
- The assets of the bank-dominated financial system have quadrupled since 2011, reaching 95 per cent of GDP in 2019, according to data from the National Bank of Georgia.

The National Bank of Georgia (NBG) supervises the entire financial sector.

Key features of the Georgian banking sector:

- Bank ownership is fully private, with a large share of foreign ownership, also by international institutional investors through publicly listed names.
- The sector is dominated by the country's two largest banks: Bank of Georgia and TBC Bank.
- The sector is generally well managed and regulated, comfortably capitalised, consistently profitable and relatively efficient in channelling credit to the real sector. The banking sector has implemented Basel III standards and progress has been made on raising the standards of capital, liquidity and transparency.

Source: IMF (2018); NBG; EBRD calculations.

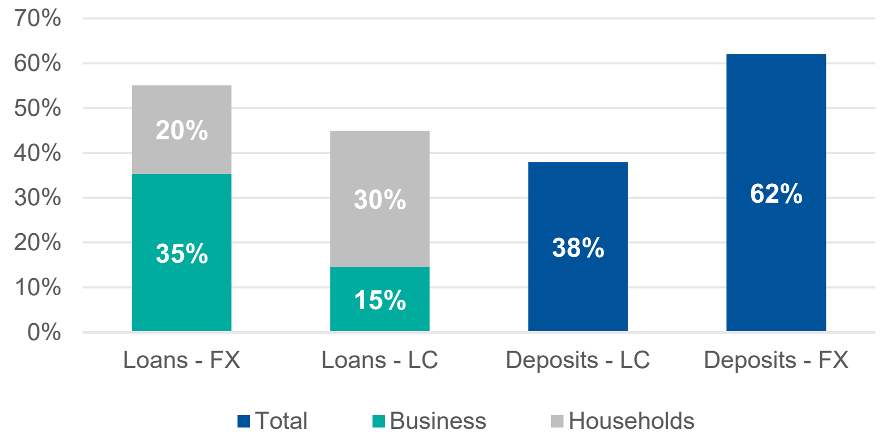
4.4 Financial- and private-sector access to finance

High level of dollarisation makes the banking sector susceptible to economic crisis and the transfer of exchange-rate risk to credit risk

European Bank
for Reconstruction and Development

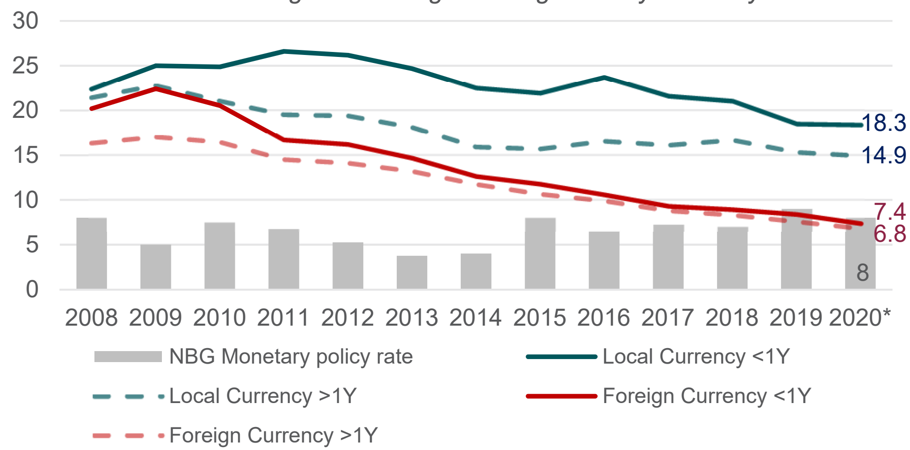
Dollarisation has been a long-standing issue in Georgia

Loans and deposits by currency (percentage of total)

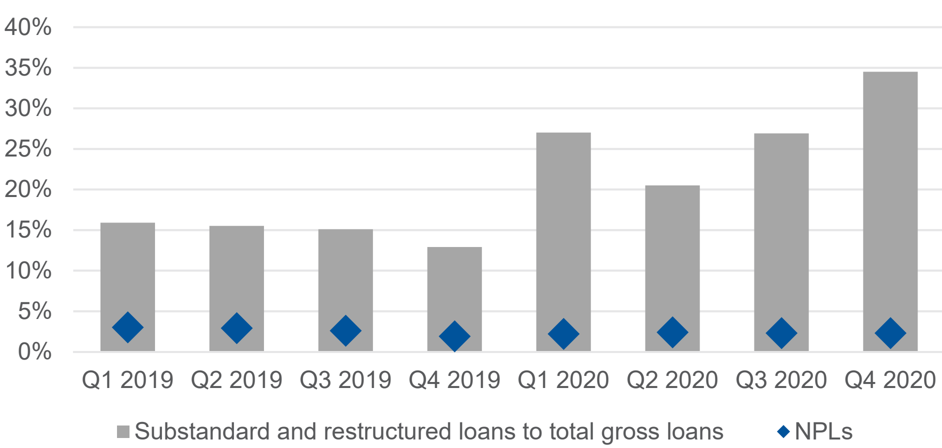


Interest rates remain high versus developed countries, but this is down to Georgia's country risk; rates have been declining in recent years

Annual weighted average lending rates by currency



While NPLs remain low, Covid-19 put asset quality under pressure, as evident in the share of substandard and restructured loans



Georgia's banking sector is facing a number of challenges.

- The sector has weathered the Covid-19 crisis fairly well, supported by the regulator's forbearance measures. **Asset quality and profitability have deteriorated**, but a recovery is underway (the return on assets and return on equity turned sharply negative in H1 2020, but had recovered to 0.2 per cent and 1.4 per cent, respectively, by year-end 2020).
- **Dollarisation** is traditionally high, even compared with the rest of the Eastern Europe and the Caucasus (EEC) region. The NBG's de-dollarisation efforts have been offset somewhat by consecutive negative external shocks.
- The high **concentration risk** resulting from the dominance of the two key systemic banks is partly mitigated by the banks' stellar performance.
- A significant portion of banks' medium- to long-term funding is sourced in foreign currency from external wholesale investors (including international financial institutions), exposing the banking system to **foreign-exchange refinancing risk**. Financial-system funds borrowed from abroad totalled around 18 per cent of GDP as of H1 2020.

Source: NBG; IMF (2021b); EBRD calculations.

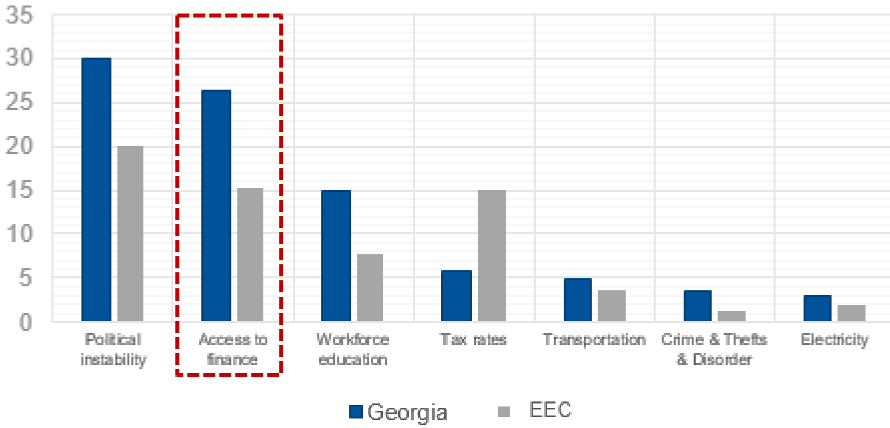
4.4 Financial- and private-sector access to finance

SMEs cite access to finance as an obstacle to growth

European Bank
for Reconstruction and Development

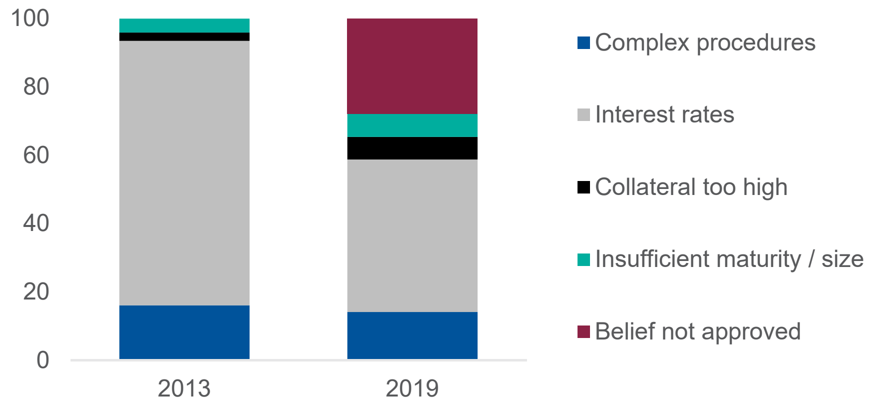
Firms in Georgia consider access to finance to be the second-largest obstacle to doing business

Firms' biggest obstacle to developing their business (%, 2019)



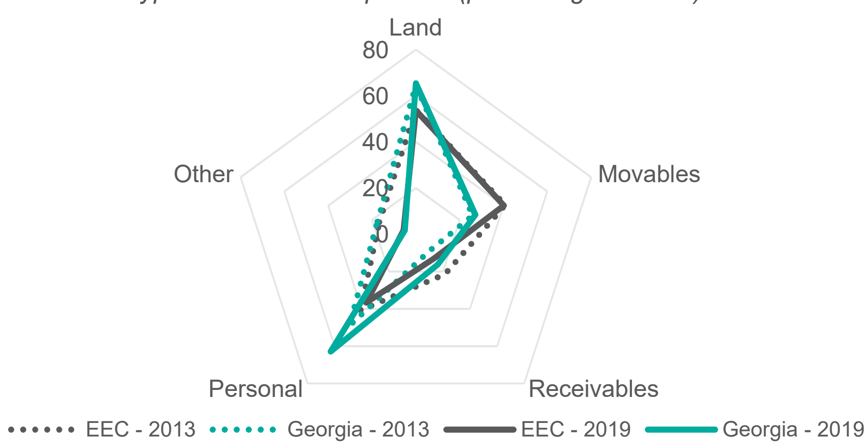
High interest rates are still the biggest hurdle to applying for a loan

Reasons not to apply for a loan, according to those who reported a need for a loan, but did not apply (percentage of respondents)



Collateral requirements remain substantial in Georgia, with land the most commonly requested asset

Type of collateral requested (percentage of firms)



SMEs consider access to finance to be one of their top two constraints.

- Internal funds are the dominant way of financing company operations and investments, followed by a far smaller share of bank loans. Credit constraints limit firms' propensity to invest, potentially impeding their growth prospects. Aggregate
- SME demand for loans in Georgia remains high, though lower than the average of the EEC region. Nearly half of firms need a loan, while only one in three manages to get one, with the rest either rejected or discouraged from applying.
- The country's comparably lower share of credit-constrained firms but higher rejection rate suggests more stringent risk assessment and credit terms. However, the easing of credit constraints should not come at the expense of high prudential standards, which contribute to the stability of the banking system.

Alternative SME financial instruments, which work well when credit risk is higher and collateral is lower, such as credit guarantee schemes, are not yet widely available.

- A lack of reliable information on banks' potential clients and the lack of available collateral may lead to occasions when banks are not willing to lend to SMEs, even at above-market interest rates.
- Credit guarantees have become more available in response to the Covid-19 crisis.

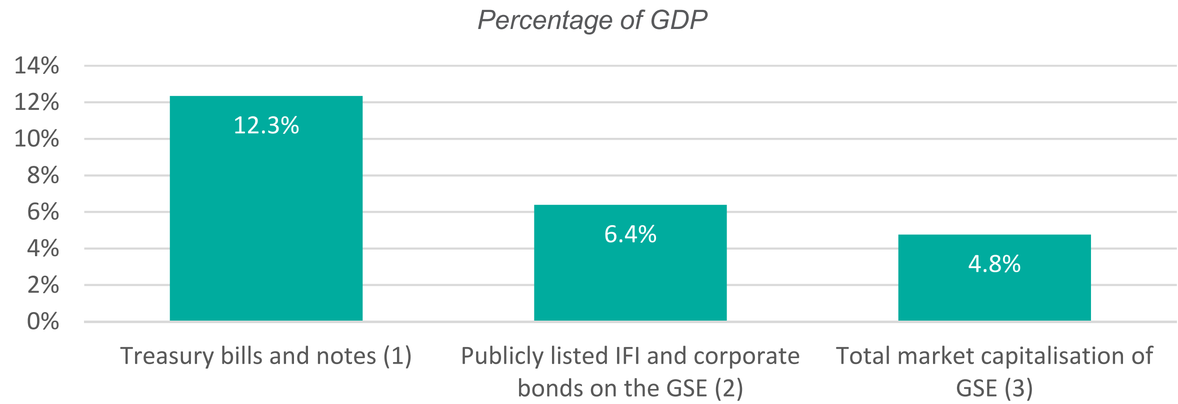
Source: EIB, EBRD and WB (2019); EBRD calculations.

4.4 Financial- and private-sector access to finance

Ongoing efforts to overhaul the fragmented and illiquid capital market

European Bank
for Reconstruction and Development

There is significant potential to develop the domestic capital market



Note: (1) as of 2020, (2) as of 2019, (3) as of October 2020

- Georgia's capital markets legal and regulatory framework has been strengthened by various reforms of late. Legislation has also been adopted to establish mandatory private pension and investment funds, which should support the development of a local institutional investor base.
- High dollarisation is holding back the development of money markets, but measures adopted by the NBG have improved access to lari (GEL) liquidity over the past decade. The reformed Tbilisi interbank rate (TIBR) benchmark is gradually becoming established as financial instruments are linked to it.
- Although it has been growing steadily in recent years, the Georgian government securities market remains small.
- The corporate bond segment is still underdeveloped and bank lending is effectively the main source of funding for the corporate sector, especially for SMEs.
- A small number of Georgian companies have chosen to list on international stock exchanges rather than the GSE, where liquidity is negligible.
- Georgia's capital-market infrastructure is fragmented, with separate infrastructural entities for corporate and government securities. The GSE is planning to upgrade its trading infrastructure and transfer all activities to a new entity created for this purpose, the Tbilisi Stock Exchange.
- A shared strategic vision and greater coordination among key stakeholders are needed for the further development of capital markets.

Source: Ministry of Finance of Georgia; GSE; Geostat; EBRD calculations.

4. Obstacles to private-sector development

4.5 Advancing the green transition and ensuring energy-sector sustainability

4.5 Advancing the green transition and ensuring energy-sector sustainability

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

European Bank for Reconstruction and Development

Electricity market development stages

1994-98	1998-06	2006-13	2013-27
First steps of national independent strategy • Electricity market restructuring initiated • GNERC was formed • Electricity unbundled into three independent sectors: generation, transmission and distribution	**Frequent blackouts, vulnerable power system** • The market operates as a “single buyer“; electricity trades are conducted through a state-owned company	**Stable power supply** • Electricity market moves to direct contracting • ESCO is formed to balance electricity market • All major assets are privatised • Stable power supply, greater system stability	**Fully competitive market structure** • Synchronising system regulations with Turkey, in line with EU standards • Approximation of legislation to EU Aquis • Gradual transition to fully competitive market

By signing the Association Agreement with the EU and joining the Energy Community, Georgia has committed to transforming its energy sector in compliance with the bloc's third energy package.

- Georgia has been making significant efforts to harmonise its legislation with that of the EU, increase market access between the EU and Georgia, promote free and competitive trade in the electricity and natural gas markets and comply with security-of-supply requirements.
- The country adopted a new energy law, followed by the Electricity Market Model Concept, in 2020. The document reflects the government's vision of the general structure, arrangements for and functioning of the Georgian electricity market, sets out its future structure and describes the rights and responsibilities of market participants. It lays out the guiding principles for the organisation and functioning of a wholesale electricity market in Georgia, thus helping to meet the country's obligations under the Energy Community Treaty, and aims to establish an attractive environment for investors by developing competitive and transparent electricity markets (Government of Georgia, 2020).

The lack of a transparent and reliable regulatory framework for renewable investments, especially for non-hydro technologies, further constrains investment in the energy sector.

Source: GNERC

4.5 Advancing the green transition and ensuring energy-sector sustainability

Energy sector plays a prominent role in the economy

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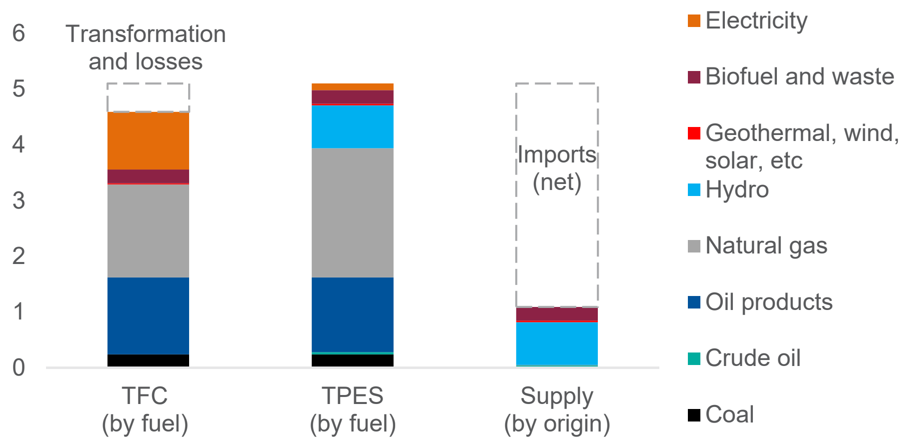
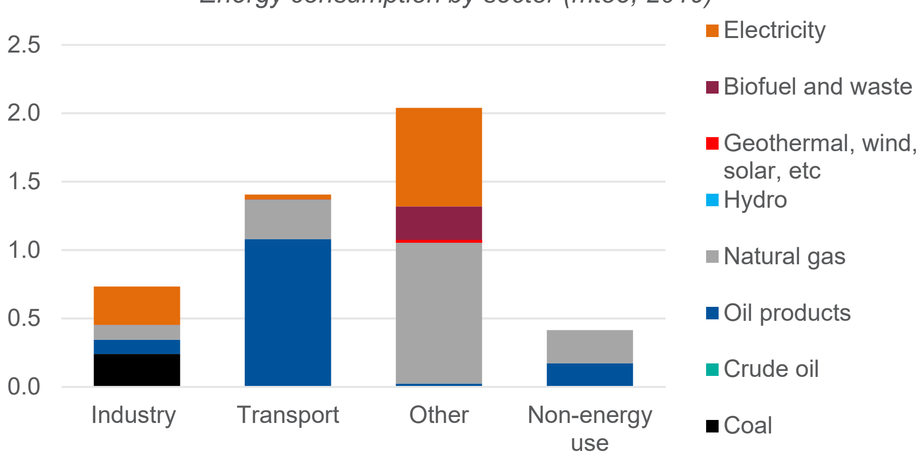
Total energy supply is dominated by imported gas and oil, as well as large domestic hydropower sources for electricity generation

Energy production, supply and consumption by fuel (mtoe, 2019)*



Natural gas and coal imports are largely used in the transport and heating sectors

Energy consumption by sector (mtoe, 2019)



Georgia is a net energy importer.

Lacking domestic hydrocarbon deposits, Georgia imports large amounts of gas and oil, largely for use in the transport and heating sectors, as well as in thermal power plants for the production of electricity.

- The country's electricity generation is dominated by hydropower, thanks to its abundance of riverine resources.

Economic growth is fuelling strong energy consumption growth.

- Georgia's total energy consumption nearly doubled from 2000 to 2018, mostly due to growth in transport, industry and bitcoin mining.

Georgia's energy infrastructure and the reliability of electricity supply have improved significantly in recent decades, but more needs to be done to create a truly smart grid suited to the widespread use of renewables.

- In the early 2000s, the electricity sector was characterised by frequent blackouts, insufficiently reliable supply and non-payment. Sweeping reforms dramatically improved the situation.
- Tighter regulation, as well as the introduction of incentives to reduce network losses and modernise the transmission network, significantly improved the quality of electricity supply.
- The diversification of gas imports from a single contracted supplier (Russia) to two import sources (Azerbaijan and Russia) also helped.

Georgia plays an important role in the transit of gas to Europe from the Caspian Sea.

- Georgia is part of the Southern Gas Corridor, transporting gas from the Shah Deniz field in Azerbaijan to Turkey via the TANAP and on to Albania and Italy via the Trans Adriatic Pipeline (TAP).
- Georgia also plays a significant role in the transit of natural gas from Russia to Armenia via the North-South gas pipeline.

The energy sector is mostly privately owned and traditionally one of the largest receivers of FDI inflows in Georgia.

- The energy sector accounts for around 12 per cent of total FDI. Including energy transit infrastructure, such as the South Caucasus Pipeline Expansion Project (estimated at US$ 2.1 billion), the sector is the country's largest FDI receiver.

Source: National Statistics Office of Georgia, EBRD calculations

** Note: Total primary energy supply (TPES) is the overall energy supply available for use in a country. Total final consumption (TFC) is the energy actually used by final consumers after transformation (in homes, transport and businesses).*

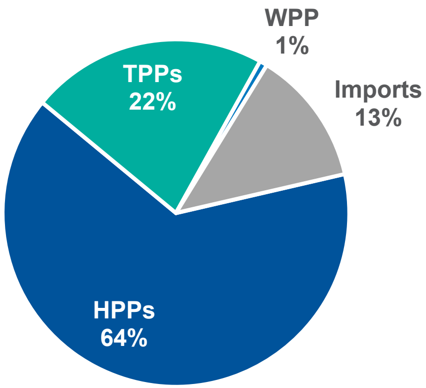
4.5 Advancing the green transition and ensuring energy-sector sustainability

Georgia's dominant hydropower is subject to seasonal factors and the adverse impacts of climate change, creating a need for additional thermal generation and pricey imports

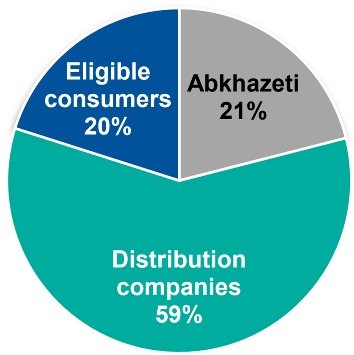
European Bank
for Reconstruction and Development

Structure of Georgia's electricity production and consumption

Power sources (TWh, 2020)

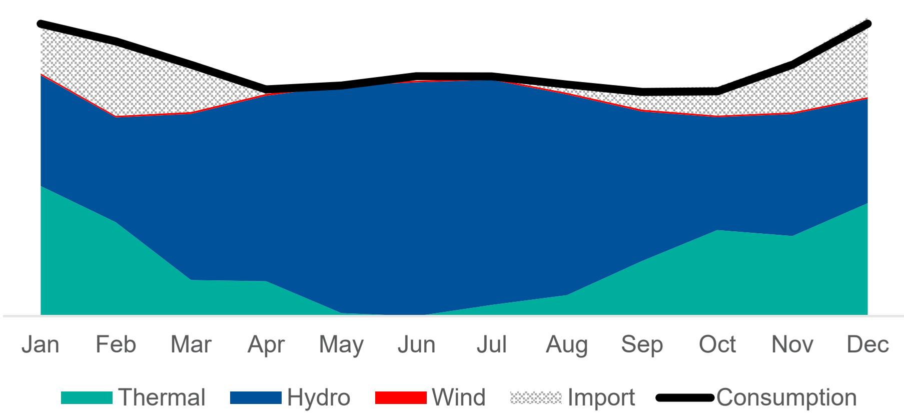


Power consumption (TWh, 2020)



Generation market characterised by seasonal generation and consumption patterns (2020)

2020



Investment in generating capacity is needed to match the rise in demand.

- Generating capacity (which saw a compound annual growth rate, or CAGR, of 2 per cent in 2012-20) is trailing consumption growth (at a CAGR of 3 per cent in 2012-20), resulting in a rise in net imports.
- Additional generating assets will be needed, bolstering the case for greater incentives to attract investment to new generating capacity.
- Hydropower plants account for around 73 per cent of Georgia's installed capacity. Except for two hydropower plants (Enghuri and Vardnili), the majority of installed generation capacity is privately owned, either by local or foreign investors.

The seasonality of power generation is offset by active cross-border trade.

- The mismatch between hydro production – with excess energy generated in summer and insufficient power to meet high demand in winter – creates export opportunities in summer and the need for imports and thermal power production in winter.
- Georgia's electricity grid is connected to that of neighbouring countries Russia, Azerbaijan, Armenia and Turkey.
- The recent refurbishment of Georgia's transmission networks, combined with planned transmission-line projects, are expected to increase the country's export capacity to neighbouring countries.

There are significant climate risks from hydropower dominance.

- These include (i) a rise in energy demand in the summer months, (ii) diverted river flows, (iii) an increase in hydro production in winter due to higher temperatures and flows, (iv) a reduction in overall hydropower potential due to variability of rainfall and higher evaporation rates, and (v) damage to energy infrastructure, which can reduce and disrupt production and prevent energy delivery.
- This means Georgia needs to diversify its energy mix away from hydro to other types of renewable, as well as increase the climate resilience of its energy infrastructure.

Source: ESCO (2021); EBRD calculations.

4.5 Advancing the green transition and ensuring energy-sector sustainability

Ongoing energy-market liberalisation is at odds with the growing role of gas and its preferential treatment in the sector

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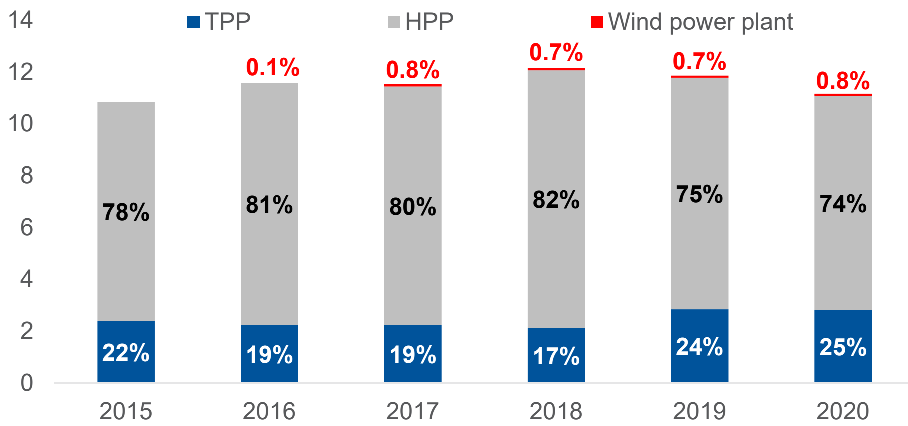
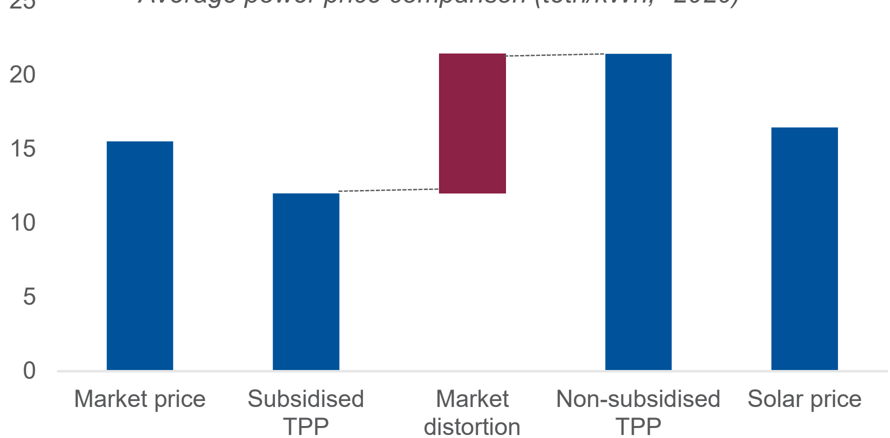
for Reconstruction and Development

Gas-fired thermal power as a share of total electricity generation has been growing (TWh)



Price regulation of social gas cuts the marginal cost of gas technology, disincentivising other technologies, such as renewables

Average power price comparison (tetri/kWh, 2020)*



Gas is supplied by two neighbouring countries with limited opportunities to diversify.

- More than 80 per cent of Georgia's gas comes from Azerbaijan (down from 94 per cent in 2018), while the rest is imported from Russia. The bilateral agreements have not been disclosed.
- The importance of gas-fired thermal power plants to the country's electricity generating mix has been growing in the recent years, reaching 25 per cent in 2020.
- With the overwhelming majority of gas consumption and a quarter of all power consumption dependent on a single supplier, the security of Georgia's energy supply is in the spotlight.

Gas from Azerbaijan is imported at a discount, which is passed on to thermal generation units that produce subsidised electricity, known as social gas, and thus on to consumers.

- Gas from Azerbaijan is mainly imported directly, but a portion is received for free as a form of fee/in-kind payment for gas transit provided to the Shah-Deniz consortium through the South Caucasus Pipeline.
- This free gas effectively becomes a subsidy for households: the gap between the subsidised and actual gas prices is estimated at 40 per cent. Georgia's residential gas prices are lower than those of many other countries that are heavily reliant on imports.

Preferential conditions in the gas sector distort the market for other sources of electricity.

- As a significant share of electricity is consumed at a regulated low price, this underpins rising gas demand in certain sectors.
- A generous government support mechanism for the development, construction and operation of new thermal power plants puts gas at a financial advantage to other sources of generation.
- As a result, other technologies, such as renewables, are being squeezed out of the market.

*Source: ESCO (2021); IEA (2020); EBRD calculations. *100 tetri = 1 lari (GEL).*

4.5 Advancing the green transition and ensuring energy-sector sustainability

Decarbonisation offers significant long-term business opportunities and Georgia is uniquely placed to reap the benefits

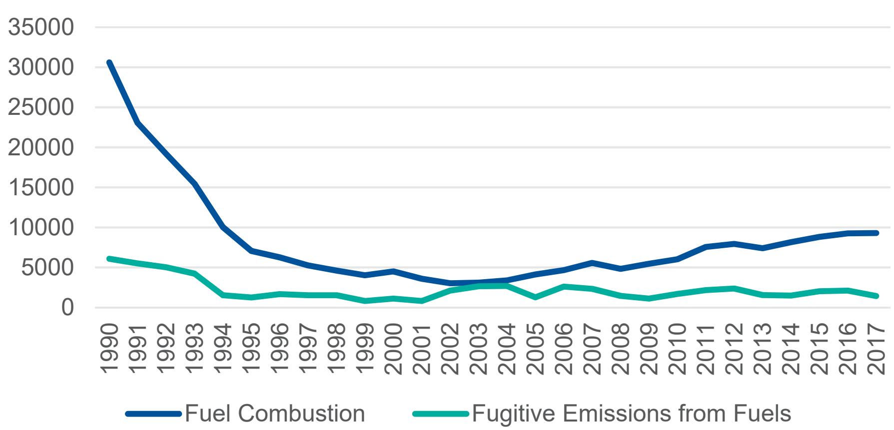
European Bank
for Reconstruction and Development

Government support mechanism for renewable technologies is changing

- The authorities are carefully monitoring the country's transition to a liberalised electricity market, as the country's large hydropower plants benefit from price guarantees and there is a risk of gaps appearing in the sovereign balance sheet should low market prices prevail. To safeguard the sustainability of Georgia's medium-term debt, the authorities are changing the support mechanism for hydropower generation.
- The framework for promoting non-hydro renewable technologies is unclear, however. Developing an appropriate support scheme to attract investors to the new and untested market will be key.

GHG emissions in the energy sector accounted for 80 per cent of Georgia's total emissions in 2017

Energy sector GHG emissions trend (Gg CO_2e)



Vast non-hydro renewable energy potential is largely untapped.

- Georgia's potential hydropower generating capacity is estimated to be upwards of 15,000 MWh per annum, more than three times its current generation, with wind potential estimated at an additional 1,500 MWh (IEA, 2020). The country's solar photovoltaic and solar thermal potential is considerable, with 250-280 sunny days a year in most regions (IEA, 2020).
- With its abundant renewable energy sources and rapid progress on adopting the EU acquis, Georgia is well positioned to reap the benefits of decarbonisation. A law on Promoting the Production and Use of Energy from Renewable Sources, approved in 2019, ambitiously aims for renewable energy to account for 35 per cent of total final energy consumption by 2030, excluding fuel wood consumption (all fuel wood used in Georgia is deemed renewable energy, though not all of it meets EU biomass sustainability criteria) (Legislative Herald of Georgia, 2019). A national action plan on renewable energy is being developed.
- In addition to a clear regulatory framework for developing renewables, Georgia is lacking a solid long-term strategy that would reflect state policy, long-term vision and objectives for carbon neutrality.

Expanding its renewable energy generation capacity would also help Georgia to reduce its total GHGs emissions, as set out in its recently revised Nationally Determined Contribution (NDC).

- Georgia submitted its revised NDC in May 2021, unconditionally committing to cap GHG emissions at 35 per cent below 1990 levels by 2030. With international support, the country is aiming to take this a step further and reduce its overall GHG emissions to 50-57 per cent of 1990 levels by 2030 (Government of Georgia, 2021a).

As a member of the Energy Community, Georgia is required to introduce energy efficiency obligation schemes (or alternative policies) in all sectors, including industry, buildings and transport.

- Georgia's energy intensity is nearly 50 per cent higher than the EU average, as measured by total primary energy supply (TPES)/GDP (purchasing power parity) in 2018.
- The government adopted laws on energy efficiency and the energy performance of buildings in May 2020 (Legislative Herald of Georgia, 2020a; 2020b). These regulations will help improve the energy performance standards of new buildings and retrofits, in line with EU standards. A national action plan on energy, climate and energy efficiency is being developed.

Source: Ministry of Environmental Protection and Agriculture of Georgia (2021).

5. Qualities of a sustainable market economy

5. Qualities of a sustainable market economy

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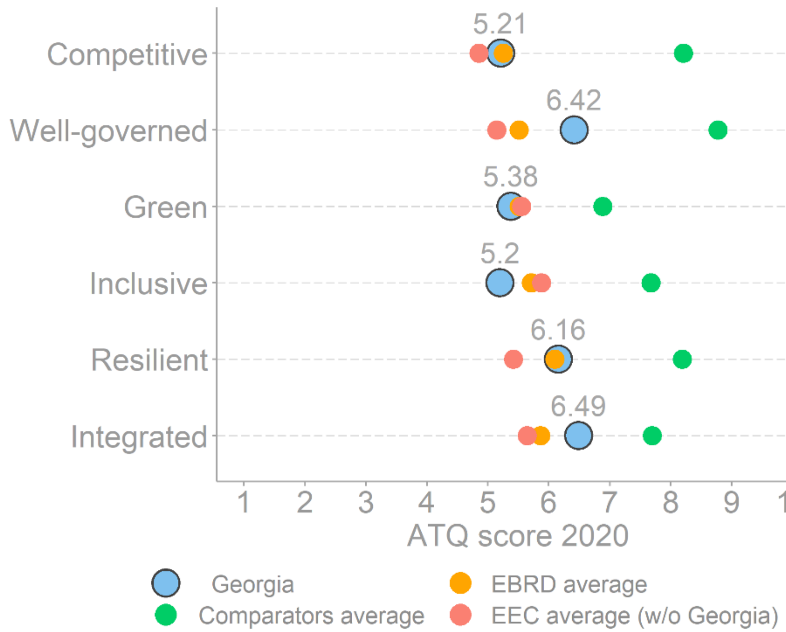
EBRD 2020 Assessment of Transition Qualities (ATQ)



The EBRD’s methodology for measuring transition gaps is based on the following six desirable qualities of a sustainable market economy: competitive, well governed, green, inclusive, resilient and integrated. Progress on a transition path is measured on a continuous scale of 1 to 10, where 10 is the best possible score and denotes the frontier. The composite indicators at quality level aggregate a wide range of sub-indicators.

**Scores for advanced comparator economies are a simple average of the scores for Canada, the Czech Republic, France, Germany, Japan, Sweden, the United Kingdom and the United States of America.*

See the EBRD *Transition Report 2020-21* for a list of indicators, data sources and methodological notes.

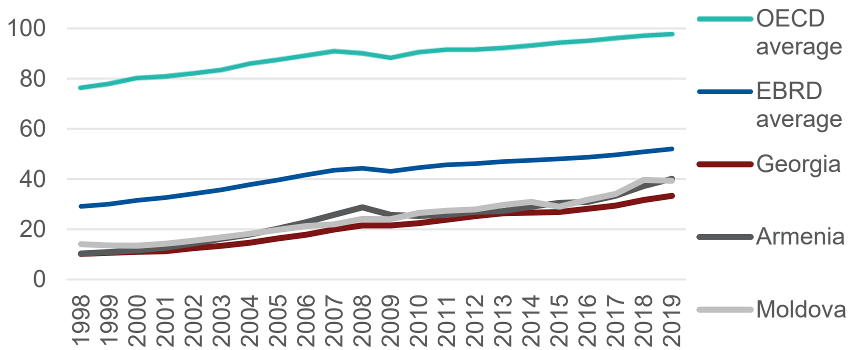
5. Qualities of a sustainable market economy

Competitive [Score: 5.21 out of 10 | Rank: 20 out of 38]

European Bank
for Reconstruction and Development

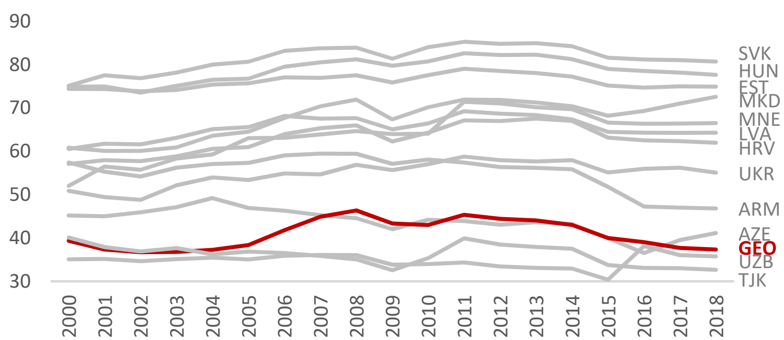
Labour productivity in Georgia is lagging that of its comparators

GDP per person employed, PPP adjusted, US$ thousand



Despite its high degree of openness to international markets, Georgia's integration into global value chains remains limited

Global Value Chain Participation Index [0 to 100, the higher the better]



Ranked 120th out of 141 on the ease of finding skilled employees and 74th on the overall ranking (WEF, 2019)

Ranked 63rd out of 131 countries on the Global Innovation Index (WIPO, 2020)

Ranked 68th out of 134 countries on the Network Readiness Index (Portulans Institute, 2020)

Georgia's competitiveness is constrained by governance challenges, a lack of appropriate workforce skills, limitations on domestic and external connectivity and persistent weaknesses in the business environment.

- Georgia has made significant improvements over the past five years and become the best Eastern Europe and the Caucasus (EEC) performer in terms of competitiveness. Its regulatory framework could be improved, however, especially in terms of competition law, institutions and enforcement. Rigorous implementation of the country's new insolvency law could also improve the corporate insolvency framework.
- The business environment for SMEs is favourable, as evidenced by the EBRD's Adjusted SME Index (where Georgia scores 5.73 compared with 5.16 for the EBRD regions as a whole), but access to finance should be advanced.
- Institutional weaknesses and political economy considerations translate into powerful vested interests, links between business and politics and undue political influence on the public governance system. There is scope to address regulatory and enforcement limitations on the competition front.
- Poor workforce skills are among main business constraints. Closing the skills gap requires addressing educational weaknesses and eliminating skills mismatches.
- Resources are locked up in low-productivity activities, capping overall labour productivity. Agriculture employs a significant share of the workforce, but has low productivity. The goods export basket is dominated by low-complexity products and export diversification is low, despite improvements over the past decade. Tourism is Georgia's main export, attracting foreign-currency inflows equal to 20 per cent of GDP in 2019, while advanced services (such as communications, financial, insurance and other business services) do not account for a significant share of the country's exports.
- Despite being open to international trade, Georgia participates little in global value chains. It is one of the weakest performers in the EBRD's Global Value Chains Participation Index. Transport barriers raise the cost of trade, restrict market access and reduce allure for productivity-enhancing foreign investment.
- Georgia appears to be an intermediate knowledge economy, ranking 14th in the EBRD regions and among the best in the EEC region, based on the EBRD Adjusted Knowledge Economy Index 2020. Georgia performs well when it comes to the presence of institutions that favour innovation and the availability and quality of skills for innovation, though the availability of technical skills is low. The weakest performance is recorded on the innovation ecosystem pillar.

Source: World Bank (n.d.); EBRD (2018); EBRD calculations.

5. Qualities of a sustainable market economy

Competitive [Score: 5.21 out of 10 | Rank: 20 out of 38], *cont'd*

European Bank
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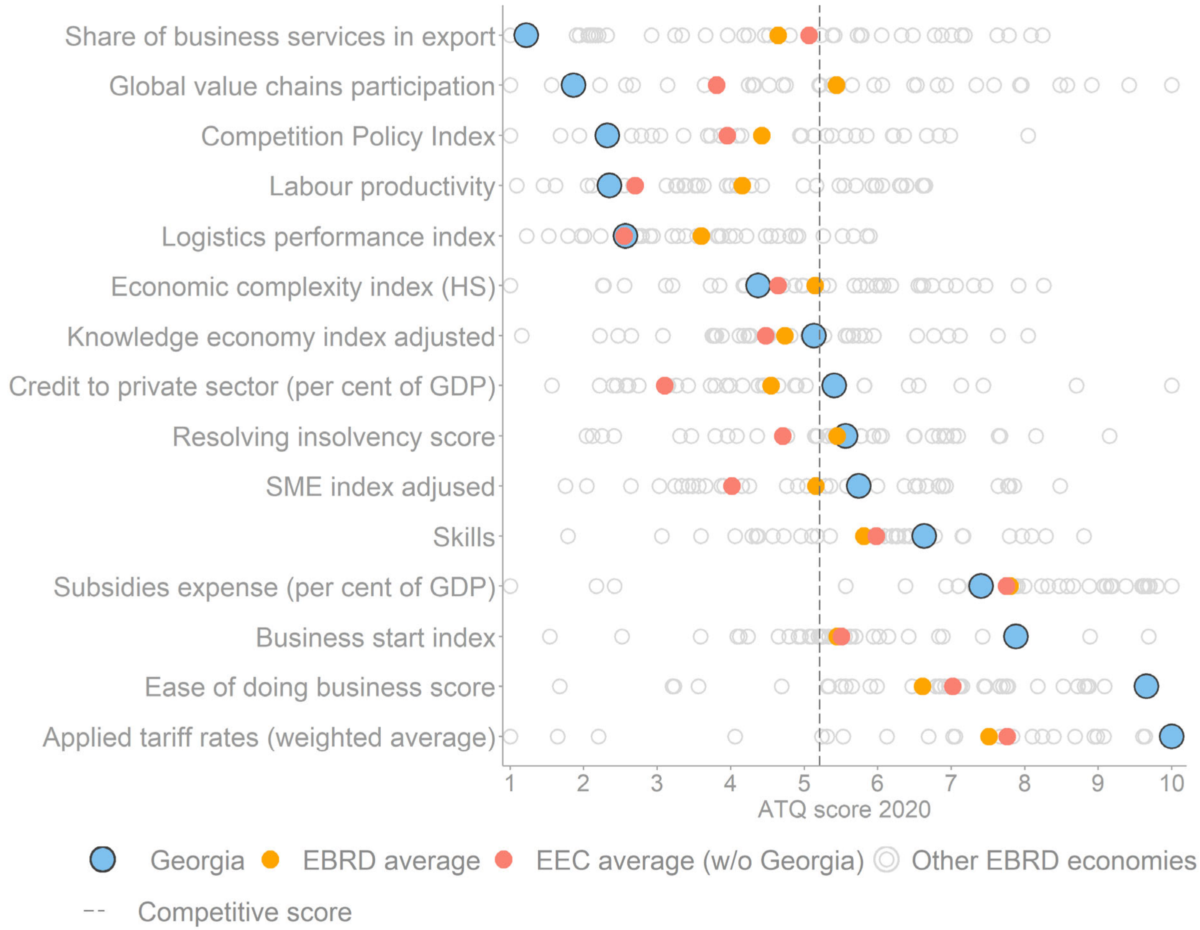


Source: EBRD

Note: Visit https://2020.tr-ebrd.com/structural-reform/ for the list of indicators, data sources and methodological notes.

5. Qualities of a sustainable market economy

Well governed [Score: 6.42 out of 10| Rank: 7 out of 38]

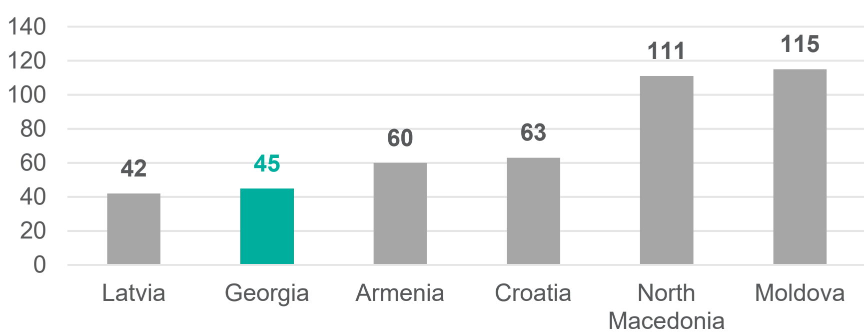
European Bank
for Reconstruction and Development

Political instability continues to have a significant impact on Georgia's business environment

WGI 2020 (data refer to 2019), scores on a scale of -2.5 to +2.5

Georgia is on a par with regional peers on corruption perception, though there is room to improve and continued vigilance is needed

Rank out of 180 economies



30 per cent of businesses in 2019 deemed political instability the main obstacle to doing business (EIB, EBRD and World Bank Group, 2019).

Georgia has the lowest level of perceived corruption amongst EEC countries, ranking 45th out of 180 economies (Transparency International, 2021).

Georgia lacks a long-term plan for development, ranking 86th of 141 economies in "government long-term vision" in 2019 (WEF, 2019).

Over the past two decades, Georgia has undertaken an ambitious reform agenda, resulting in significant improvements in the investment climate. However, major challenges remain and governance standards must remain high on the reform agenda to foster a better investment climate and strengthen the rule of law.

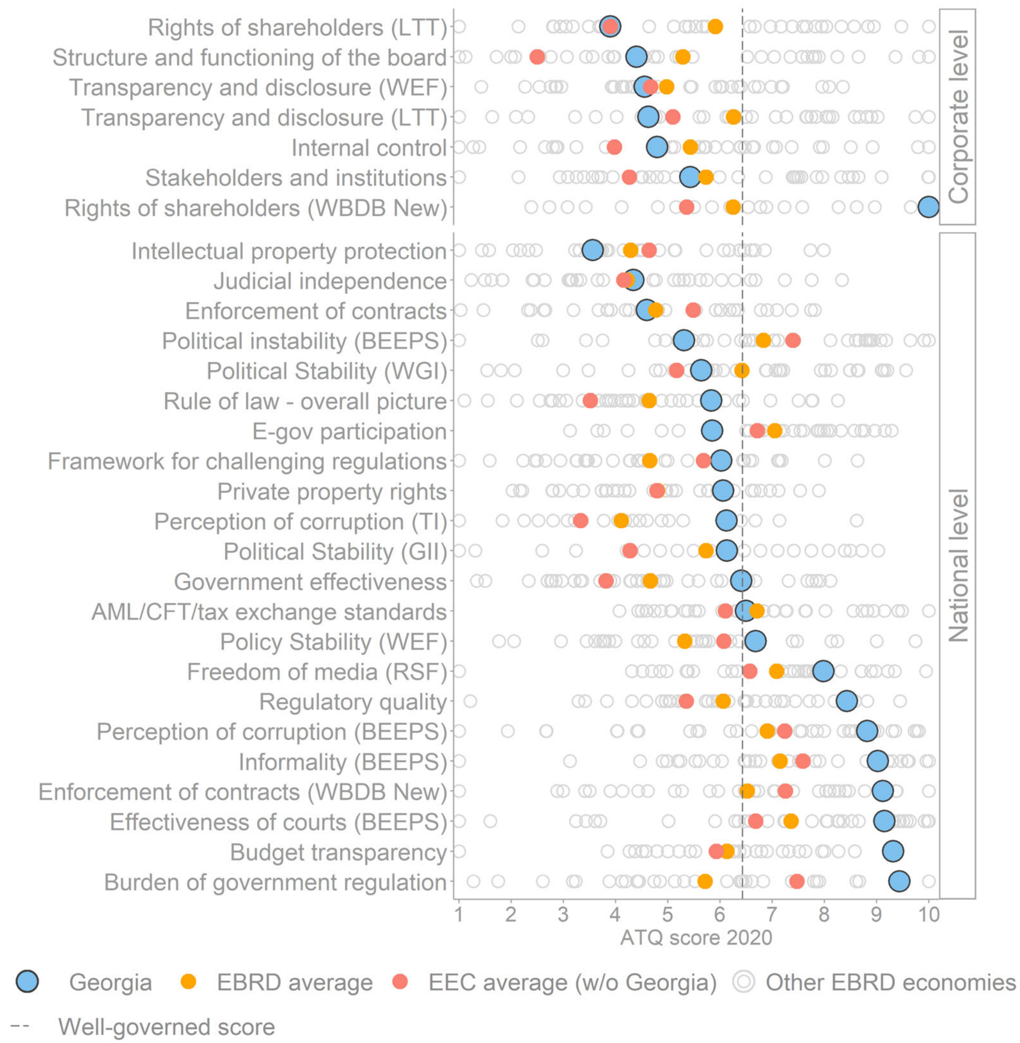
- Political volatility is the most constraining governance shortfall in Georgia. A polarised and personalised political scene plagued by strong mutual mistrust helps create an enabling environment for the excessive centralisation of power and a lack of continuity or predictability in policy making.
- Georgia ranks highest in the region on corruption perception, though concerns persist over undue partisan influence on law enforcement, rendering agencies next to incapable of investigating cases of potential high-level corruption.
- The public administration continues to display significant shortcomings, with vested interests, the concentration of power, limited institutional memory (due to high staff turnover, significant capacity gaps in key governmental institutions) and a perception of civil servants' personal loyalties being prized over competence remaining significant areas of concern.
- Inefficiencies in the court system – including a significant backlog of cases, further exacerbated by Covid-19 – and a lack of judicial independence remain major challenges, compounded by a lack of judicial capacity and competence to adjudicate commercial disputes in an effective and timely way.
- Georgia lacks a corporate governance code or unified legal act, with rules on corporate conduct defined in a number of different laws. The structure and functioning of company boards and internal corporate controls were deemed "weak" in the EBRD's 2017 corporate governance assessment (EBRD, 2017).
- Public procurement in Georgia was digitised a decade ago, simplifying the procurement process and increasing transparency. Even so, concerns remain about the risk of corruption.
- Motivated by the recent deterioration in the financial performance of state-owned enterprises, the government is preparing a comprehensive SOE governance reform bill to limit fiscal risk and increase efficiency.

Source: World Bank (n.d.); Transparency International (2021); EBRD calculations.

5. Qualities of a sustainable market economy

Well-governed [Score: 6.42 out of 10| Rank: 7 out of 38], *cont'd*

European Bank
for Reconstruction and Development



Source: EBRD

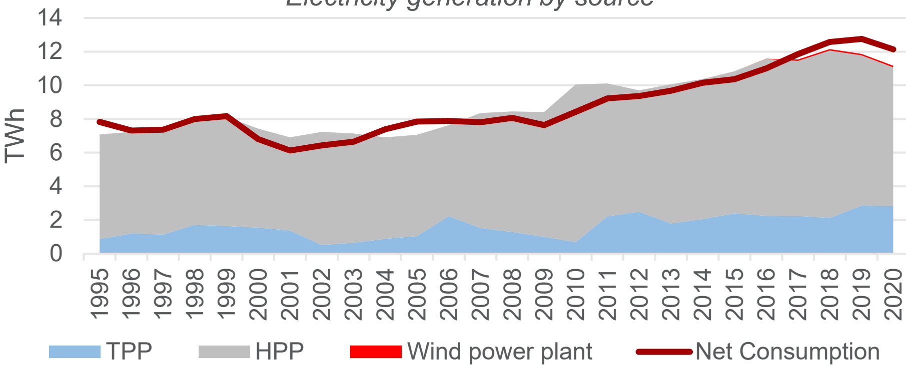
Note: Visit https://2020.tr-ebrd.com/structural-reform/ for the list of indicators, data sources and methodological notes.

5. Qualities of a sustainable market economy

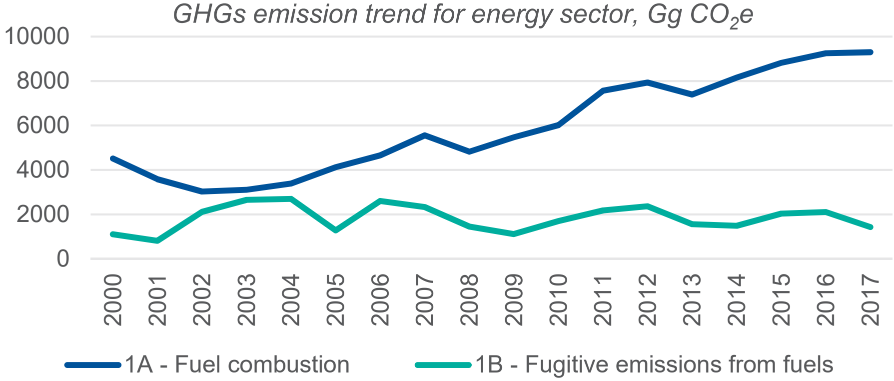
Green [Score: 5.38 out of 10 | Rank: 21 out of 38]

European Bank
for Reconstruction and Development

Negligible contribution to electricity generation by renewable energy sources other than hydro



Greenhouse gas emissions in the energy sector have been rising



In 2000-18, total final consumption of energy increased almost twofold, while the renewable contribution to total primary energy supply fell from 41 per cent to 24 per cent.

Potential generation capacity from renewable energy sources, not counting hydro, is upwards of 15,000 TWh per annum.

Georgia has a high level of forest cover (40 per cent), the highest in the Caucasus and Central Asia, which average 4-13 per cent.

Georgia's green economy transition will need to focus on promoting sustainable energy and addressing climate change and waste management by aligning its legislation with that of the EU. In its NDC, Georgia committed to reducing GHG emissions by 15 per cent from business as usual by 2030 (Government of Georgia, 2021a). As a member of the European Energy Community, Georgia is working to align its legislation with the EU energy acquis, in particular, to promote energy efficiency and renewable energy.

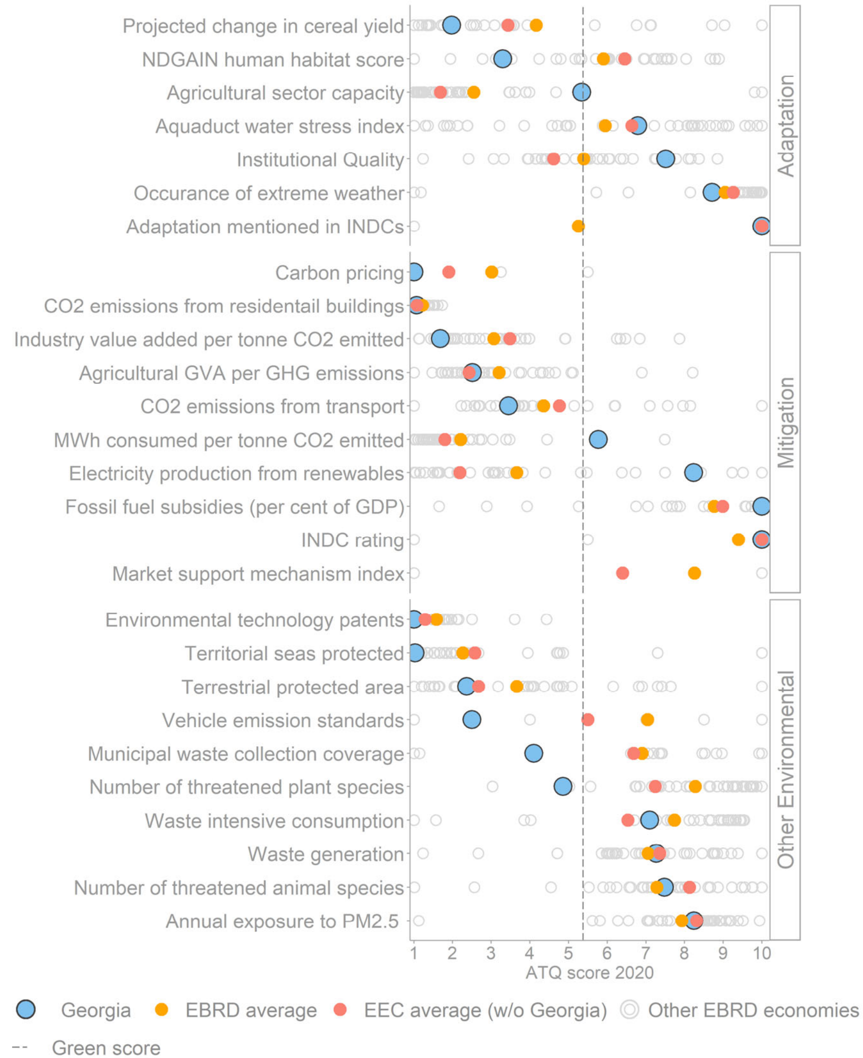
- Georgia should continue to improve its legal and institutional framework to align the energy sector with EU regulation, including by gradually phasing out implicit subsidies and cross-subsidies in the electricity and gas sectors. While the Energy Strategy of Georgia 2020-30 is in place (Ministry of Environmental Protection and Agriculture of Georgia, 2019), further work is needed, such as including strategic targets based on supply-demand trends and running various scenarios for the energy sector.
- Georgia's economic growth correlates with a rise in energy demand that is showing no signs of decoupling. Georgia's energy intensity is about 30 per cent higher than the EU average, highlighting the need for greater energy efficiency. Laws on buildings energy efficiency and performance from 2020 are steps in the right direction.
- Georgia's vast renewable energy source potential outside of hydro is largely untapped. Its energy strategy targets diversified generation and more trade with neighbouring countries. The Law of Georgia On Promoting the Production and Use of Energy from Renewable Sources ambitiously aims for renewable energy to account for 35 per cent of total final energy consumption by 2030 (Government of Georgia, 2019). The sustainability of fuelwood consumption (counted as renewable, even though not all of it meets the EU sustainability criteria for biomass) should be improved.
- Around 900,000 tonnes of waste is generated annually in Georgia and around 75 per cent of that is estimated to end up in landfill, more than double the EU average (EU Neighbours East, 2018). Many illegal dumpsites are located near populated areas, motorways, natural water reservoirs, riverbeds and ravines. Most of the 63 landfill sites operating under local government authorities do not have proper measures in place for groundwater protection, leachate collection or treatment. The legal environmental framework is outdated and does not cover recent policy developments. The Third National Environmental Action Programme (NEAP-3) proposes a range of priority actions in addressing waste (Government of Georgia, 2018).
- Georgia is facing severe negative consequences of climate change, including a rise in temperatures, changes in precipitation patterns, reduced water availability, a rise in Black Sea water levels, an increase in the frequency and intensity of floods, flash floods, landslides and mudflows, drought and extended evaporation. Moreover, changes in precipitation patterns and water body regimes affect the hydro resources deemed an environmentally sound alternative source of electricity. The NEAP-3 identifies a range of actions to address climate change (Government of Georgia, 2018).

Source: IEA (2020); World Bank (n.d.); Government of Georgia (2021b).

5. Qualities of a sustainable market economy

Green [Score: 5.38 out of 10 | Rank: 21 out of 38], *cont'd*

European Bank
for Reconstruction and Development



Source: EBRD

Note: Visit https://2020.tr-ebrd.com/structural-reform/ for the list of indicators, data sources and methodological notes.

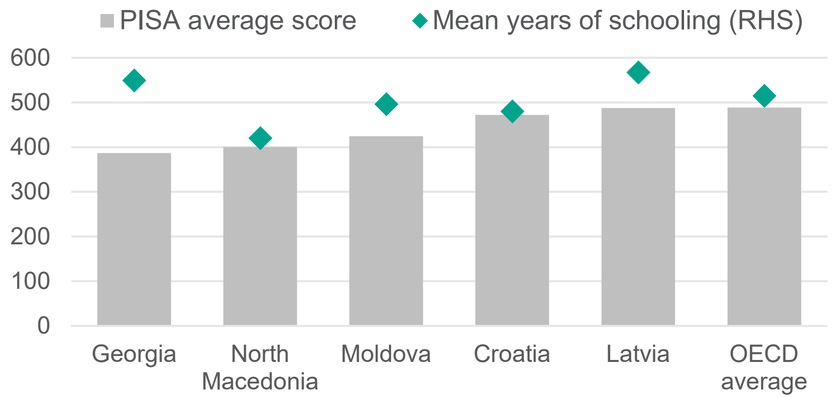
5. Qualities of a sustainable market economy

Inclusive [Score: 5.20 out of 10 | Rank: 28 out of 38]

European Bank
for Reconstruction and Development

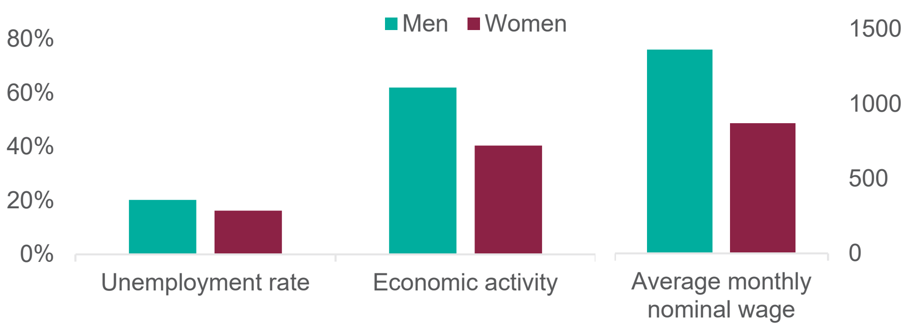
Skills of students compare poorly with those of the wider region, despite high educational achievement levels

Average scores (PISA), in 2018



Employment outcomes show large gender disparities

Share of 2020 working-age population (in GEL, 2019)



Share of youth not in employment, education or training totalled 26 per cent in 2019 (Geostat).

Spending on vocational education was 3.2 percent of total spending on education in 2019 (Galt and Taggart, 2020)

Tbilisi employs more people and generates more value added than all other regions of Georgia combined (Geostat).

Challenges associated with skills and labour shortages are becoming one of the most pressing obstacles to doing business in Georgia, as labour-force skills do not match the evolving needs of companies. Persistent gender disparities and wide regional differences need to be addressed.

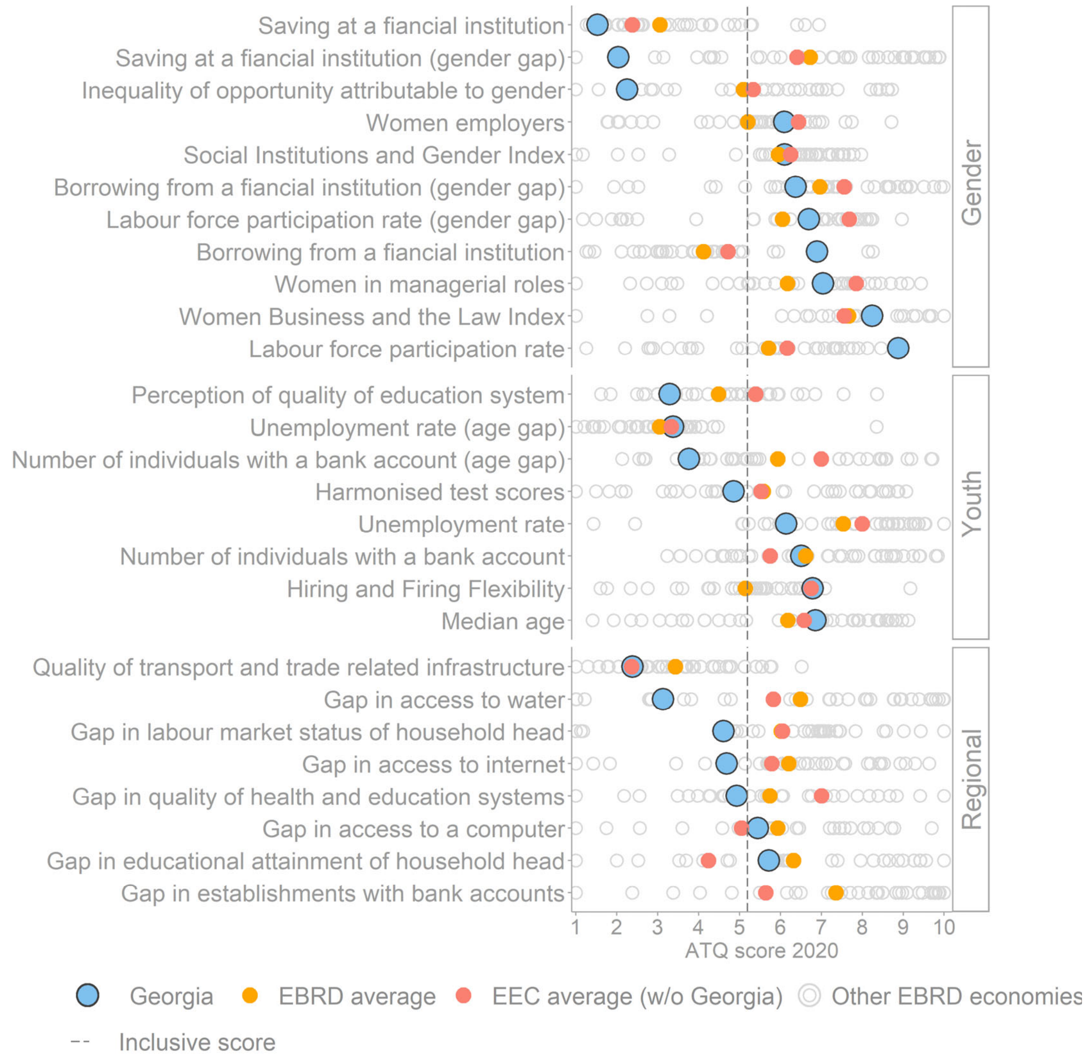
- Addressing high youth unemployment, improving workforce skills and resolving youth inclusion issues requires addressing weaknesses in the education system and skills mismatches. The poor quality of Georgia's education system is affecting the learning outcomes of youth, despite the country's high educational achievement levels. At the same time, there are significant skills mismatches, with around a third of Georgia's population over-qualified for the work available. In addition, there is also high unmet demand for technical skills. The gap between youth and adult unemployment in Georgia is large and roughly on a par with the regional average. Young people's access to banking services is noticeably constrained, as reflected in the low rates of bank-account ownership among young people compared with older age groups; the gap is wider than both the EBRD and regional averages.
- Georgia performs relatively well and in line with regional and EBRD averages when it comes to evaluating the potential discriminatory stance of social institutions that could restrict women's and girls' access to rights, justice and empowerment opportunities. The share of women in managerial roles and the share of women employers are low (though higher than the EBRD average). Women's labour-force participation was 43 per cent in 2019, compared with 62 per cent for men, reflecting a considerable gender gap (though somewhat lower than the regional average) (Geostat, n.d.). Gender pay gaps are also significant in Georgia, with the average male employee earning about 57 per cent more than their female counterparts (the figure changes if taking into account the number of hours worked, educational background and other factors) (Geostat, n.d.). Access to finance is one of the main barrier to women's economic empowerment, with the rates of women saving at financial institutions in Georgia among the lowest of the EBRD countries.
- There are considerable regional disparities in employment outcomes, as well as access to public services, such as transportation and water services. Slightly less significant regional disparities also exist in terms of the labour-market status of household heads, access to the internet, and inter-regional health and education quality compared with the EBRD and regional averages.

Source: OECD (2018); WEF (2019); National Statistics Office of Georgia; EBRD calculations.

5. Qualities of a sustainable market economy

Inclusive [Score: 5.20 out of 10 | Rank: 28 out of 38], *cont'd*

European Bank
for Reconstruction and Development



Source: EBRD

Note: Visit https://2020.tr-ebrd.com/structural-reform/ for the list of indicators, data sources and methodological notes.

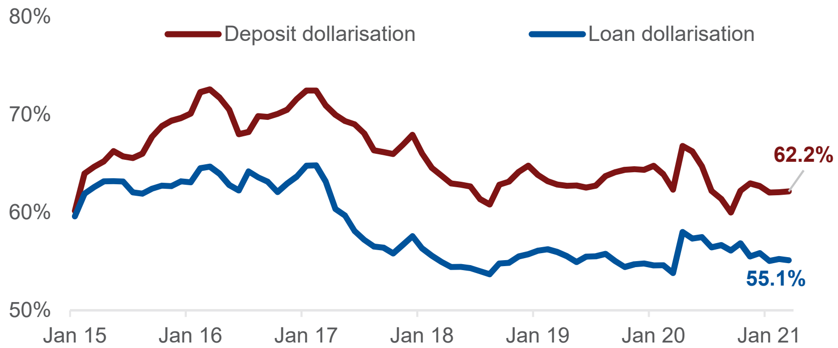
5. Qualities of a sustainable market economy

Resilient [Score: 6.16 out of 10 | Rank: 17 out of 38]

European Bank
for Reconstruction and Development

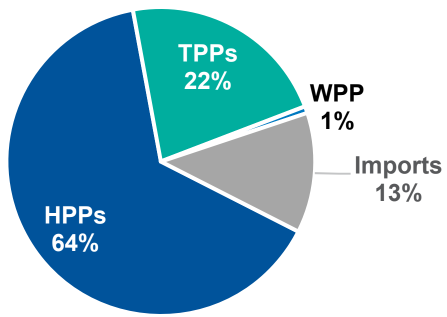
Dollarisation is a perennial concern

As share of total deposits/loans



Power generation is dominated by hydro resources

Power sources in TWH, 2020



Around 61 per cent of deposits and 55 per cent of loans were in foreign currency at the end of 2020 (NBG).

Financial system funds borrowed from abroad were about 18 per cent of GDP as of H1 2020. The loan-to-deposit ratio stood at 130 per cent in May 2020 (NBG).

Hydro power plants accounted for 74 per cent of power generation in 2020, but other sources of renewable energy are underutilised.

The Georgian banking sector has demonstrated resilience to adversity. It is generally well managed, comfortably capitalised, consistently profitable and relatively efficient in channelling credit to the real sector. The fallout from the pandemic has been managed well, although it may still have a debilitating impact on banks' balance sheets. Ensuring the sustainable transition of the energy sector, meanwhile, requires continued reform, in line with the EU acquis, and greater decarbonisation efforts.

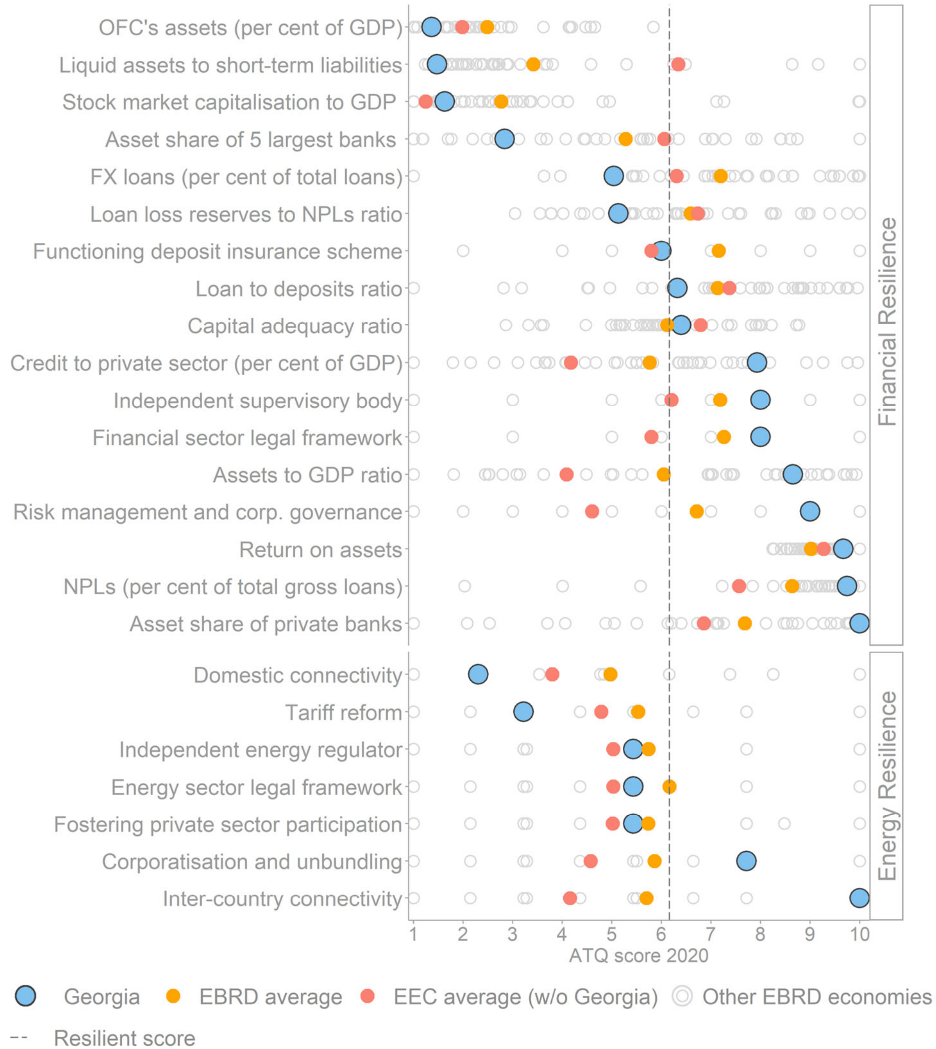
- The banking sector is fully private and overwhelmingly foreign owned, including by international institutional investors through publicly listed shares. Basel III capital and liquidity requirements are in place and the banking resolution framework has been brought into compliance with sound practices.
- The two largest banks, both listed on the London Stock Exchange, together account for around three-quarters of total loans and deposits and close to 80 per cent of sector assets. Their role in preserving financial stability is crucial, though concentration risk is mitigated by their stellar performance as regional flagships.
- The financial system has weathered the Covid-19 crisis well, supported by the regulator's forbearance measures. However, banking-sector balance sheets are not immune to the pandemic. Substandard and restructured loans have risen and profitability has fallen dramatically, but a recovery is underway.
- Dollarisation is a perennial concern. NBG's de-dollarisation efforts have been undermined by the trust-eroding depreciation of the GEL in recent years.
- A significant portion of banks' medium- to long-term funding is sourced in foreign currency from external wholesale investors (including international financial institutions), exposing the banking system to foreign-exchange refinancing risk.
- Domestic capital markets are under-developed and lack capacity to cater for the local currency wholesale funding needs of Georgian companies.
- Georgia is reliant on primary energy imports for domestic consumption as the country does not have natural resources such as oil and gas.
- The electricity sector is dominated by hydro power plants. Due to the seasonality of hydrology, gas-fired power plants and imports play an important role in balancing the power system, especially in the winter months.
- The implementation of the country's electricity market reform, and the expected date for the power exchange, were postponed to 1 January 2022. This is going to require substantial effort from both policymakers and private players if it is to be accomplished and deliver benefits to consumers.
- There is space to improve sectoral regulation and reduce consumer fossil-fuel subsidies, which have a distortive effect on the power market.

Source: NBG, ESCO (2021); EBRD calculations.

5. Qualities of a sustainable market economy

Resilient [Score: 6.16 out of 10 | Rank: 17 out of 38], *cont'd*

European Bank
for Reconstruction and Development



Source: EBRD

Note: Visit https://2020.tr-ebrd.com/structural-reform/ for the list of indicators, data sources and methodological notes.

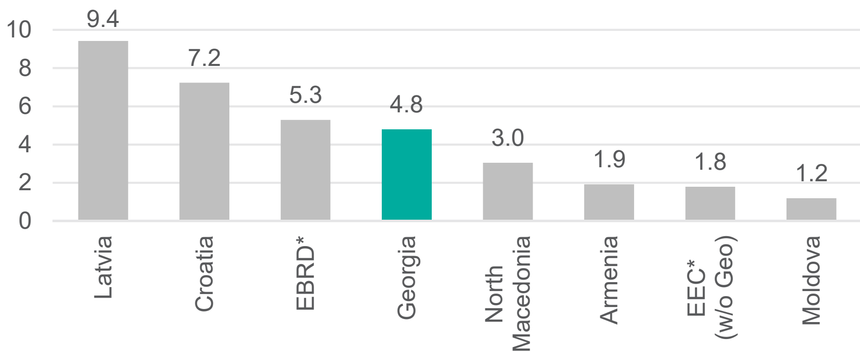
5. Qualities of a sustainable market economy

Integrated [Score: 6.49 out of 10 | Rank: 13 out of 38]

European Bank
for Reconstruction and Development

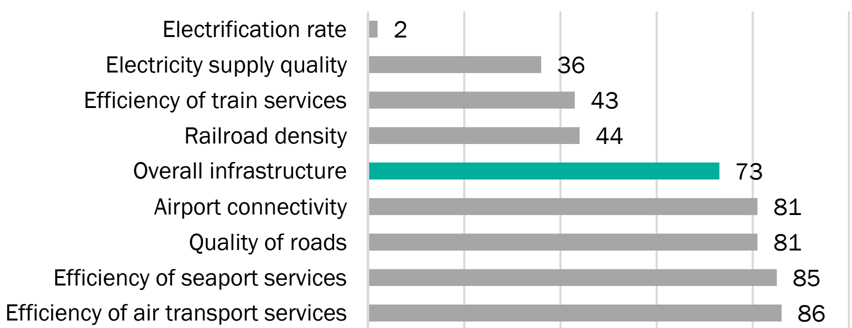
FDI stock per capita is higher than the EEC average, but lower than in other comparators, such as Latvia

Thousand US$ per capita, 2019



Overall quality of infrastructure is ranked 73rd on the WEF Global Competitiveness Index

Rank out of 140, 2019



Georgia ranks 29th regarding road connectivity among all EBRD countries with intercity travel times typically being 90 per cent longer than the frontier.*

148th (out of 181) on Liner Shipping Connectivity Index which captures level of integration into global liner shipping networks (UNCTAD)

Ranked 119th out of 160 countries on Logistics performance (international) index (WB LPI, 2018)

Internal and external integration is constrained by the need to improve international transport services and infrastructure.

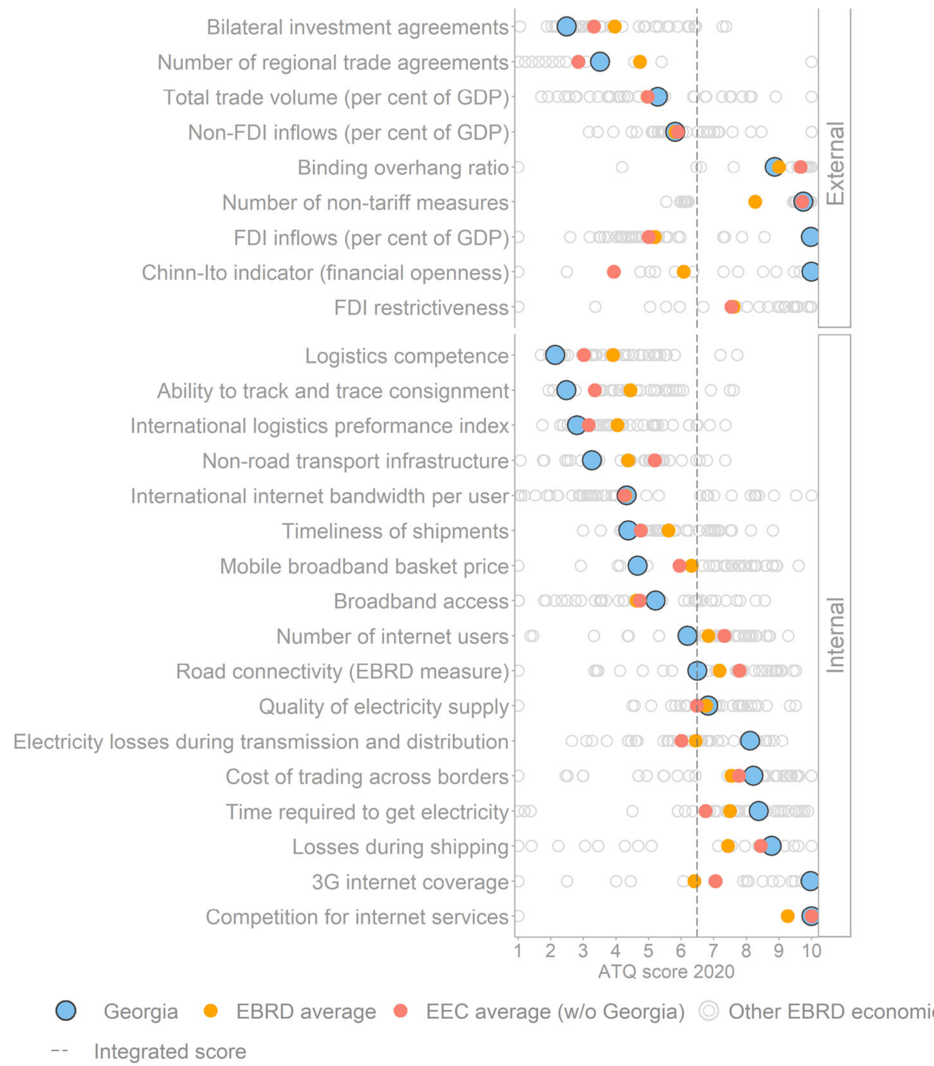
- Exports and imports of goods and services as a share of GDP in Georgia (103 per cent) are above the EBRD average of 97 per cent, but are driven by the tourism sector. As a non-EU state, the country has only signed 13 regional trade agreements, below EBRD and OECD comparator country averages (18 and 33, respectively). Georgia's weighted average applied tariff rate is very low (0.67 per cent in 2016) and it has one of the lowest reported Most Favoured Nation (MFN) rates in the world. However, Georgia's binding overhang ratio (the gap between the bound and applied MFN rates) is far higher than the EEC and EBRD averages, suggesting that its trade policies are less predictable. There are 129 non-tariff measures in use in the country, fewer than the EBRD average of 900.
- Georgia's openness to FDI flows (10.3 per cent of GDP on average over the past five years) is considerably above the regional (4.6 percent) and EBRD averages (5.4 per cent). The country's FDI inflow-to-GDP ratio is among the highest of all the economies in which the EBRD invests, but the composition of those FDI inflows in the recent years has been skewed towards retained earnings rather than new investments. The country is party to 37 bilateral investment agreements, about a third of the OECD average.
- According to EBRD's Road Transport Connectivity Index, Georgia lies in the bottom 10 EBRD economies when it comes to quality of road transport. Intercity travel times are typically 90 per cent longer than the frontier,* compared with an EEC average of 60 per cent. Efficiency and access to air transport and seaport services are also below average.
- Logistical competence (such as transport operators and customs brokers), the ability to track and trace consignments and the timeliness of shipments achieve low scores, but are on a par with other EEC countries. The cost of trading across borders is below the EEC and EBRD averages. To build on Georgia's strategic position, these need to be improved.
- Georgia's quality of electricity supply is above the EEC and EBRD averages. Electric power transmission and distribution losses and time required to get electricity are on a similar level to OECD comparator countries. The country has better 3G coverage and broadband access than the regional and EBRD averages, while 72.5 per cent of the population uses the internet (ITU, n.d.).

Source: UNCTADstat (n.d.); WEF (2019); EBRD Road Transport Connectivity Index.
** In km/h over a distance of 100 km as the crow flies.*

5. Qualities of a sustainable market economy

Integrated [Score: 6.42 out of 10| Rank: 13 out of 38], *cont'd*

European Bank
for Reconstruction and Development



Source: EBRD

Note: Visit https://2020.tr-ebrd.com/structural-reform/ for the list of indicators, data sources and methodological notes.

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