Georgian-European Policy and Legal Advice Centre (GEPLAC)

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GEORGIAN ECONOMIC TRENDS

Quarterly review

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GEORGIAN ECONOMIC TRENDS

Georgian Economic Trends (GET) is a quarterly publication of the Georgian-European Policy and Legal Advice Centre (GEPLAC), which aims at providing all interested readers with a review of developments in the Georgian economy and analysis of economic reform and policy pursued by the government. GET is issued in both Georgian and English languages and is available on the internet.

GET is an independent publication. The materials represent the views of the authors and do not represent any official opinion of the European Commission, the Georgian-European Policy and Legal Advice Centre, or the Georgian Government.

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GEPLAC SURVEY

Some Empirical Evidence on the Capacities for Investment and Growth in Georgian Industrial Companies

At the end of 2006, GEPLAC conducted a survey of the capacities for investment and growth of Georgian industrial companies.* A business survey questionnaire in Georgian was sent to more than 70 firms from which there have been 34 complete answers. In addition, field visits have been conducted within 17 firms.

The survey included companies of various types of ownership (state-owned and private) who are active in diverse sectors and whose combined sales in 2005 accounted for 10.6 percent of the total sales of the Georgian manufacturing industry. Amongst the surveyed were three firms with annual sales lower than 100.000 GEL, 20 firms with annual sales between 100.000 and one million GEL, nine firms with annual sales between one million GEL and ten millions GEL, one firm with sales between 10 and 50 millions GEL and one firm with sales above 50 millions GEL.

The survey confirmed a significant upward trend in output and exports: between 2004 and 2006, the respondents reported an overall increase of sales by 145 percent and of exports by 283 percent. It should be noted that these figures are higher than the recorded average growth of Georgian industry and may reflect some positive bias in the survey. We contacted firms which we could identify through the World Wide Web or through such organisations as the Georgian National Investment or the Federation of Georgian Businessmen. Relatively unsuccessful companies, which have not been restructured, are often not represented in such organisations and are without web sites.

Despite the fact that the survey was conducted at a moment when relations with Russia were quite tense, the results show that businessmen were rather optimistic with regards to their future prospects. They expected a 39 percent annual growth of sales in 2007 and a 25 percent growth of their exports.

At this stage, the evidence was that investments (including the rebuilding of inventories of intermediate inputs) have grown much less than output and exports. This mainly reflects the fact that there is still some over-capacity to produce at the enterprise level. On average, firms consider that they use only 60 percent of their existing capacity. The situation may be changing for better, however, as they anticipate the growth in their investment (47 percent) will be substantially higher in 2007 than the growth in their output and exports. For these investments, 12 respondents intend to get a 100 percent bank credit or leasing, ten respondents will finance them exclusively with their own equity (retained earnings and capital increase) and 11 will have a mix of debt and equity.

It is interesting to note that amongst the 14 firms which consider that they use more than 70 percent of their capacity, ten have foreign partners in their share capital knowing that only 17 firms out of 34 are in this situation.

Through the medium of a questionnaire, we tried to identify the main factors determining today the willingness to invest. The factors playing a very positive role were given a mark of 2, those playing a positive role were identified with a mark of 1, neutral ones received a mark of 0, negative ones were given a mark minus 1 whilst extremely negative factors received a mark of minus 2.

The results of the survey showed a generally positive mood amongst the firms surveyed. There were no extremely negative answers (minus 2) and only six negative answers (minus 1) from within a total of 306 responses. Four of the latter were recorded in the factor "Strength of international demand for the products" and were related to wine producing companies and obviously reflecting the consequences of

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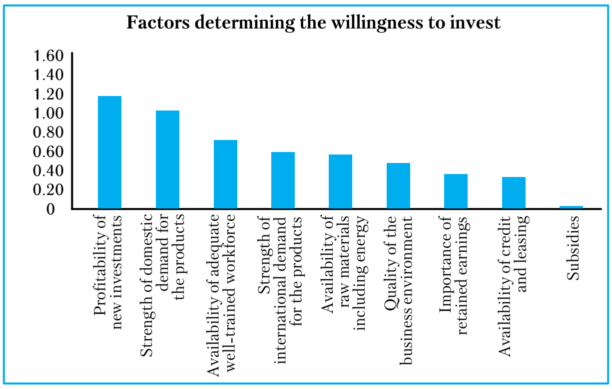
* *The team comprised GEPLAC experts Christophe Cordonier and Rostom Gamisonia.*

the Russian embargo on their sales. The two others were connected with foreign controlled companies which evaluate negatively the “Quality of the business environment” on their development prospects.



The first factor determining the willingness to invest is the profitability of new investments for which the average of answers gives a figure of 1.35 (between positive and very positive). It shows that Georgian competitive advantages remain strong, despite the recent increase in the real effective exchange rate and in the labour costs.

The second positive factor is associated with the strength of the domestic demand. For this factor, we obviously note a big difference between export-oriented firms and firms geared towards the internal market. The average figure of 1.18 does not reflect this polarisation as there are 15 firms considering that this factor plays a very positive role and nine saying that it is neutral.

The factor “Availability of adequate well-trained workforce” gets a 0.82 average mark which is rather positive taking into account the current situation of the vocational training system. For this factor, the best answers are usually recorded with wine producing companies.

The factor “Strength of international demand of the products” gets a 0.68 average mark which is quite a positive result given the Russian embargo. The same can be said of the factor “Availability of raw materials including energy” (0.65).

Paradoxically, the “Quality of the business environment” is not recognised as an important factor for investing and gets only a 0.55 mark. This may reflect the desire for alleviating the administrative pressure still existing in the business environment.

Finally, we must stress that firms do not consider the financial environment as a key positive factor for their willingness to invest. The importance of their retained earnings gets a 0.41 mark, that of the availability of credit and leasing receives a 0.38 mark and that of subsidies obtains a negligible 0.03 mark. Once again, these figures show that the banking sector still does not play a positive role for the development of production in Georgia.

MAIN ECONOMIC EVENTS

2006

2 October

The Russian State Duma, the lower house of the Parliament, will develop a **draft law giving the government the right to ban money transfers from Russia** into "certain countries" in "cases of emergency," Russian Duma Chairman Boris Grizlov said. He stated that the move is a response to Georgia's detention of four Russian military officers. Recently, some politicians and analysts in Russia are calling for more economic sanctions against Georgia, including banning of money transfers from Russia, where several thousand Georgians are working.

2 October

The Ministry of Transport of the Russian Federation has announced the **suspension of air, sea, rail and land traffic with Georgia**. An official from the Russian Transport Ministry cited the debts of Georgian air companies for air traffic service as the reason behind the decision. Officials in Tbilisi say that no official notification about the decision has been received from the Russian side.

13 October

Georgia's delegation to the World Trade Organisation (WTO) said it will not set **a date for the next round of multilateral talks over Russia's WTO accession**. The statement of the Georgian Foreign Ministry reports that Russia's ban on imports of Georgian wine, sparkling and mineral water, as well as vegetable products, was further deteriorated after air, sea, land, rail and postal communication between the two countries was severed in a situation "equal to a total economic blockade of Georgia." In March 2006, before Russia imposed sanctions on Georgia, Tbilisi announced that it would give its go-ahead to Russia's WTO bid only after Moscow put an end to the illegal operation of two border checkpoints; namely, Adleri-Leselidze, at the border between Russia and breakaway Abkhazia, and the Roki Tunnel, at the border between Russia and breakaway South Ossetia.

17 October

The French bank, **Société Générale, marked the launch of its operations in Georgia** with the announcement of its acquisition of a 60 percent share in the Georgian Bank Republic in September. The terms of the deal were not disclosed. President Saakashvili said that this investment is a sign that Georgia "is trusted." The European Bank for Reconstruction and Development (EBRD) also acquired a 10 percent stake in the Bank Republic in September. The Bank Republic, with 74000 clients, had GEL 7.1 million net profit in 2005 and GEL 5.8 million net profit in the first half of 2006.

19 October

Georgia is making **progress in its performance on the policy benchmarks** used to determine eligibility for investments of US assistance, according to a Millennium Challenge Corporation (MCC) press release. Georgia entered into a USD 295 million US aid programme as part of the Millennium Challenge Account (MCA) in 2005. "Georgia has continued to adopt dramatic anti-corruption reforms even after being selected as an MCA-eligible country as well as improvements in political rights, civil liberties, immunisation rates and fiscal policy," the press release says. Sixteen indicators that measure a country's performance against its peers in areas of "Ruling Justly," "Investing in People" and "Economic Freedom" are used by the MCC to determine whether or not countries are eligible for funding from the Millennium Challenge Account. "The indicators reflect what we expected. Georgia has been working to improve in all the areas measured by the indicators but especially in the area of controlling corruption," Colin Buckley, MCC's Resident Country Director in Georgia, said.

24 October

Iran has signed a mutual executive **agreement to swap electricity with Georgia via Armenia.** Following talks with his Georgian counterpart, Nika Gilauri, in Tehran, Iranian Energy Minister, Parviz Fattah, said that according to the agreement, Iran will transfer some 50 megawatts of electricity via Armenia to Georgia starting from late November. The Iranian Minister also noted that Iran can transfer electricity to Russia via Georgia, adding that the countries have expressed interest in connecting electricity networks to Russia according to a three-party agreement. He added that the sides will invite Russia to take part in the next meeting, to be held in three months, and asked to join the electricity network.

27 October

The construction of a gas pipeline that will link Russia's North Ossetia with Georgia's breakaway of South Ossetia has been launched. South Ossetian leader, Eduard Kokoity, and Head of the North Ossetian Republic, Teimuraz Mamsurov, attended an official ceremony to launch the construction of the Dzaurikau-Tskhinvali gas pipeline. Some of the sections of the 163-km long pipeline will be constructed at 3 000 meters above sea level. Construction is expected to be finished by the end of 2007. Breakaway South Ossetia currently receives gas from the territory controlled by the Georgian central authorities. Georgian Parliamentary Chairperson, Nino Burjanadze, called on the international community to condemn, as she put it, the "illegal construction of a pipeline on Georgia's territory."

2 November

Georgian Prime Minister, Zurab Nogaideli, said that the authorities should intensify **talks with Azerbaijan, Turkey and Iran to diversify energy supplies**. He also said that Georgia should immediately launch construction of two new hydro power plants. The Prime Minister convened a session of the government's energy council after the news broke on 2 November that **Gazprom plans to increase gas prices for Georgia** in 2007 from the current USD 110 to USD 230 per 1000 cubic meters of gas. Prime Minister Nogaideli said that it is "a political price." He instructed the Energy Ministry "to support" gas distributing companies in Georgia in holding talks with Gazprom in order "to achieve as acceptable a price as possible for these companies and for consumers."

4 November

A two-day **conference supported by the OSCE Mission to Georgia** was opened in Tbilisi where economic experts from the South Caucasus countries are looking at ways to improve the business climate in the region, the OSCE reported. Economists and government representatives from Armenia, Azerbaijan and Georgia are analysing the current investment climate and will draw up recommendations for improvement. "Business development is crucial to underpin economic development in Georgia and the region," Head of the OSCE Mission, Ambassador Roy Reeve, said. "At this conference, we will take a snapshot of the business climate for the region as a whole. By doing so, we hope to foster dialogue that will improve trade, foster economic integration and promote investment for all countries in the South Caucasus. Through such regional economic integration, Armenia, Azerbaijan and Georgia can all be winners," Ambassador Reeve added.

7 November

Georgia is ranked 99th in a 2006 Corruption Perceptions Index (CPI) issued by the corruption watchdog Transparency International. The CPI is a composite index that draws upon multiple expert opinion surveys that poll perceptions of public sector corruption in 163 countries around the world. Georgia was ranked 130th among 159 nations surveyed in a similar report by Transparency International last year. Moldova and Armenia, respectively, ranked 79th and 93rd in the 2006 CPI and have the best rating amongst CIS countries

8 November

The Georgian Foreign Ministry warned Russia's consumer protection agency that **any agreement reached with the secessionist authorities in Abkhazia will be considered illegal**. The chief of Russia's Consumer Protection Agency, Genady Onishchenko, said that his agency is in talks with breakaway Abkhazia about the possibility of introducing Abkhaz wines into the Russian market. Russia banned imports of Georgian wines in March 2006. "He [Onishchenko] not only unreasonably bans the import of Georgian products on the Russian market, thus considerably obstructing Russia's accession to the World Trade Organisation, but also makes statements, specifically on the treatment of Georgian-Russian trade relations, which go far beyond his competences," the Georgian Foreign Ministry said.

8 November

Gazprom will sell its gas to Georgia at the current price, USD 110 per 1000 cubic meters, if Tbilisi agrees to give some of its assets to the Russian gas monopoly, Gazprom's export chief, Alexander Medvedev, said. Otherwise, he affirmed, Gazprom's price for Georgia will be USD 230 per 1000 cubic meters. Medvedev did not specify what Georgian assets are wanted by Gazprom. Gazprom made moves last year to purchase Georgia's North-South Caucasus gas pipeline system which is used to deliver Russian gas to Georgia and Armenia. Previously, there were considerations in Tbilisi about selling the pipeline to Gazprom but the idea was rejected most likely as a result of US pressure. After gaining control of Armenia's gas distribution network, Gazprom announced that the gas price in Armenia will remain USD 110 per 1000 cubic meters.

9 November

The Financial Police, Tax and Customs departments will merge as a result of a reforms aimed to ease ties between the state and business, Georgian Finance Minister, Lexo Alexishvili, said. A relevant draft law is ready for consideration by the Parliament and will enter into force starting from 1 January 2007, he added. Alexishvili said that the Revenue Service – the name of the new unified structure – will have three major functions; namely: providing service to taxpayers, providing information and offering control and investigation of alleged financial wrong doings. "The major tasks will be, on the one hand, to provide full service to tax-payers and, on the other hand, to continue to fight against economic crimes," Alexishvili said.

9 November

The InterContinental Hotels Group is planning to build "the best five-star hotel in the region" in downtown Tbilisi within the next two years, President Saakashvili said at a presentation of the project. The InterContinental-Tbilisi will be built where the Ministry of Agriculture is currently located on Kostava Street. InterContinental plans to invest USD 50 million in the construction of a 155-room hotel. Construction is expected to begin in March 2007. "Several months ago, I attended a signing ceremony here for **the launch of the construction of a Hyatt five-star hotel in Tbilisi.** Hyatt has come before InterContinental in this respect but I offer you [InterContinental] to outstrip Hyatt in finishing the construction process," Saakashvili said.

15 November

Georgian Foreign Minister, Gela Bezhuashvili, and his counterpart from Finland which currently holds the EU presidency, Erkki Tuomioja, signed the recommendations on the implementation of the **EU-Georgia Action Plan in the framework of the European Neighbourhood Policy (ENP)**, the Georgian Foreign Ministry reported. The European side referred to the ENP Action Plan as a cornerstone of future co-operation between the two sides and expressed readiness to assist Georgia in both the successful implementation of the Action Plan and the resolution of political and economic problems in the country, according to the Georgian Foreign Ministry.

15 November

Wine producer Badagoni has announced that it will sue Samtrest, the wine agency under the Georgian Agriculture Ministry. Samtrest alleged that wine produced in the company's factory in Kakheti, in eastern Georgia, was counterfeit. "Our Italian partners and their attorneys will take measures to protect our rights and reputation in court. We will, first of all, sue Samtrest and its officials who have cast doubts about the quality of our wines and who have removed some of our product from the factory on the grounds that it was fake," Paata Darsmelia, director of the Badagoni factory, said at a news conference. The ultra-modern wine factory in Akhmeta was opened on 27 October with the assistance of a USD 12 million investment made by an Italian partner.

17 November

The Greenoak Group reported that it has purchased 80 hectares of land in the Ajara Autonomous Republic from the Georgian government for the price of USD 27.1 million for the **construction of an industrial complex**. The plot of land, which is adjacent to the Batumi Seaport, will be used to construct a crude oil refinery, a methanol plant and an ammonia plant, the Greenoak Group said in a statement. **The company projected that USD 3.2 billion will be the total cost of the project** and said that it will create more than 5000 new jobs in Batumi, during the construction period, and at least 1000 jobs on an ongoing basis. In May 2006, the Greenoak Group purchased the management rights of the Batumi Seaport for a period of 49 years for the price of USD 92 million. The company, which also owns the Batumi Oil Terminal, signed a deal in September with the Kazakh state-run KazMunaiGas to set up a joint company to secure the flow of more Kazakh crude oil.

22 November

Standard and Poor's has revised its outlook on the government of Georgia to 'stable' from 'positive' owing to increased geopolitical risk, the credit rating agency said in a statement on 21 November. Standard and Poor's gave a positive outlook to Georgia in an assessment unveiled last December. In a recent report, however, the agency said that Georgia's weak external indicators are aggravated by tensions in its relationship with Russia which is a key trading partner. "The outlook change reflects Standard and Poor's view that the geopolitical risks in the region have increased significantly and may impair positive trends in external liquidity, investor sentiment and economic growth," Luc Marchand, Standard and Poor's credit analyst, said. He also stated, however, that risks are "partly balanced by still strong economic prospects, underpinned by rapid reform, continued prudent fiscal policies and an increasingly market-oriented economic structure."

29 November

Bank of Georgia is the first Georgian bank ever and the second bank from the CIS to be listed on the London Stock Exchange ("LSE"). Bank of Georgia raised USD 159843.7 million through the initial public offering of its shares in the form of GDRs on the LSE. Commenting on the successful IPO, Lado Gurgenidze, Chairman of the Supervisory Board of Bank of Georgia noted: "We are very pleased that the Offering of the Bank's GDRs received such a significant level of interest from a broad range of investors across Europe. The Offering provided to be a success story and was priced above the upper level of the indicated price range. The IPO and listing on the Exchange are intended to diversify bank's capital structure and funding sources, raise the profile of the Bank and its operations, and provide the funds required to expand our banking operations in Georgia and other markets." The President of Georgia, Mikheil Saakashvili, who opened the trading on the LSE, congratulated Bank of Georgia with its success.

8 December

President Saakashvili said that the Economy Ministry will be in charge of the **state-funded internship programmes** from 2007 in order to further increase the effectiveness of the initiative which, officials say, has already helped 10 000 citizens to find jobs. The programme, which was launched in September 2006 under the supervision of the Social and Healthcare Ministry, provided GEL 450 to each participant during three-month internships in various businesses. Over 35 000 citizens participated in the programme, officials say. "Each enterprise that is providing new jobs needs encouragement from the state. We need those people who provide new jobs. Those who provide new jobs are our friends and friends of the country and I want to create a **new medal with which those people who have employed the most people will be awarded**. We have military-related medals and now we have to encourage those who fight on the economic front because this [economy] is the frontline of our defence," Saakashvili said.

11 December

Kempinski Hotels, teamed up with London-based Capital Vostok Ltd., has marked the launch of the development of a new five-star hotel in downtown Tbilisi. "In the last two years, five major hotels have decided to invest in Georgia and now we can say that all the major hotels are in Georgia which means that Georgia and Tbilisi have become well-established on the world map. It means more tourists," President Saakashvili said at the presentation of the project in Tbilisi. He said that Georgia will see a construction boom in the next year that will require three times more workers "which means that we will have a huge deficit of human resources in this sector." Saakashvili added that Sheraton will launch the construction of a hotel in Ajara. The 200-room hotel, which will be designed by Krier-Kohl Architects, is projected to be constructed by 2010. Reports say that USD 50 million is planned to be invested in the project.

12 December

Georgia will seek gas supplies from Iran if it fails to receive sufficient gas from Azerbaijan's Shah-Deniz field, Georgian Prime Minister, Zurab Nogaideli, told Rustavi 2 television in Washington. "First of all, we are in talks with Azerbaijan and Turkey [over the redistribution of gas shares from the Shah-Deniz field] and only after these talks, if we need to, will we continue discussions with Iran. It is clear for everyone that Georgia cannot remain without gas in winter and we will have the full understanding in this respect from our partners," Prime Minister Nogaideli, who held talks with top-level US officials in Washington, said.

12 December

Despite Georgia's strong underlying economic performance, **Russia's current economic embargo** will lead "to moderately slower growth of 6-7 percent" in 2007, an IMF mission said. The IMF mission, which visited Georgia from 2-12 December, reviewed the recent economic developments and also said that the inflation rate has slowed down from its peak in mid-2006 – 14.5 percent, and is likely to be "less than 10 percent" by the end of this year. Despite external shocks related to the loss of Russian export markets, **Georgia's economy "remains robust"** and real GDP growth could be about 8 percent in 2006, according to the mission. The IMF, however, has also warned that Russia's **embargo will increase the external current account deficit** by approximately USD 250-300 million in 2007. "The [Georgian] authorities expect that this will be financed by higher foreign exchange proceeds generated by the large inflow of foreign direct investment projects for this year and 2007 as well as by a very substantial increase in tourism revenues," the IMF mission said. In view of the considerable uncertainty regarding the size and timing of foreign direct investment inflows, however, the mission recommended reducing the size of the overall fiscal deficit from the current projection of 2.5 percent of GDP for 2007 to ease adjustment to the external shock.

14 December

Georgian Economy Minister, Giorgi Arveladze, is in Beijing where a **Georgian-Chinese business forum has been opened**. Georgia will try to promote its tourism and construction sectors, as well as wine, amongst Chinese business circles, according to the Georgian Economy Ministry. Trade turnover between Georgia and China amounts to USD 50 million per year and China's share is 1 percent in total foreign investments in Georgia, according to the Economy Ministry.

15 December

The World Bank and the Government of Georgia signed a **credit agreement for the First East-West Highway Improvement Project** for USD 19 million, the World Bank reported. The project aims to improve Georgia's major transit corridor, the East-West Highway, by upgrading the highway from two to four lanes and contributing to the capacity building of road sector institutions. The credit was signed during a Symposium in Washington highlighting the improving investment climate in Georgia which was attended by Georgian Prime Minister Zurab Nogaideli.

15 December

Georgia is expected to receive 1.01 billion cubic meters of **gas from Azerbaijan's Shah-Deniz field.** The gas agreement was reached during the talks amongst Turkey, Azerbaijan and Georgia in Baku, according to the Georgian Energy Ministry. Turkey was ready to give 1.3 billion cubic meters of gas to Azerbaijan and 800 million cubic meters to Georgia from its originally defined share of 2.8 billion cubic meters of Shah-Deniz gas. Moreover, Georgia will receive 250 million cubic meters allotted to the country in the original contract. Gas will begin to flow through the Shah Deniz pipeline on 20 December instead of the previously announced date of 15 December.

22 December

The Russian energy giant, **Gazprom, said, that it has signed agreements with three companies in Georgia** on the supply of a total of 1.1 billion cubic meters of gas in 2007. The chief of the Russian gas monopoly's export arm Gazexport, Alexander Medvedev, said at a news conference in Moscow that the contracts envisage the purchase of gas by companies in Georgia for USD 235 per 1000 cubic meters. In Moscow, Medvedev said that Gazexport signed contracts for one year terms with two companies and for a three-month term with KazTransGaz-Tbilisi, a company distributing gas in the Georgian capital. The two other companies are Saqcementi, a cement producing factory which needs about 250 million cubic meters of gas annually, and the Russian-owned electricity grid, Telasi, which needs about 300 million cubic meters of gas annually for its power generator plant number 9 in Gardabani.

27 December

Georgia plans to set up a free economic zone in Poti on the Black Sea coast in 2007, President Mikheil Saakashvili said. "We want to create a free economic zone on the Back Sea coast and it will not be an economic zone covering only the port [in Poti]. It will serve the entire region including Samegrelo, Guria and Ajara... This will be a zone with zero bureaucracy, where registration of a new enterprises will be able to be done in 15 minutes, where disputes will be resolved in two hours… This zone will be linked to a new transport infrastructure including the [Baku-Akhalkalaki-] Kars railway, the construction of which we plan to launch next year, the new airport in Batumi and a new highway," Saakashvili said.

29 December

Prime Minister Zurab Nogaideli said that **Georgia will purchase gas from Azerbaijan for USD 120 per 1000 cubic meters starting from January 2007**. He said that an agreement was reached with the Azeri side during his visit to Baku on 25 December over the delivery of 1 million cubic meters of gas per day. Prime Minister Nogaideli was speaking at the Parliamentary Session whilst presenting a revised draft of the 2007 state budget. He said that the **revision of the initial draft budget became necessary because of additional funding for the Energy Ministry**. Nogaideli said that at least GEL 90 million will be allocated to the Energy Ministry for a credit to gas distributor companies to prevent a swift gas price hike for households in January.

29 December

Parliament approved the 2007 state budget with 150 votes to 9. The budget sets revenues at GEL 3.7 billion (approximately USD 2.1 billion) and expenditures at GEL 4 billion (approximately USD 2.3 billion). The document sets the growth rate for the GDP, which is expected to reach GEL 16 billion, at 7.5 percent and inflation rate at 6 percent. Opposition lawmakers say that the forecasted inflation rate is unrealistic against the background of anticipated price hikes on gas and electricity. An initial draft discussed by lawmakers in November called for GEL 3.4 billion in revenues and GEL 3.8 billion in expenditures.

SUMMARY MACROECONOMIC INDICATORS

		2000	2001	2002	2003	2004	2005	2006**
GDP and real sector								
Nominal GDP	mln GEL	6043.1	6674.0	7456.0	8564.1	9824.3*	11621.0	9837.5
Real GDP	mln GEL, 1996	4618.2	4840.1	5105.0	5669.6	6001.8	6562.8	5203.5
Nominal GDP per capita	GEL	1298.6	1445.0	1711.2	1997.9	2275.5*	2679.8*	2231.6
	USD	657.5	697.0	780.3	922.6	1139.1	1479.4	1247.8
Real GDP per capita	GEL, 1996	992.4	1047.9	1113.2	1244.5	1323.3	1452.2	659.9
GDP by sectors								
Industry	% of nominal GDP	17.3	16.6	17.6	17.7	16.1	15.7*	14.2
Agriculture	% of nominal GDP	20.6	21.0	19.2	19.3	16.4	14.8	11.7
Construction	% of nominal GDP	3.7	3.9	5.1	6.4	8.1	8.1*	6.9
Real GDP growth	% over prev. year	1.8	4.8	5.5	11.1	5.9	9.6*	8.5
Real growth by sectors								
Industry	% over prev. year	3.2	-2.5	8.4	7.7	4.0	11.4	17.4
Agriculture	% over prev. year	-12.0	8.2	-1.4	10.3	-7.9	12.0	-14.1
Construction	% over prev. year	4.0	10.3	43.1	46.6	35.9*	14.1*	7.1
Price indexes								
GDP deflator	1996=100	130.5	137.5	145.8	150.6	162.8*	175.6*	187.1
Consumer prices (year average)	2000=100	100	104.7	110.5	115.8	122.4	132.5	143.3
Producer prices (year average)	2000=100	100	103.6	110.8	113.9	119.2	128.0	141.3
Investments								
GFCF[1]	% of nominal GDP	25.4	27.2	24.5	26.7	27.5	26.3	25.5
Net FDI[2] inflow	mln USD	131.7	109.9	163.3	336.3	489.5	539.3	711.6
Labour market and Wages								
Population	mln	4.63	4.60	4.57	4.54	4.52	4.52	4.40
Labour force	mln	2.05	2.11	2.10	2.05	2.04	2.02	1.95
Unemployment rate	%	10.3	11.1	12.6	11.5	12.6	13.8	13.7
Average nominal wage	GEL	72.5	82.6	99.1	101.5	116.4	149.3	184.4
	%, over prev. year	7.1	13.9	20.0	2.4	14.7	28.3	28.5
Living standards								
Level of poverty	% population	51.8	51.1	52.1	54.5	35.7	39.4	38.5
Depth of poverty		20.2	19.3	19.8	21.1	12.2	13.5	13.4
Severity of poverty		10.7	9.9	10.3	11.2	6.1	6.6	6.7
National accounts								
Household consumption	% of nominal GDP	89.4	78.6	77.0	71.6	72.8	66.4*	80.9
Government consumption	% of nominal GDP	8.5	9.6	9.8	9.8*	14.0*	17.3*	14.0
Gross capital formation	% of nominal GDP	26.6	28.3	25.5	27.7	28.3	28.6*	26.4
Net exports	% of nominal GDP	-16.7	-14.4	-13.2	-14.6	-16.6	-17.8	-24.8
Government finance								
Revenue	mln GEL	639.4	740.3	816.1	956.0	1773.0	2607.5	2661.9
Expenditure	mln GEL	833.9	906.4	1040.7	1118.5	1923.6	2616.5	2577.7
Deficit(-) or Surplus (+)	mln GEL	-194.5	-166.1	-224.6	-162.5	-150.6	-9.0	84.2
Financing of deficit								
Domestic	% of deficit	77.4	13.5	40.0	31.9	11.0	398.0	-
Foreign	% of deficit	22.6	86.5	60.0	68.1	89.0	-298.0	-
Total Debt	mln GEL	4192.5	4449.5	4843.3	4608.0	4306.6	4076.1	3996.7
Domestic	% of debt	35.7	33.5	31.4	34.0	36.6	37.7	37.8
Foreign	% of debt	64.3	66.5	68.6	66.0	63.4	62.3	62.2
Monetary indicators								
M2 (year end)	mln GEL	382.1	403.8	462.3	527.4	846.1	1069.9	1273.4
Velocity of money (M2)		19.53	17.89	17.78	16.23	11.78	10.83	11.21
Deposit rate***	% per annum	12.2	11.1	11.4	10.6	9.5	8.7	8.0
Lending rate****	% per annum	25.3	24.0	23.1	21.6	20.2	17.9	17.0
Treasury bill rate	% per annum	17.14	29.93	43.42	44.26	19.66	12.57	-

		2000	2001	2002	2003	2004	2005	2006**
Balance of payments								
Current account	mln USD	-161.2	-211.4	-197.6	-369.5	-346.9	-692.9	-875.7
Capital account	mln USD	-4.8	-5.2	17.6	19.9	40.8	58.7	82.7
Financial account	mln USD	92.1	218.7	222.2	356.3	483.3	731.5	731.7
Net errors and omissions	mln USD	53.9	44.8	-3.7	-24.3	1.3	14.3	61.3
Overall balance	mln USD	20.0	-46.9	-38.5	17.6	-178.5	-111.6	0.0
External economic position								
Gross international reserves	mln USD	109.7	159.9	198.4	191.6	383.7	474.1	632.9
	Import. coverage (month)	1.4	1.8	2.3	1.6	2.3	2.1	1.8
Exchange rate (year average)	USD/GEL	1.9759	2.0723	2.1945	2.1459	1.9168	1.8126	1.7911
Real effective exchange rate	%, 1995=100	110.2	108.2	102.7	94.9	107.0	110.3	110.8
Terms of trade (year end)	1995=100	99.5	97.8	96.0	77.0	72.0	75.0	-
NPV[3] of external debt	% of nominal GDP	38.9	36.8	36.6	39.6	28.3	22.7	-
Foreign debt service	% of total exports	9.1	6.3	5.0	4.6	6.5	5.0	-

Source: Georgian Government. Basic Data and Directions 2007-2010; Department for Statistics, Ministry of Economic Development; Ministry of Finance; National Bank of Georgia (NBG) and IMF

*Note: * Verified data*

*** 9 month*

**** the numbers of deposit rate reflect weighted average rates on time deposits denominated in domestic and foreign currency*

***** the numbers of credit rate reflect weighted average rates on short term (up to one year) and long term (over the one year) credits denominated in domestic and foreign currency*

Acronyms used:

1.GFCF -Gross Fixed Capital Formation

2.FDI - Foreign Direct Investments

3.NPV- Net Present Value

Georgian economy compared with EU25

	Georgia							EU-25
	2000	2001	2002	2003	2004	2005	2006**	2006*
Real GDP growth, % over prev. year	1.8	4.8	5.5	11.1	5.9	9.6*	7.5	2.9
GNI per capita (PPP, Euro)	-	-	-	2308.0	2331.0	2627.8	-	20098.0[2]
in % of EU-23[1] (PPP)	-	-	-	11.7	11.6	-	-	-
GDP per capita (nominal USD)	657.5	697.0	780.3*	922.6*	1196.6*	1479.4*	1599.0	29247.0
Inflation (year average)	4.0	4.7	5.6	4.8	5.7	8.2	5.0	2.2
end of year	4.6	3.4	5.4	7.0	7.5	6.2	6.0	-
Lending rate (year average)[4]	25.3	24.0	23.1	21.6	20.2	17.9	-	4.9[5]
Fiscal balance, % to GDP	-3.2	-2.5	-1.9	-3.2	-2.3	-0.1	-3.1	-2.3
Public debt, % to GDP	69.4	66.7	65.0	53.8	43.8	35.1*	35.3	63.4[3]
of which:								
domestic	24.8	22.3	20.4	18.3	16.0	13.2*	11.6	-
foreign	44.6	44.4	44.6	35.5	27.8	21.9	23.7	-
Current account, % to GDP	-5.3	-6.9	-5.8	-9.3	-6.8	-10.8	-10.6	-0.6[3]
Net FDI inflow, mln USD	131.7	109.9	163.3	336.3	489.5	539.3	-	-140462.0
Memorandum items:								
Nominal GDP								
mln GEL	6043.1	6674.0	7456.0	8564.1	9824.3	11621.0*	13080.0	-
mln USD	3058.4	3220.6	3399.9*	3994.7*	5166.3	6415.8	7186.8	13494524.0[3]
mln Euro	3310.7	3594.0	3591.2	3523.7	4119.0	5139.2	-	10844200.0[3]
Exchange rates (nominal, year average)								
USD/GEL	1.9759	2.0723	2.1945	2.1459	1.9168	1.8126	1.8200	-
Euro/USD	0.9238	0.8961	0.9461	1.1326	1.2443	1.2444	1.2556	-

Source: Georgian Government. Basic Data and Directions 2007-2010; Department for Statistics, Ministry of Economic development; NBG; World Bank; IMF; European Central Bank and Eurostat

*Note: * Verified data*

*** preliminary data and partly projections*

[1] EU23 (excludes Cyprus and Malta)

[2] 2004

[3] 2005

[4] The number for Georgia reflect weighted avarege rates on short term (up to one year) and long term (over the one year) credits denominated in domestic and foreign currency, the number for the EU refers to the euro zone (EU12) only and reflects the rate on new loans in Euro with durartion of up to one year

[5] October 2006

Part I. Overview of the Georgian Economy

1. GROSS DOMESTIC PRODUCT

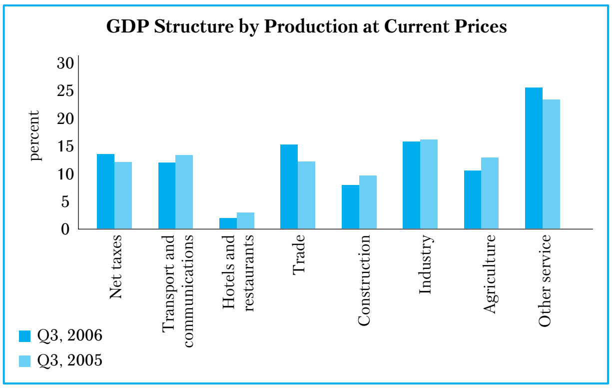
Table 1: Nominal and Real Gross Domestic Product

	Nominal GDP (mln GEL)	Share of Labour cost (%)	Share of Operating Surplus and Mixed Revenues (%)	Share of Net Taxes on Manufacturing and Imports (%)	GDP Deflator (1996=100)	Real GDP (in 1996 prices, mln GEL)	Change in Real GDP Compared to Last Year's Corresponding Period (%)	Real GDP per Capita (in 1996 prices, GEL)
2000	6043.1	27.6	64.9	7.5	130.5	4618.0**	1.8	1045.4**
2001	6674.0	25.2	66.9	7.9	137.5	4839.9**	4.8	1103.6**
2002	7456.0	22.3	69.6	8.2	145.8	5104.8**	5.5	1171.6**
2003	8564.1	20.3	72.1	7.6	150.6	5669.3**	11.1	1309.3**
2004	9824.3	20.7	69.5	9.9	162.8**	6001.4**	5.9	1390.1**
Q1	2021.5	24.9	67.2	7.9	154.5**	1304.4**	6.5**	302.3**
Q2	2431.0	20.5	70.1	9.4	163.0**	1486.8**	7.3	344.5**
Q3	2575.2	19.7	69.5	10.7	165.9**	1548.1**	5.0**	358.6**
Q4	2796.6	18.7	70.5	10.8	167.8**	1622.1**	4.9	384.8**
2005	11591.8	16.9**	70.9**	12.2**	175.6**	6577.5**	9.6**	1516.8**
Q1	2508.7**	15.8**	73.4**	10.8**	176.2**	1416.1**	8.6**	327.7**
Q2	2824.0**	16.7**	71.3**	12.0**	171.6**	1636.4**	10.1**	378.0**
Q3	3032.9**	16.7**	70.5**	12.7**	173.1**	1742.7**	12.6**	401.6**
Q4	3255.4**	18.0**	69.0**	13.1**	181.7**	1782.3**	7.2**	409.5**
2006								
Q1	2834.5**	17.1**	70.5**	12.4**	182.9**	1534.7**	8.4	348.7**
Q2	3354.4**	17.5**	68.6**	14.0**	188.3**	1767.9**	8.0**	401.0**
Q3*	3648.6	15.4	70.5	14.0	188.6	1900.9	9.1	430.6

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*
*** Verified data*

Despite Russia's trade embargo and transport ban on Georgia, the country's GDP continued with its high annual and quarterly growth in Q3, 2006, due mainly to increased household consumption, budget spending and imports of raw material and machinery.

An increase in labour productivity (added value per employee), comprising an annual 12.5 percent in basic prices, was still a determining factor of the economic growth. The mentioned indicator almost doubled in the sphere of financial intermediation (GEL 1207), showing a certain growth in construction (GEL 1370), transport and communications (GEL 2390) and industry (GEL 1580) but a downward trend in hotels and restaurants (GEL 2950) and real estate transactions (GEL 1530).



Source: Department for Statistics, Ministry of Economic Development

Sixty percent of business activity was concentrated in five sectors wherein industry had the highest share (15.4 percent) followed by trade at 14.9 percent, transport and communications at 11.9 percent, agriculture at 10.3 percent and construction at 7.7 percent.

Table 2: Contribution of Selected Sectors of the Economy to GDP Real Change 2006, Q3*

	Change to Last Year corresponding period (%)	Contribution to GDP Real Change (percentage points)
Agriculture	-18.4	-2.7
Mining	35.2	0.3
Manufacturing	23.1	2.0
Electricity Generation	19.1	0.5
Household Production	9.0	0.3
Construction	12.2	1.0
Trade	43.5	5.2
Hotels and Restaurants	-3.5	-0.1
Transport	11.2	0.9
Communications	6.1	0.2
Financial Intermediation	52.6	1.0
Real Estate	1.6	0.0
Rent	-0.8	0.0
Public Administration	-19.2	-1.2
Education	2.5	0.1
Health Care	21.0	0.7
Other Social Services	0.2	0.0
Hired Employment in Household	6.4	0.0
FISIM	5.0	-0.1
GDP at Basic Prices	9.1	8.1
Taxes	8.7	1.1
Subsidies	-17.6	-0.1
GDP at Market Prices	9.1	9.1

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*

It is noteworthy that the growth rate of added value in most sectors of the economy (with the exception of communications) was higher than that of the GDP with the financial intermediation and trade sectors exceeding it many times. At the same time, agriculture continued to show a significant decrease due to unfavourable weather conditions.

The impressive upward dynamics in the sphere of financial intermediation was, as in the previous quarter, conditioned by credit boom which, for its part, was the result of an increase in deposits, capital and borowings by banks. This, however, was associated with a certain increase in bank risks.

Table 3: Indicators of Industry

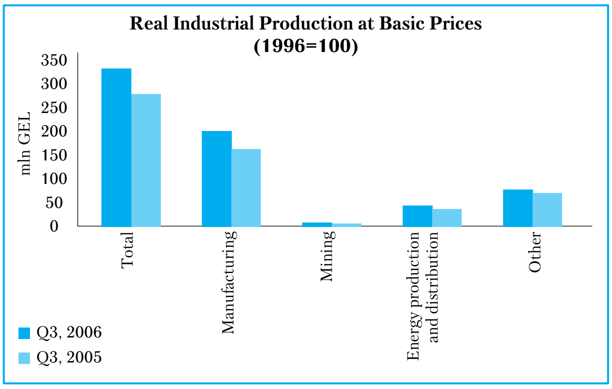
	Value Added in Industry at Current Basic Prices (mln GEL)	Index of Industry (1996=100)	Real Value Added in Industry at Basic Prices (% changes over the same period of the previous year)	Share of Value Added in Industry at Current Basic Prices (%)			
				Mining	Manufacturing	Energy Production and Distribution	Other
2000	1044.2	108.2**	3.4**	3.9	49.5	25.2	21.4
2001	1111.0	105.0**	-2.9**	3.4	46.4	23.1	27.1
2002	1315.8	114.0	8.6**	3.8	47.5	23.7	25.0
2003	1515.3	122.9**	7.8**	5.0	49.2	21.4	24.4
2004	1581.9**	127.1**	3.4**	4.9	50.8	19.2	25.1
Q1	328.4**	104.2**	11.5**	4.9	46.5	27.0	21.6
Q2	371.4**	119.1**	6.2**	5.0	56.1	18.7	20.1
Q3	407.3**	126.6**	-3.6**	5.1	51.8	14.1	29.0
Q4	475.0	158.5**	2.6**	4.5	48.8	18.7	28.0
2005	1823.0**	140.9**	10.9**	5.0**	54.8	17.9**	22.3**
Q1	361.3**	108.2**	3.9**	5.4**	49.8**	24.7**	20.1**
Q2	432.7**	134.8**	13.2**	4.9**	59.4**	17.8**	17.9**
Q3	480.3**	142.3**	12.4**	5.0**	55.8**	14.2**	25.0**
Q4	548.8**	178.2**	12.5**	4.9**	53.5**	16.7**	24.9**
2006							
Q1	392.1	117.6**	8.7**	5.9	57.7	22.1	14.3
Q2	442.2**	166.4**	23.4**	7.8**	57.1	19.2**	15.9**
Q3*	562.4	170.8	20.0	7.6	59.8	13.7	18.9

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*
*** Verified data*

The highest share of industrial output in the GDP was the consequence of a significant enhancement in manufacturing. A sharp increase was further observed in mining and quarrying. In addition, electricity generation and household production were marked with high annual growth rates.

The high annual growth of mining can be explained by the output increase in construction materials, chemical industry and minerals for fertilisers as well as the increase in the extraction of precious metal ores and concentrates.

Positive developments were seen in separate sub-sectors of the manufacturing industry. A significant increase was observed in the production of bakery, tobacco, concrete, cement, manufactured metal articles, timber, printing material and non-ferrous and ferrous metals. The production of fruit and vegetable juices, however, went down because of the decrease in agricultural produce.



Source: Department for Statistics, Ministry of Economic Development

It is noteworthy that the step-up in the manufacturing and mining industries is primarily linked to the increase in export demand.

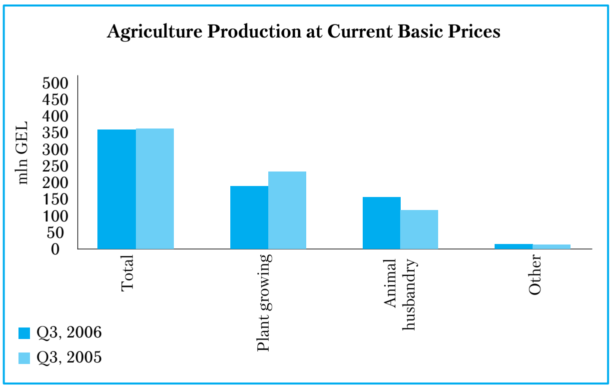
Despite a notable increase in energy output, a low level of oil, natural gas and coal production was a continued problem as Georgia remained dependent on imported energy resources.

Table 4: Indicators of Agriculture

	Value Added in Agriculture at Current Basic Prices (mln GEL)	Index of Agriculture (1996=100)	Real Value Added in Agriculture at Basic Price (% changes over the same period of the previous year)	Share of Value Added in Agriculture at Current Basic Prices (%)		
				Plant Growing	Animal Husbandry	Other
2000	1245.0	91.3	-12.0	43.2	45.6	11.2
2001	1399.0	98.8	8.2	46.7	44.2	9.1
2002	1434.6	97.3	-1.4	46.7	47.3	6.0
2003	1653.0	107.4	10.3	46.9	41.0	12.1
2004	1610.7	99.0	-7.9	44.4	46.6	9.0
Q1	344.1	84.7	-21.8	29.2	52.6	18.2
Q2	471.5	114.7	0.1	48.4	42.1	9.5
Q3	420.7	100.0	1.8	50.8	46.0	3.2
Q4	374.4	96.4	-11.2	45.9	47.5	6.6
2005	1716.4**	110.8	12.0	46.9	45.3	7.8
Q1	467.1**	100.9**	19.0**	31.4**	56.5	12.1**
Q2	460.4**	115.1**	3.0**	51.2**	39.7**	9.1**
Q3	381.1**	118.2**	18.2**	64.3**	32.2**	3.5**
Q4	407.8**	109.2**	13.4**	48.0**	47.8**	4.2**
2006						
Q1	361.6	92.0**	-8.8**	33.8**	56.6**	9.6**
Q2	410.7**	98.5**	-14.4	47.4**	43.2**	9.4**
Q3*	377.8	96.5	-18.4	52.9	43.3	3.8

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*
*** Verified data*

In contrast to observed positive trends, the agriculture sector showed no improvements due to unfavourable weather conditions. Summer droughts and malfunctioning irrigation systems adversely affected most sorts of agricultural produce including grains, fruit and vegetable and walnut and grape crops. The lack of supplies of fruits and vegetables led to price hikes on local products.



Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations

The situation in animal husbandry was unsatisfactory as it showed a decrease in the productivity and the number of cattle.

The development of agriculture was also affected by the embargo imposed by Russia on Georgia's agricultural products.

Table 5: Indicators of Transport and Communications

	Value Added in Transport and Communications at Current Basic Prices (mln GEL)	Index of Transport and Communications (1996=100)	Real Value Added in Transport and Communications at Basic Prices (% changes over the same period of the previous year)	Share of Value Added in Transport and Communications at Current Basic Prices (%)	
				Transport	Communications
2000	858.8	238.4**	12.8**	82.4	17.6
2001	911.1	241.5**	1.3**	79.6	20.4
2002	1057.4	261.5**	8.3**	79.3	20.7
2003	1187.5	289.6**	10.8**	74.2	25.8
2004	1313.1**	308.0**	6.4**	71.0	29.0
Q1	281.4	264.9**	6.8**	69.6	30.4
Q2	312.2	290.8**	0.1**	70.0	30.0
Q3	365.6	343.7**	11.6**	71.5	28.5
Q4	353.9	332.6**	6.7**	72.3	27.7
2005	1443.0**	335.8	8.8**	67.8**	32.4**
Q1	293.3**	271.0**	2.3**	66.0	34.0
Q2	354.4**	331.9**	14.1**	68.5**	31.5**
Q3	395.2**	370.9**	7.9**	67.5**	32.5**
Q4	400.1**	366.9**	10.3**	67.9**	32.1**
2006					
Q1	370.8	332.7**	22.8**	71.2	28.8
Q2	335.5**	368.3**	11.0**	70.0**	30.0**
Q3*	428.1	409.1	10.3	70.7	29.3

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*
*** Verified data*

In the reviewed period, the real annual growth of transportation comprised 11.2 percent. As a result of the increased intensity of international and intra-country transportation, the cargo turnover by road and sea showed a significant growth which was also facilitated by the rehabilitation of motor highways. An annual decrease was observed in the air transportation service which can be explained by the disruption of air traffic between Georgia and Russia. Given a seasonality factor, however, the passenger transportation by air increased somewhat in quarterly terms. The volume of cargo handled by seaports showed an annual decrease and a quarterly increase as well. The reviewed period saw the annual increase in pipeline transportation. Stepped up business and trade relations largely influenced the development of tourism.

Compared to the transport sphere, the sector of communications showed a lower annual and much higher quarterly growth (respectively, 6.1 percent and 21.2 percent). This was the result of the expansion of mobile telephone networks, an increased number of internet providers and an improved quality of service.

Table 6: Indicators of Construction

	Value Added in Construction at Current Basic Prices (mln GEL)	Index of Construction (1996=100)	Real Value Added in Construction at Basic Prices (% changes over the same period of the previous year)
2000	224.7	167.3	4.0
2001	259.6	184.6	10.3
2002	379.5	264.2	43.1
2003	547.4	387.3	46.6
2004	793.2	526.3	35.9
Q1	151.6	419.0	126.0
Q2	170.1	437.5	20.8
Q3	223.5	592.0	40.0
Q4	248.0	656.8	13.5
2005	937.9**	600.4	14.1**
Q1	204.2**	530.6	26.6**
Q2	216.6**	598.0	36.7**
Q3	279.6**	706.2	19.3**
Q4	237.4**	566.8	- 13.7**
2006			
Q1	165.0	586.7	10.6**
Q2	235.5**	585.0**	-2.2**
Q3*	282.4	792.7	12.2

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*
*** Verified data*

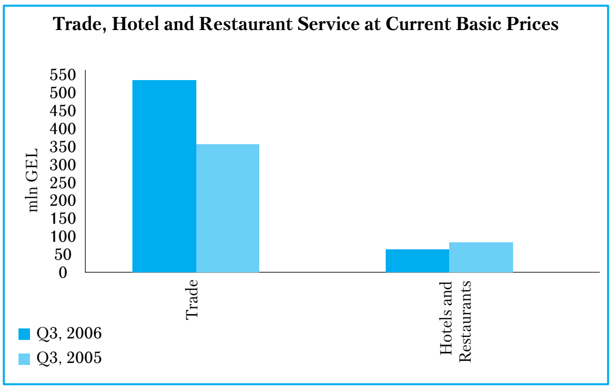
Construction remained as one of the most dynamic sectors. Primarily as a result of a seasonality factor, its quarterly growth rate was higher than the annual rate by as many as three times. The increase was observed both in public and private sectors. Despite the completion of large energy projects, the high growth rate of construction was facilitated by the construction and rehabilitation of airports, schools, health facilities, motor roads and highways through budget allocations and international financing and, as well, by a housing boom. At the same time, the share of the informal segment remained high in the construction sector (31.4 percent).

Table 7: Indicators of Trade, Hotels and Restaurants

	Value Added in Trade at Current Basic Prices (mln GEL)	Index of Trade (1996=100)	Real Value Added in Trade at Basic Prices (% changes over the same period of the previous year)	Value Added in Hotels and Restaurants at Current Basic Prices (mln GEL)	Index of Hotels and Restaurants (1996=100)	Real Value Added in Hotels and Restaurants at Basic Prices (% changes over the same period of the previous year)	Share of Value Added in Hotels and Restaurants at Current Basic Prices (%)	
							Hotels	Restaurants
2000	762.3	119.4	10.8	141.1	165.1	8.2	19.7	80.3
2001	871.0	129.9	8.8	192.1	220.9	33.7	46.2	53.8
2002	956.2	135.0	3.9	218.6	237.5	7.6	35.2	64.8
2003	1137.6	151.3	12.1	244.9	271.2	14.2	30.9	69.1
2004	1247.2	163.6	8.2	266.2	279.8	3.2	24.5	75.5
Q1	247.6	131.4	1.9	67.3	286.4	25.9	31.4	68.6
Q2	309.3	164.3	10.1	61.1	254.7	23.0	18.7	81.3
Q3	317.1	171.3	9.2	64.6	269.2	-25.0	23.1	76.9
Q4	373.2	187.6	10.3	73.2	308.9	6.1	24.2	75.8
2005	1388.8**	179.0**	9.4**	330.3**	327.7**	17.1**	29.1**	70.9**
Q1	289.9**	146.9**	11.8**	70.2**	289.0**	0.8**	29.5**	70.5**
Q2	334.9**	185.7**	13.0**	86.4**	346.1**	36.0**	31.3**	68.7**
Q3	362.3**	181.0**	5.7**	84.1**	326.6**	21.4**	29.1**	70.9**
Q4	401.7**	202.3**	7.8**	89.6**	349.2**	13.0**	25.7**	73.4**
2006								
Q1	359.3	170.4**	16.0**	70.1	313.0**	8.2**	28.5**	52.5**
Q2	449.9**	218.2**	17.5**	64.3**	379.9	9.8**	31.9**	68.1**
Q3*	543.3	259.9	43.5	64.3	315.1	-3.5	35.3	64.7

Source: Department for Statistics, Ministry of Economic Development and GEPLAC calculations
*Note: * Preliminary assessment*
*** Verified data*

The annual GDP growth was largely influenced by the trade sector, which showed an impressive increase of trade in locally produced and imported good; namely, in raw and semi-finished textile material, motorcars, fuel, wood and construction material, manufactured food products, computers and household utensils. It is noteworthy that, despite the ban on outdoor trade and the ongoing legalisation of this sphere, 60 percent of added value created in this sector accounted for the informal segment. The share of this segment was high both in retail and wholesale trade.



Source: Department for Statistics, Ministry of Economic Development

The accounting period saw a notable decrease in annual and quarterly growth rate of the hotels and restaurants sector. This was mainly the result of a sharp drop in restaurant service. It is noteworthy that the added value in the informal segment of restaurants business was twice higher than that in formal segment.

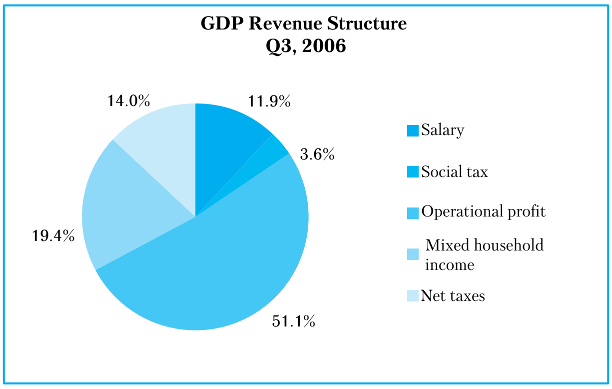
The legalisation of the economy continued in the reviewed period which translated into an annual 7 percentage point decrease of the informal segment.

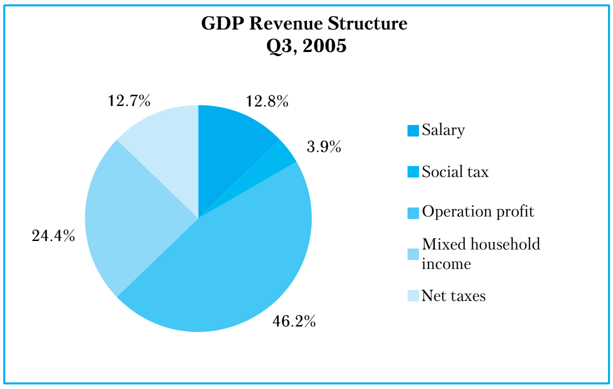
It should be noted that the verification of statistics, which took place in the third quarter, significantly altered the 2004-2005 annual and quarterly data, changing, in particular, the GDP structure, GDP use and revenue formation, national income and other indicators of national accounts.

The upward trend in depending upon consumption (85.6 percent of GDP) and import (59.4 percent of GDP) persisted in the economy in the accounting period.

Although the construction of large international energy projects, such as the Baku-Tbilisi-Ceyhan oil pipeline, was completed, the fixed capital showed an annual growth which can be explained by the increase in the Shah-Deniz pipeline financing and the public sector investments.

The reviewed period saw a notable increase of the net tax share in the market value of the production. Moreover, the enhancement of the legalisation of the economy led to a significant increase in operational profits.





Source: Department for Statistics, Ministry of Economic Development

The annual increase in Gross National Income, Net National Income and Net Disposable Income persisted in the third quarter, comprising, respectively, 21.7; 22.4 and 21.9 percents, which can be explained by the increase in Georgian residents' income from foreign sources and in remittances on top of the GDP growth.

2. PUBLIC FINANCE

Table 8: Total Consolidated Budget Revenues

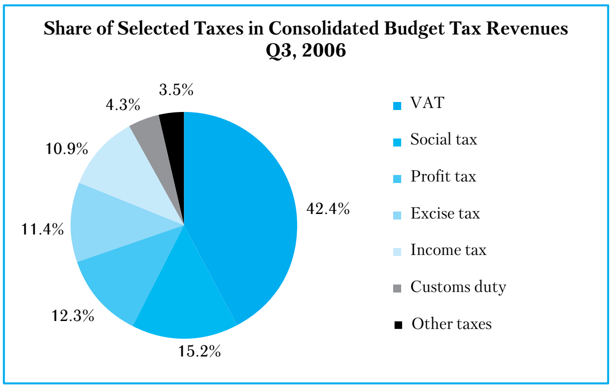
	Total Revenues (mln GEL)	Total Tax Revenues (mln GEL)	GDP %							
			Total Revenues	Total Tax Revenues	VAT	Profit Tax	Excise Duty	Income Tax	Customs Duty	Social Tax
2000	905.2	854.3	15.0	14.1	4.6	1.3	1.5	1.8	0.9	2.1
2001	1033.9	954.7	15.5	14.3	5.2	1.0	1.3	2.0	0.8	2.1
2002	1135.3	1054.7	15.2	14.1	5.4	1.1	1.2	1.9	0.8	1.7
2003	1272.7	1186.6	14.9	13.9	4.8	1.2	1.2	1.8	0.8	2.1
2004	2102.0	1827.6	21.4	18.6	6.4	1.6	1.6	2.7	1.0	3.0
Q1	391.2	328.6	19.4	16.3	5.1	1.7	1.4	2.6	0.7	2.9
Q2	511.5	445.2	21.0	18.3	6.1	2.0	1.6	2.6	1.0	2.8
Q3	562.8	501.0	25.0	19.5	7.0	1.5	1.7	2.6	1.1	3.0
Q4	636.5	552.8	22.8	19.8	7.0	1.4	1.8	3.0	1.2	3.3
2005	3152.7	2411.5	27.2	20.8	8.5	1.8	2.4	2.5	1.1	3.7
Q1	618.2	471.1	25.6	19.5	8.1	1.8	2.2	2.8	1.0	3.1
Q2	608.0	566.0	29.5	20.1	8.2	2.1	2.7	2.4	1.0	3.1
Q3	745.9	655.2	25.7	25.7	8.4	2.1	2.7	2.4	1.2	3.9
Q4	918.6	719.2	21.8	21.8	9.2	1.4	2.3	2.6	1.1	4.5
2006										
Q1	827.7	609.7	22.2	22.2	9.3	2.5	2.2	2.8	1.2	3.5
Q2	997.4	780.7	30.1	23.5	9.6	2.9	2.6	2.6	1.6	3.5
Q3	1200.6	853.6	32.9	23.4	9.9	2.9	2.7	2.6	1.0	3.5

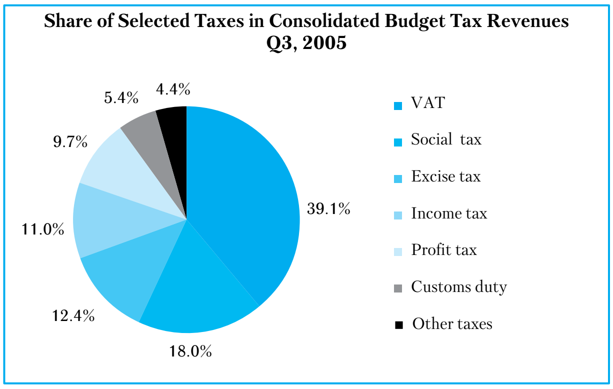
Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

In Q3, 2006, total consolidated budget revenues and grants showed high annual and quarterly growth rates (respectively 59 percent and 25.6 percent). The annual dynamics of revenues was influenced by a notable increase in tax and non-tax revenues and a significant increase in state property privatisation proceeds. The quarterly growth was largely influenced by revenues from capital operations.

The upward trend in total revenues to GDP continued in the reviewed period which resulted in the increase of the fiscal efficiency indicator by 7.2 percentage points, compared to the corresponding period in the last year, and by 2.8 percentage points compared to the previous quarter.

A high annual growth rate of tax revenues was maintained as a result of collections in the form of profit, income and value added taxes. On the other hand, the relatively modest quarterly dynamics can be explained by a significant decrease in customs revenues which was the result of decreasing or zero-rating a large number of customs tariffs. This fact diminished the share of customs duties in the tax revenue structure. At the same time, the VAT and profit tax shares continued to rise. The share of social tax, however, showed an annual decrease and a quarterly increase.





Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculation

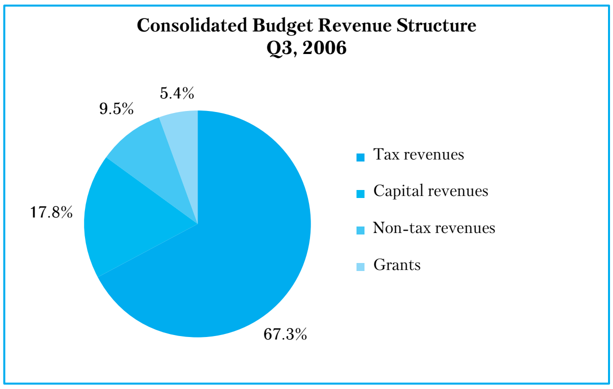
In the accounting period, compared to Q3, 2005, VAT revenues grew by 41.2 percent, remarkably pushing up the VAT share in tax revenues. This was caused by a significant increase in VAT collections from the import of vehicle petroleum, diesel, vegetable and animal food products, wheat and transportation means. The quarterly growth in revenues from this tax can be mainly attributed to the increase in import of computer equipment and devices as well as non-precious metals and articles thereof.

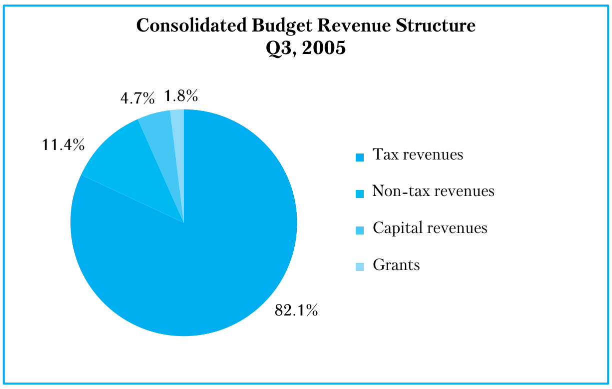
Despite a modest growth rate of the social tax in the third quarter (9.6 percent), it remained the second largest source of tax revenues. The private sector's contribution to the budget exceeded that of the public sector by 2.2 times, due mainly to salary increases in the private sector and, partially, to the rise in the number of employees.

The enhancement of business activity and the legalisation of the economy supported the trend of high growth in profit tax in both annual and quarterly terms (respectively, 63.4 and 10.8 percent). This tax ranked the third in tax revenues.

An accelerated annual growth of income tax continued into the reviewed period (29.3 percent) although the quarterly growth was less impressive (6.6 percent). The annual dynamics were mainly affected by new jobs in the private sector and the rise in salaries of senior public officials.

The introduction of new customs tariffs from 1 September 2006 led to a sharp drop in customs revenues to 29.2 percent as compared to the previous quarter. In particular, this affected collections from the import of ready-made food products, chemical production, clothing and footwear. A relatively insignificant annual growth (3.7 percent) was mainly attained due to the increase in revenues in the form of customs duties from the import of vegetable and animal food products as well as weapons and combat materials.





Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

A high rate of annual and quarterly growth of non-tax revenues (32.8 and 32.1 percent, respectively) was mainly maintained due to a notable increase in amounts received from license fees, fines and penalties in the sector of communications and post and state duties.

As a result of large-scale privatisation, capital revenues in the accounting period comprised GEL 226.4 million, exceeding the corresponding indicators from the last year and previous quarter by, respectively, 37.9 and 80.1 percent.

The third quarter saw a notable annual increase (14.2 percent) and a sharp quarterly increase (5.3 times) in government grants which mainly resulted from the growth of ongoing grants from international organisations.

Table 9: Consolidated Budget Expenditures

	Total Expenditure (mln GEL)	GDP %						
		Total Tax Expenditure	General State Service	Defence, Public Order and Security	Foreign Debt Service	Education	Health Care	Social Safety and Social Service
2000	1126.5	18.6	2.2	1.7	-	2.2	0.6	3.4
2001	1237.9	18.5	3.1	2.0	-	2.1	0.8	2.9
2002	1409.5	18.9	3.5	2.0	0.9	2.2	0.9	3.0
2003	1522.1	17.8	3.1	1.9	0.9	2.1	0.4	4.0
2004	2412.2	24.6	3.6	4.4	0.5	2.9	1.0	4.7
Q1	417.5	20.4	4.4	2.9	0.6	2.1	0.4	4.2
Q2	516.9	21.3	3.0	3.1	0.6	3.2	0.5	5.1
Q3	576.1	22.4	3.4	4.0	0.4	2.5	0.9	4.5
Q4	901.7	32.2	3.7	6.8	0.4	3.1	1.9	5.0
2005	3280.8	28.3	3.1	5.9	0.3	2.5	1.8	5.4
Q1	621.2	25.7	3.2	5.5	0.5	2.2	1.4	6.4
Q2	773.4	27.4	2.5	5.4	0.3	2.1	1.7	6.0
Q3	827.8	27.1	2.8	5.7	0.2	2.4	1.8	4.8
Q4	1058.4	32.1	4.8	6.8	0.4	3.1	2.0	4.6
2006								
Q1	766.7	27.9	3.3	6.4	0.3	2.5	1.3	5.2
Q2	1074.5	32.4	3.8	8.1	0.2	2.9	1.8	4.7
Q3	1178.1	32.3	3.5	5.4	0.7	3.1	1.8	4.9

Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

The consolidated budget expenditure showed a fast growth in annual terms but increased only by 9.6 percent in quarterly terms. At the same time, the expenditure structure changed somewhat: spending on the housing and utilities sector increased significantly due to the seasonality factor whilst spending on defence decreased. It is noteworthy that only 17.2 percent of state budget was used on capital expenditure.

The enhancement of the country's defence capability was again one of the top priorities in budgetary expenditure. The increase in spending on defence comprised 97.1 per cent in annual terms and 7.1 percent in quarterly terms. The mentioned amounts were mainly used for financing the optimisation of the management of armed forces, the modernisation of the military infrastructure, the refurbishment of military facilities and field trainings. Almost half of allocation (48.2 percent) was used for capital expenditure.

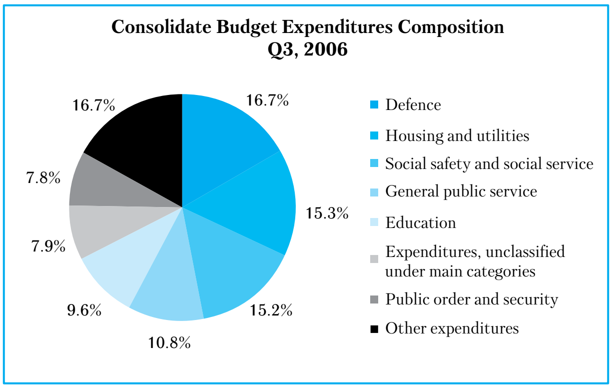
Given a seasonality factor, a remarkable upward trend in financing housing and in the utilities sector, which was outlined in the previous quarter, was maintained both in annual (two times) and quarterly (81.6 percent) terms. The amounts allocated for this purpose were primarily used for the development of the utilities infrastructure and the rehabilitation of the water supply system.

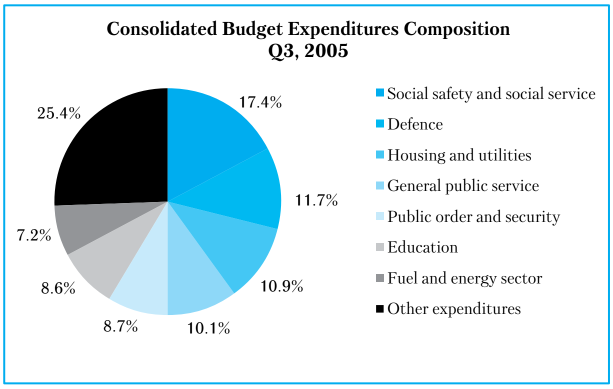
Allocations for social safety and social service showed somewhat lower but still significant annual and quarterly growth rates (respectively, 24.2 and 15.8 percent) in the accounting period. Most of the allocations were used on social allowances, pensions, social integration of handicapped people, job searches for the unemployed and for projects on social involvement.

Although an annual growth rate of spending on general public service was high (51.3 percent), it showed almost no change compared to the previous quarter. The majority of such allocations were directed towards the financing of the activity of executive and legislative powers, foreign relations and other government costs.

The expenditure on education exceeded last year's corresponding indicator by 59.4 percent and the previous quarter indicator by 18.4 percent. These amounts were mainly used to rehabilitate educational institutions, to organise general national examinations and carry out institutional reforms in the education system.

The increase in annual and quarterly spending on public order and security comprised respectively 26.6 percent and 8.6 percent. A significant part of funding was used for the upgrade of the material and technical base of courts and the rehabilitation of penitentiary facilities and state security measures.





Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

The state debt comprised GEL 3996.7 by the end of Q3, 2006. The largest part of it, 62.2 percent, was a foreign debt whilst the remaining, 37.8 percent, was a domestic debt. The debt service comprised 2.2 percent of consolidated budget expenditure. GEL 15.3 million was allocated for domestic debt service and GEL 10.2 million for foreign debt service.

Table 10: Consolidated Budget Balance

	mln GEL	Balance (expenditure %)	Balance (GDP %)
2000	- 207.0	18.4	3.4
2001	- 155.9	12.6	2.3
2002	- 251.6	17.9	3.4
2003	- 201.3	13.2	2.4
2004	- 288.4	12.0	2.9
Q1	- 25.0	6.0	1.2
Q2	- 5.1	1.0	0.2
Q3	+ 3.4	0.6	0.1
Q4	- 261.7	29.0	9.4
2005	-24.0	0.7	0.2
Q1	+ 7.5	1.2	0.3
Q2	+78.8	10.2	2.8
Q3	- 29.7	3.6	0.1
Q4	-80.6	7.6	2.4
2006			
Q1	+70.6	9.2	2.6
Q2	-64.1	6.0	1.9
Q3	+90.9	7.7	2.5

Source: Treasury Service, Ministry of Finance; Department for Statistics, Ministry of Economic Development and GEPLAC calculations

Given that the consolidated budget revenue growth rate well exceeded that of expenditure both in annual and quarterly terms, the budget deficit was overcome in the reviewed period. The surplus comprised GEL 90.9 million.

3. MONEY AND BANKING

Table 11: NBG Accounts (thousand GEL, end of period)

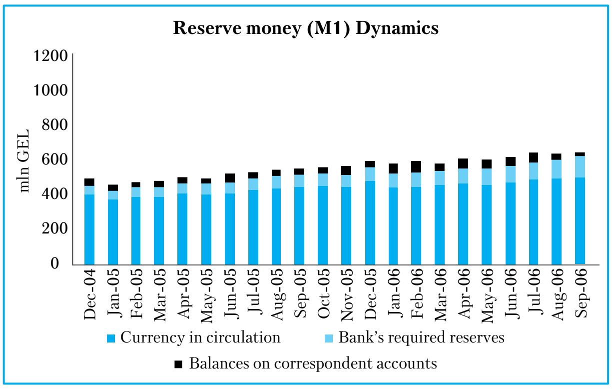
	NBG International Reserves	NBG Claims on General Government	Reserve Money (M1)	Currency in Circulation	Banks' Deposits		Real Cash Balances Index (December 1995=100)*
					Required Reserves	Balances on Correspondent Accounts	
2000	217058	760750	391737	329157	38943	23636	2100
2001	332861	749415	429857	365669	53300	10888	2256
2002	414573	766681	508969	417178	72228	19525	2242
2003	397636	795572	579912	472242	81405	25214	2590
2004	700174	841414	836536	676158	92334	68045	3442
Q1	424325	815639	594008	466212	89946	32550	2527
Q2	527641	811349	655670	504188	74223	71259	2781
Q3	671522	816652	747390	600225	75342	71793	3252
Q4	700174	841414	836536	676158	92334	68045	3442
2005	851599	832849	1001451	811400	129833	60218	3890
Q1	699838	841691	809154	658218	97725	53211	3253
Q2	794216	841972	879314	694576	109141	75597	3513
Q3	802746	836230	933404	746508	122067	64829	3757
Q4	851599	832849	1001451	811400	129833	60218	3891
2006							
Q1	877952	832849	978908	775443	139334	64132	3664
Q2	954043	832849	1044679	803260	158689	82729	3642
Q3	1075874	832849	1096913	853577	202331	41005	3861

Source: NBG and GEPLAC calculations
*Note: * The real cash balance is derived from dividing the indicator for currency in circulation by CPI for the corresponding period (December 1995=100)*

In Q3, 2006, the volume of Georgia's international reserves was mainly determined by the NBG's foreign currency purchases at Tbilisi Interbank Currency Exchange (TICEX) (USD 89.8 million), foreign currency inflows from privatisation (USD 104 million) and licensing of cellular communication frequency (USD 39.7 million) as well as foreign debt service (USD 89.2 million).

The dynamics of reserve money (M1) was largely affected by government deposits in the NBG, which increased by GEL 122 million in the reviewed period, reaching GEL 370 million by the end of September. Interestingly, monthly average indicators showed a significant decrease in government deposits throughout the period. An average deposit indicator for July decreased by GEL 38 million compared to June whilst that for July decreased by GEL 77 million compared to August. September was the only month throughout the quarter that saw the increase in government deposits in absolute terms and in a monthly average indicator. The latter exceeded the corresponding August indicator by GEL 63 million. Moreover, as a result of the NBG's purchases of large foreign currency amounts at TICEX to avoid a sharp fluctuation of the Lari, an additional GEL 55 million was released into circulation in the third quarter.

Spending of government deposits, the NBG's foreign currency purchases and decreased balances on commercial banks' correspondent accounts led to annual and quarterly increases in currency in circulation (14.3 percent and 6.3 percent, respectively). As currency in circulation increased, so did the index of real cash balances.



Source: NBG

The reserve money (M1) growth rate was also affected by a sharp increase in commercial banks' required reserves which comprised 27.5 percent, compared to the previous quarter, and 65.7 percent, compared to Q3, 2005. This was the result of minimal reserve requirements on deposits in national currency, introduced by the NBG, with the aim to neutralise excess currency in circulation.

The decrease in amounts on correspondent accounts may be connected to the spending of budget means in the same period, at the end of the quarter, and to the increase in credit investments by commercial banks.

Table 12: Commercial Banks' Accounts (thousand GEL, end of period)

	Commercial Banks' Credits to Economy	Share of Credits to Non-Budgetary Sector (%)	Net Foreign Assets	Net Assets		Share of Households in Deposits (%)
				in National Currency	in Foreign Currency	
2000	430315	100.0	-12610	67094	235868	-
2001	489783	99.51	3708	54989	328606	42.5
2002	629486	98.93	25040	71478	401301	53.5
2003	785923	98.42	42456	85863	532989	60.3
2004	964917	99.97	54595	230104	665836	50.5
Q1	726407	99.33	85595	115454	570494	57.0
Q2	739842	99.74	66743	127018	589566	58.3
Q3	875977	99.92	19311	173273	610244	54.8
Q4	964917	99.97	54595	230104	665836	50.5
2005	1730466	100.00	-231480	333611	841285	54.7
Q1	1070710	99.98	20984	203870	684471	57.2
Q2	1229399	99.98	-18482	253233	738697	58.2
Q3	1431937	99.98	-22138	296225	825201	54.0
Q4	1730466	100.00	-231480	333611	841285	54.7
2006						
Q1	1948496	99.99	-269532	378414	915702	55.0
Q2	2263516	99.35	-308977	522700	1032399	48.2
Q3	2536840	100.00	-408385	500689	1117334	52.2

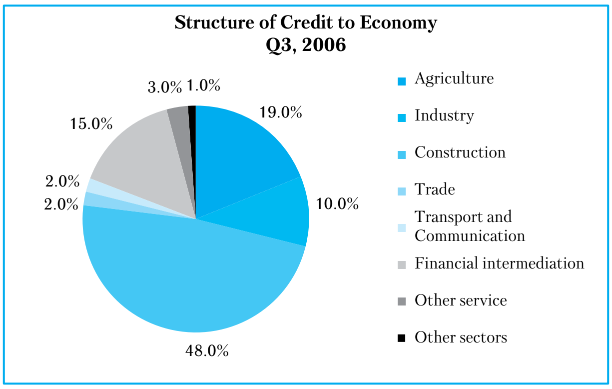
Source: NBG and GEPLAC calculations

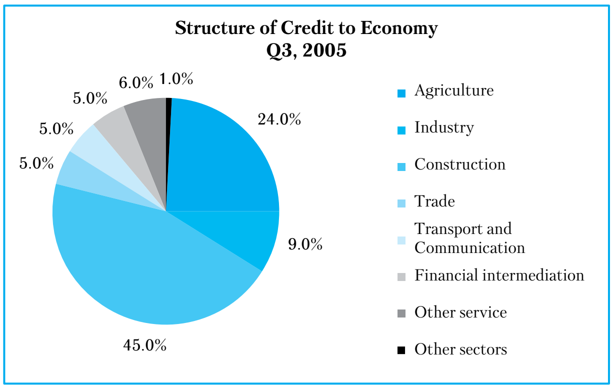
As a result of the stepping up of mediation activity, a high-rate annual growth in households and legal persons' deposits persisted in Q3, 2006, although the quarterly dynamics showed a significant slowdown. It is noteworthy that a downward trend in deposit dollarisation, which was observed over the past few years, obviously slowed down the pace and the dollarisation indicator grew by 4 percent. Nevertheless, the mentioned indicator (70 percent) was still lower than the previous year's corresponding indicator (74 percent).

In the accounting period, 47.5 percent of legal persons' deposits were denominated in foreign currency whereas the similar indicator for physical persons' exceeded 91 percent. It is worth noting that by the end of September 2006, balances on commercial banks' correspondent accounts increased by 51 percent compared to the same period in the previous year, thus reflecting a stable trend in the legalisation of the economy. It should also be noted that in September, time deposits decreased by GEL 5.2 million but still exceeded the September 2005 indicator by 43 percent.

Commercial banks' credits to the economy continued to grow in the third quarter. An annual increase in credits to private enterprises comprised 83.2 percent and showed a quarterly increase of 14.5 percent. The annual growth rate of loans in national currency (110 percent) was faster than that of loans in foreign currency (71 percent) which can be assessed as a positive development. As a result, the dollarisation coefficient of loans decreased by 4 percent in September 2006 compared to the same period in the last year. Moreover, the accounting period saw a doubling of long-term credits including a 158 percent increase in loans issued in national currency.

It is noteworthy that in the setting of increased crediting, the share of overdue liabilities in total debts to commercial banks remained unchanged. The indicator of negatively classified debts was also quite low (6.4 percent) and certainly lower than the average EU indicator (10 percent). Presumably, given the fast increase in the credit portfolio of the banking system, the mentioned indicators do not fully reflect associated credit risks.





Source: NBG and GEPLAC calculations

The share of agriculture was still small in credit structure which can probably be explained by unfavourable weather conditions as well as the transport blockade and trade embargo imposed by Russia. The latter also largely affected the crediting to industry, the share of which dropped by 5 percent, compared to the corresponding period, in the last year, but slightly increased (1 percent) compared to the previous quarter. The share of construction also showed an insignificant growth. Trade and service sectors continued to dominate the structure of crediting.

Table 13: Money Aggregates (thousand GEL, end of period)

	Money outside Banks (M0)	Reserve Money (M1)	Broad Money (M2)	Broad Money (M3)	Money Multiplier		Money Velocity	
					M2	M3	M2	M3
2000	315007	391737	382101	617969	0.98	1.58	19.53	11.67
2001	348850	429857	403839	732445	0.94	1.70	17.89	10.23
2002	390787	508931	462265	863566	0.91	1.70	17.78	9.54
2003	441536	579912	527398	1060388	0.91	1.83	16.23	8.07*
2004	615993	836536	846097	1511933	1.01	1.81	11.78	6.59
Q1	431144	594008	546598	1117092	0.92	1.88	18.24	8.92
Q2	467749	655670	594768	1184334	0.91	1.81	16.76	8.42
Q3	537663	747390	710937	1321181	0.95	1.77	14.02	7.55
Q4	615993	836536	846097	1511933	1.01	1.81	11.78	6.59
2005	736284	1001451	1069895	1911181	1.07	1.91	10.83	6.07
Q1	608555	809154	812425	1496897	1.00	1.85	14.27	7.74
Q2	636495	879314	889728	1628425	1.01	1.85	13.03	7.12
Q3	686116	933404	982341	1807542	1.05	1.94	11.80	6.41
Q4	736284	1001451	1069895	1911181	1.07	1.91	10.83	6.07
2006								
Q1	709102	978908	1087516	2003218	1.11	2.05	12.03	6.53
Q2	729106	1044679	1251806	2284205	1.20	2.19	9.69	5.31
Q3	773243	1096913	1273391	2421024	1.16	2.21	11.21	6.0

Source: NBG
*Note: * Verified data*

Broad money (M2) growth rates decreased in the reviewed period in annual and, especially, quarterly terms. The dynamics of the mentioned aggregate was influenced, on the one hand, by the increase in currency in circulation and, on the other, by a slowdown in the annual growth rate of deposits in national currency and a quarterly decrease in its volume.

The third quarter saw the increase in all the components of broad money aggregate (M3) save the deposits in national currency. A high annual growth rate of this aggregate (33.4 percent) was primarily conditioned by increased deposits in foreign currency. It is noteworthy that because of a higher growth rate of broad money, as compared to reserve money, the (M3) multiplier increased by 0.9 percent whilst the (M2) multiplier decreased by 3.3 percent. The dynamics of (M3) and (M2) multipliers clearly indicate that the process of monetisation in foreign currency went on at a higher pace in the third quarter than the monetisation in national currency.

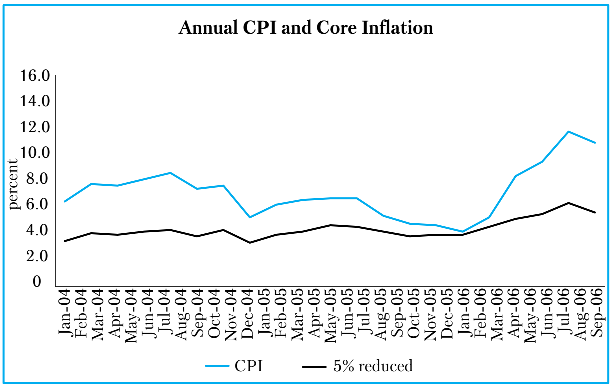
Table 14: Change in Prices

	Consumer Price Index December 1995=100 (end of period)	Change in Consumer Price Index (%, as compared with the end of the previous period)	Change in Core Inflation (%, as compared with the end of the previous period)*	Producer Price Index December 2000=100 (end of period)
2000	156.7	4.6	0.9	100.0
2001	162.1	3.4	1.3	108.9
2002	170.9	5.4	0.5	111.3
2003	182.7	7.0	2.3	118.7
2004	196.5	7.5	2.2	120.1
Q1	184.5	1.0	0.2	119.5
Q2	181.3	-1.7	-0.3	118.3
Q3	184.6	1.8	0.9	119.4
Q4	196.5	6.4	1.4	120.1
2005	208.6	6.2	3.0	130.1
Q1	202.4	3.0	0.6	129.8
Q2	197.7	-2.3	0.0	128.3
Q3	198.7	0.5	1.1	127.4
Q4	208.6	5.0	1.2	129.2
2006				
Q1	211.6	1.5	0.6	133.9
Q2	220.3	4.1	0.9	145.3
Q3	221.0	0.4	-1.1	146.1

Source: Department for Statistics, Ministry of Economic Development and NBG
*Note: * The core inflation indicator no longer includes exogenous factors and mainly reflects the impact of monetary policy on the price developments. A stable core inflation reflects the fact that the pursued monetary policy did not induce sharp change in consumer prices*

The accounting period was marked with high inflation rates. The July indicator of the annual inflation was 14.5 percent, the August indicator – 13.4 percent and that for September – 11.2 percent. The rise in prices was observed mainly on perishable consumer goods-first and foremost, on food products (the annual 13.8 percent)- whilst a relatively moderate rise was observed on medium-term consumer goods (1.9 percent). Prices on long-term consumer goods decreased slightly (2 percent).

In annual terms, the inflationary processes were largely influenced by exogenous factors amongst which the rise in world prices for oil and sugar, an increase in the price of natural gas, a rise in electricity tariffs as well as a decrease in vegetable imports and unfavourable weather conditions for agriculture are to be singled out. The inflationary pressure was also largely conditioned by the dynamics of money supply which, in annual terms, mainly depended on government deposit spending and the NBG's purchases of excess foreign currency. This assumption is also proved by the core inflation curve trajectory over the period to September 2006.



Source: Department for Statistics, Ministry of Economic Development

Given the created situation, the NBG decided to reinstate the reserve requirements on commercial banks' means in national currency and to issue its own deposit certificates which brought about quite positive results. The core inflation notably decreased in September as did the annual inflation rate.

Producers' prices continued to rise in Q3, 2006 which, naturally, affected the changes in consumer prices.

Table 15: Interest Rates

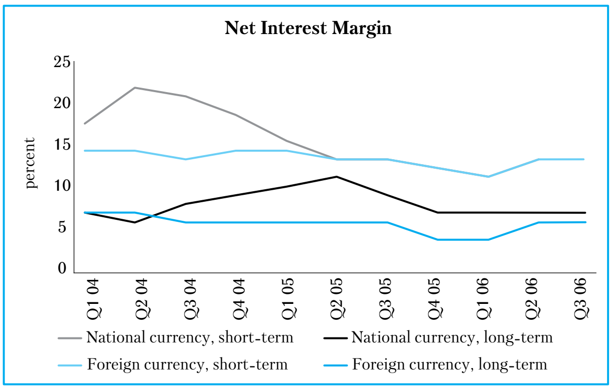
	Money Market Rate (GEL)*	Money Market Rate in Foreign Currency)**	Commercial Banks' Interest Rates (annual weighted average)							
			on Loans				on Deposits			
			GEL		Foreign Currency		GEL		Foreign Currency	
			short-term	long-term	short-term	long-term	short-term	long-term	short-term	long-term
2000	-	-	22	17	30	20	11	2	11	13
2001	-	-	24	17	27	21	8	3	11	12
2002	24	16	25	16	25	20	11	12	11	12
2003	12	13	25	19	23	19	10	12	10	11
2004	8	8	27	20	22	17	8	12	9	11
Q1	17	11	27	20	23	18	10	13	9	11
Q2	16	8	29	19	23	18	8	13	9	11
Q3	6	7	27	20	22	17	7	12	9	11
Q4	6	7	25	21	22	17	7	12	8	11
2005	8	7	22	21	20	16	9	12	8	10
Q1	9	5	23	21	22	16	8	11	8	10
Q2	7	7	22	22	21	16	9	11	8	10
Q3	8	8	21	21	20	16	8	12	7	10
Q4	10	8	21	20	20	15	9	13	8	11
2006										
Q1	7	11	21	20	19	15	10	13	8	11
Q2	7.8	9	20	20	19	16	7	13	6	10
Q3	9.1	11.4	20	20	18	16	7	13	6	10

Source: NBG and GEPLAC calculations

*Note: * The money market interest rate in national currency includes an annual weighted average interest rate on up to 1-year maturity loans issued through Interbank Credit Auctions and bank to bank market*

*** The money market interest rates in foreign currency include an annual weighted average interest rate on up to 1-year maturity loans issued directly at the bank-to-bank market*

Despite a sharp increase in deposits in commercial banks, the reviewed period did not see any changes towards the increase of deposit rates. Loan rates were also stable. As a result, the net interest margin actually remained the same.



Source: NBG and GEPLAC calculations

Unlike the previous quarter, the NBG was no longer the main buyer on the money market. Interbank credit auction showed an annual (1.1 percent) and quarterly (1.3 percent) growth in average interest rate of up to one-year maturity loans. Overall, a weighted average rate on all credit resources in three quarters in 2006 comprised 8 percent.

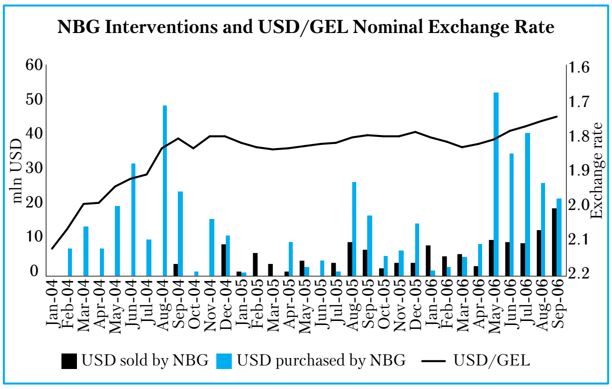
In Q3, 2006, the turnover on a direct bank-to-bank market significantly exceeded the turnover of credit auction. As transactions in short-term credit resources in foreign currency increased, so did an average interest rate on up to one-year maturity loans. Its annual growth comprised 3.4 whilst showing a quarterly growth of 2.4 percent. Such an upward trend in interest rates on the money market clearly reflects a sharp increase in demand on credits in foreign currency in the reviewed period.

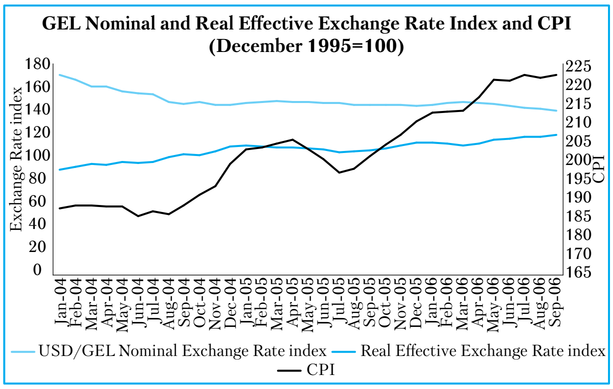
Table 16: Exchange Rates and NBG Net Interventions

	Nominal Exchange Rate (average for the period)		USD/GEL Banknote Rate (average for the period)	Real Effective Exchange Rate December 1995=100 (end of period)	Net NBG Interventions (thousand USD)
	USD/GEL	Euro/GEL			
2000	1.9759	-	-	110.2	-71416
2001	2.0723	1.8473	2.0816	108.2	-35448
2002	2.1945	2.0714	2.3822	102.7	-40459
2003	2.1459	2.4243	2.1502	94.9	-42685
2004	1.9168	2.3814	1.9160	107.0	-182662
Q1	2.0589	2.5753	2.0587	97.3	-21982
Q2	1.9506	2.3513	1.9475	100.7	-60226
Q3	1.8484	2.2582	1.8455	108.5	-80379
Q4	1.8094	2.3409	1.8124	107.0	-20075
2005	1.8126	2.2601	1.8154	110.3	-42919
Q1	1.8272	2.3995	1.8302	103.6	-10600
Q2	1.8250	2.3032	1.8276	104.1	-10885
Q3	1.8046	2.2039	1.8068	104.6	-24652
Q4	1.7936	2.1338	1.7960	110.2	-17982
2006					
Q1	1.8148	2.1810	1.8131	105.5	11323
Q2	1.8033	2.2637	1.8008	111.1	-74282
Q3	1.7552	2.2373	1.7146	110.8	-47544

Source: NBG and GEPLAC calculations

In Q3, 2006, the domestic currency market conjuncture was formed by the interrelation of such factors as foreign direct investments, remittances from abroad, foreign credit lines and changes in government deposits. Despite quarterly and, especially, a sharp annual deterioration of the current account balance, the tendency of excess supply of foreign currency still dominated the market.





Source: NBG

Under such circumstances, the exchange rate of the Lari against the USD increased by 2.6 percent, compared to the previous quarter, and by 2.7 percent, compared to the same period in the last year. In order to avoid undesirable appreciation of the Lari, the NBG actively applied bilateral interventions on TICEX. July was marked with remarkable instability when the NBG had to purchase a large amount of foreign currency in the amount of USD 31.4 million. A comparatively lower but yet significant demand on the Lari was also observed in August when the NBG bought USD 13.4 million. The currency market stabilised only in September. Nevertheless, a strong expectation towards appreciation of the Lari was observed throughout this period which was reflected in the Lari banknote rate velocity.

The Lari real effective exchange rate continued to increase in the reviewed period in annual (6.2 percent) terms which, in addition to the appreciation of the nominal exchange rate, was mainly caused by a relatively high inflation rate in trade partner countries. It should also be noted that, compared to the previous quarter, the Lari real effective exchange rate somewhat changed although it had no real effect on the external sector of Georgia's economy.

4. LABOR MARKET AND HOUSEHOLD BUDGETS

Table 17: Population and Employment (thousand persons)

	Total population over 15 years old	Economically active population *		Employed					Total employment rate (%)
		Total	Labor force participation rate (%) *	Total	Hired	Self-employed	Employment rate among people of working age (%)	Employment rate among people older then working age (%)	
2000	3148.1	2051.6	65.2	1839.3	684.3	1043.9	79.2	20.8	58.4
2001	3191.1	2113.3	66.2	1877.7	654.6	1135.9	80.2	22.0	58.8
2002	3239.5	2104.2	65.0	1839.2	650.9	1184.9	80.0	20.1	56.8
2003	3098.8	2050.4	66.1	1814.5	618.5	1195.2	79.8	18.9	58.5
2004	3151.1	2041.0	64.8	1783.3	600.9	1180.8	77.9	19.2	56.6
Q1	3142.6	2006.7	63.9	1746.4	619.8	1125.4	83.4	20.6	55.6
Q2	3121.7	2053.9	65.8	1809.0	608.1	1200.6	87.1	20.7	57.9
Q3	3180.9	2093.1	65.8	1819.2	577.5	1239.3	86.2	22.1	57.2
Q4	3159.3	2010.2	63.6	1758.6	598.1	1158.1	84.2	20.5	55.7
2005	3162.3	2023.9	64.0	1744.6	600.5	1143.3	82.0	18.8	55.2
Q1	3177.9	1999.4	62.9	1705.1	595.1	1108.7	80.3	19.7	53.7
Q2	3148.7	2035.5	64.6	1763.2	604.5	1158.0	82.9	17.1	56.0
Q3	3131.5	2011.8	64.2	1744.9	587.4	1156.7	81.2	18.8	55.7
Q4	3191.1	2048.8	64.2	1765.1	614.8	1149.9	83.9	19.4	55.3
2006									
Q1	3169.8	1925.1	60.7	1643.1	586.2	1055.5	82.9	17.1	51.8
Q2	3138.7	1952.3	62.2	1699.9	566.9	1130.4	83.8	16.2	54.2
Q3	3113.0	1960.5	63.0	1691.5	574.8	1116.2	83.5	19.4	54.3

Source: Department for Statistics Ministry of Economic Development
*Note: * ILO "strict" methodology*

Unemployment in Q3 2006 remains a persistent problem for the working-age population and, although self-employment is still prevailing, its shrinking share in total employment and a somewhat relatively stable hired employment share in total employment are positive signs. The labour force participation rate, even having slightly decreased, remains relatively high which reflects active job-seeking endeavours. Hired employment numbers have been shrinking in line with civil service restructuring and optimisation. The portion of the working-age population engaged in salaried employment has been on the downward trend at 18 percent. The average salaries across the economy, particularly those of civil servant, have been growing in absolute terms as were prices. The unemployment rate showed a slight annual growth.

The labour force participation rate grew in quarterly terms and decreased in annual terms. This was in support of a downward annual trend that has been taking shape for several years. The quarterly changes of the labour force participation rate do not always fit in a seasonal pattern to be traced over recent years. Even taking into consideration all the above-mentioned fluctuations, however, the participation rate remains high. Transition countries usually feature high participation rates which is a natural reflection of the endeavours of several household members engaged in the job search given the fact that a one-breadwinner income is usually insufficient to support a family and stable jobs are a rare find.

Amongst the features of the labour market pattern in Q3 2006 were a decrease in the number of hired employees and a shrinking of the share of hired employment in total compared to a year ago. It did, however, show quarterly growth. The quarterly fluctuations during the past several years at times fail to compose a well-articulated seasonal trend. The anecdotal evidence shows both the government restructuring and optimisation exercises and private sector employment opportunities.

In contrast to the previous quarter developments, the share of the self-employment in the total employment shrank by 0.3 percentage points whilst the share of the hired employment grew in total by same 0.3 percentage points. It seems that the hired employment could absorb some of those who abandoned self-employment activities. Given the fact that the total employment number decreased during the same period and its share in the labour force appeared to have shrunk (by 0.4 percentage points), however, that is unlikely. The share of self-employment in total employment has been going up and down from quarter to quarter whilst the absolute figures have been diminishing since 2003. In spite of this downward trend, self-employment still prevails over hired employment and predominates over the labour force at large. In Q3 2006, the self-employment share in total employment was 66.0 percent and was 56.9 percent in the total labour force.

In Q3 2006, the share of total employment in the labour force fell by 0.4 percentage points in annual terms. Whilst it was both hired employment and self-employment figures that decreased over the year – which was reflected in the employment rate that decreased correspondingly – the total employment share decreased even at the background of the smaller labour force that shrank by 1.2 percentage points.

Table 18: Unemployment (thousand persons)

	Total population over 15 years old	Unemployment *		Unemployment rate (%) *		Non-active population of 15-70 years old *	
		Total	Unemployment Rate (%) *	Among people of working age **	Among people older then working age **	Total	Employed in household
2000	3148.1	212.2	10.3	12.2	2.6	898.8	265.0
2001	3191.1	235.6	11.1	13.4	1.8	872.4	250.5
2002	3239.5	265.0	12.6	14.9	2.2	910.0	280.2
2003	3104.9	235.9	11.5	13.4	2.3	847.1	257.3
2004	3151.1	257.6	12.6	14.9	1.8	895.4	257.1
Q1	3142.6	260.2	13.0	15.3	1.8	923.2	268.5
Q2	3121.7	244.9	11.9	14.0	1.7	861.5	242.2
Q3	3180.9	273.8	13.1	15.5	2.2	868.9	254.2
Q4	3159.3	251.6	12.5	14.8	1.6	927.9	263.3
2005	3162.3	279.3	13.8	16.3	0.9	913.6	248.5
Q1	3177.9	294.3	14.7	17.3	2.3	941.5	258.8
Q2	3148.7	272.3	13.4	15.9	1.3	902.5	241.0
Q3	3131.5	266.9	13.3	15.7	0.8	911.7	244.9
Q4	3191.1	283.7	13.8	16.1	2.7	898.6	2494
2006							
Q1	3169.8	282.0	14.6	16.5	0.5	1244.6	279.1
Q2	3138.7	252.4	12.9	14.3	1.1	1186.4	242.1
Q3	3113.0	269.0	13.7	15.4	0.4	1152.5	253.0

Source: Department for Statistics, ‚e Ministry of Economic Development
*Note: * ILO "strict" methodology*
*** Working age is given as 15-60 for women and 15-65 for men*

During the period under consideration, the labour force participation rate fell and the unemployment rate grew. The participation rate decreased by 1.2 percentage points whilst the unemployment rate grew by 0.4 percentage points in annual terms. The unemployment rate seasonal growth constituted 0.8 percentage points with the labour force participation rate growing by the same 0.8 percentage points. This resulted in the quarterly growth (by 0.8 percentage points as well) of the national unemployment rate calculated by the ILO "strict" methodology that was 13.7 percent. The rural unemployment rate is usually far below that in urban areas.

Table 19: Wages (GEL)

	Average monthly wages and salaries	Average nominal monthly wages and salaries share in minimum subsistence		Nominal monthly wages and salaries*	
		of a working man (%)	of a family of four (%)	Pubic sector including budgetary organisations	Private sector
2000	72.5	62.9	35.9	54.0	106.1
2001	82.6	70.0	39.9	63.0	120.6
2002	99.1	79.0	45.0	77.6	139.4
2003	101.5	77.7	44.3	79.3	145.8
2004	116.4	84.9	48.4	93.7	160.0
Q1	109.5	80.6	45.9	86.6	159.8
Q2	112.8	84.1	47.9	88.9	155.9
Q3	121.8	91.1	51.9	98.9	165.7
Q4	121.6	84.0	48.3	101.3	158.4
2005	149.3	98.0	56.1	130.9	184.0
Q1	128.0	84.2	47.9	108.3	162.9
Q2	146.1	96.5	55.0	124.0	182.4
Q3	156.4	102.4	58.9	142.9	184.8
Q4	166.7	109.1	62.7	148.3	206.1
2006					
Q1	171.2	182.6	103.1	155.6	211.9
Q2	188.9	187.1	105.6	161.8	233.8
Q3	193.2	185.4	104.6	163.2	242.7

Source: Department for Statistics, Ministry of Economic Development

The average monthly nominal salary of hired employees across the economy showed substantial annual growth (by 23.5 percent). The minimum subsistence level for an average family (family of four) grew significantly (by 17.3 percent in annual terms) as well.

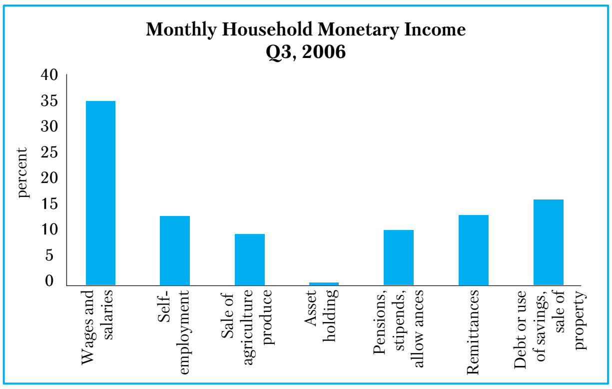
Since the importance of income from hired employment for many Georgian households is difficult to overestimate, it seems reasonable to see what part of the minimum subsistence – especially for an average family – is accounted for by salaries and wages. The minimum subsistence of a family of four accounted for 91 percent of the average monthly salary, the level for a working man for 54.2 percent and the level for an average consumer for 48 percent of the average monthly salary at the end of Q3 2006. The share of minimum subsistence for an average family (family of four) in the average monthly salary of private sector employees (70.2 percent of total hired employment) comprised 72.4 percent and the average monthly salary of public sector employees (29.8 percent of total hired employment), including employees of budgetary organisations, was lagging behind the level of minimum subsistence for an average family by 7.2 percent.

Table 20: Monthly Household Monetary Income (GEL)

	Wages and salaries	Self-employment	Income from sale of agricultural produce	Income from asset holdings	Pension, stipends, family allowances, benefits	Remittances	Debt or use of savings, sale of property	Total monetary income	Wages (% of total income)
2000	43.9	21.6	20.9	1.3	8.5	11.9	26.9	135.0	32.5
2001	52.7	24.3	21.4	1.6	12.3	18.1	18.6	149.0	35.4
2002	57.5	28.9	28.9	1.0	12.2	23.6	44.4	196.5	29.3
2003	60.4	32.2	30.8	1.6	8.3	38.6	41.7	213.7	28.3
2004	67.4	36.6	34.3	2.3	15.6	34.1	42.7	232.9	28.9
Q1	62.0	33.5	36.5	2.3	8.0	31.3	40.6	214.1	29.0
Q2	65.6	34.9	30.5	2.3	15.6	31.4	46.0	226.2	29.0
Q3	72.4	37.0	30.6	2.0	19.6	35.0	42.5	239.2	30.3
Q4	69.5	41.0	39.5	2.7	19.4	38.6	41.8	252.5	27.5
2005	87.5	39.5	32.1	3.3	25.6	36.6	43.1	267.6	29.7
Q1	73.9	41.1	31.1	3.6	22.2	34.7	40.5	247.0	29.9
Q2	87.3	41.5	24.5	3.1	26.8	32.7	36.9	252.7	34.6
Q3	90.6	39.7	28.6	3.1	25.5	37.5	40.2	265.2	28.1
Q4	98.0	35.7	44.2	3.4	27.8	41.4	54.9	305.4	26.0
2006									
Q1	95.9	35.6	34.7	1.9	27.7	38.4	36.4	270.1	25.2
Q2	103.8	37.8	26.3	0.9	32.8	45.5	54.8	301.6	27.8
Q3	112.4	42.3	31.2	1.5	33.5	43.0	52.0	316.1	28.8

Source: Department for Statistics, Ministry of Economic Development

The average monthly household income nationally was GEL 390.3 in Q3 2006. 19 percent of the total monthly household income was accounted for by the non-monetary income.



Source: Department for Statistics, Ministry of Economic Development

In Q3 2006, the share of wages and salaries in the total monetary household income was the largest of all monetary household income items. The share of this item grew both compared to a year and a quarter ago. The second largest share was accounted for, as in Q2, by debt and the use of savings and the sale of property and showed an annual increase and a quarterly decrease. The share of remittances from outside Georgia and assistance from relatives and friends was the next largest amongst the monetary household income items. It appeared smaller both in annual and quarterly terms. The fourth place belonged to income from self-employment that decreased compared to a year before and increased compared to the previous quarter.

The share of pensions, stipends, family allowances and benefits showed an increase in annual terms and a decrease in quarterly terms. The share of income from agricultural produce sale decreased in annual terms and grew in quarterly terms. Proceeds from the sale of agricultural produce is an item of household income whose annual fluctuations usually reflect the harvest trends and CPI trends whereas quarterly changes are especially susceptible to seasonal changes. It is difficult to overestimate the importance of this source of monetary income for the majority of rural households since alternative sources of monetary income are scarce.

The share of income from asset holdings showed an annual decrease and a quarterly growth. Although both annual and seasonal changes are interesting for analysing the household budget situation, the annual figures appear more interesting for tracing trends since some of the items are especially susceptible to seasonal factors.

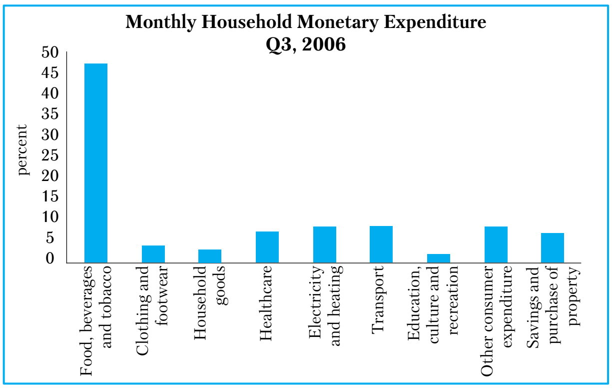
Table 21: Monthly Household Monetary Expenditure (GEL)

	Total Monetary Expenditures *	Consumer Consumer expenditure (purchase of goods and services)	Food, beverages, tobacco	Clothing and footwear	Household goods	Health care	Electricity and heating	Transport	Education, culture and recreation	Other consumer expenditure	Savings and purchase of property
2000	217.0	197.0	100.9	12.7	27.1	10.2	15.8	13.6	7.0	9.7	20.0
2001	222.6	201.8	106.7	12.2	25.6	11.5	17.1	12.4	7.3	9.2	20.6
2002	240.0	216.7	113.0	12.4	7.6	15.7	20.0	25.7	13.3	9.1	23.2
2003	245.9	219.8	116.8	13.3	7.6	13.8	20.0	22.2	6.2	19.9	26.1
2004	268.2	245.7	131.6	14.5	9.1	15.3	21.8	23.5	6.6	23.1	22.7
Q1	261.6	233.0	124.4	14.0	10.1	14.5	22.0	20.9	6.8	20.3	28.6
Q2	256.3	232.8	128.0	12.5	8.8	15.1	18.0	22.4	7.7	20.4	23.4
Q3	257.1	238.1	131.4	12.4	8.0	16.0	18.1	24.3	4.6	23.2	19.1
Q4	298.6	278.9	142.8	19.2	9.7	15.8	29.2	26.4	7.3	28.6	19.6
2005	287.0	265.5	133.9	14.9	9.8	19.5	26.1	27.0	7.9	26.5	21.5
Q1	279.5	261.1	131.7	15.0	10.2	18.4	27.1	26.5	8.6	23.5	18.5
Q2	273.7	257.4	132.0	12.9	8.7	20.3	22.9	27.3	9.0	24.2	16.4
Q3	272.2	250.0	128.6	13.3	9.2	18.8	22.7	25.5	5.8	26.1	22.2
Q4	322.3	293.3	143.3	18.2	10.9	20.3	31.7	28.6	8.1	32.2	29.0
2006											
Q1	281.0	262.2	131.6	14.7	10.4	19.4	30.2	22.2	9.1	24.6	18.8
Q2	316.2	276.2	139.5	12.2	9.5	26.2	23.8	29.4	10.0	25.6	40.0
Q3	307.3	285.2	150.1	12.9	10.2	23.4	27.2	27.7	6.6	27.0	22.1

Source: Department for Statistics, Ministry of Economic Development
*Note: * Total expenditures in this table do not include agricultural expenditures and transfers*

Monetary expenditure accounted for 81.5 percent of the total monthly household expenditure in Q3 2007. Expenditures on consumer goods and services constituted 92.8 percent of total monetary expenditures which was an increase in both annual and quarterly terms. 48.8 percent was accounted for by the expenditures on food, beverages and tobacco which is, as always, the largest item in the consumer expenditures. The share of money spent on food and beverages grew in annual terms as well as in quarterly terms.

The second on the list of the total monetary household expenditure was expenditure on transport which fell both in annual and quarterly terms. Expenditures on electricity and heating appeared in the next place with this item showing growth as compared to a year ago and, as well, to a quarter ago. This time, Georgian households spent more on healthcare and the purchase of medicines than the year before and less than in the previous quarter. Savings and the purchase of property decreased both annually and seasonally. Clothing and footwear expenditures appeared more modest than the year before and showed some growth from the previous quarter. Expenditures on household goods followed in next place with its share in total slightly decreasing in annual terms and growing in quarterly terms.



Source: Department for Statistics, Ministry of Economic Development

This time, the smallest share in the total household monetary expenditures belonged to money spent on education, culture and recreation which remained virtually unchanged compared to a year before and decreased against the previous quarter.

5. EXTERNAL SECTOR

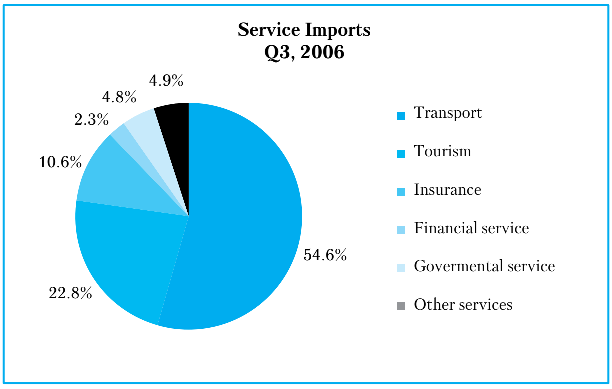
Table 22: Main Components of External Economic Relations (million USD)

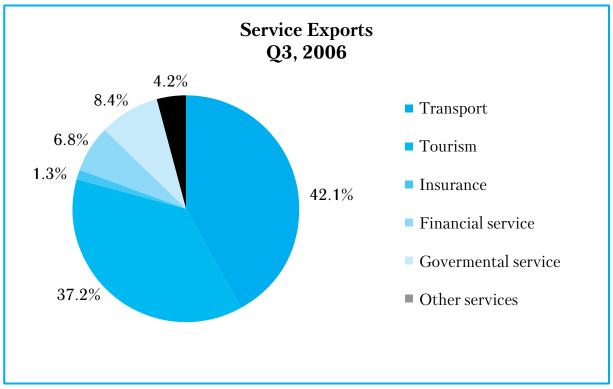
	Trade Balance of Goods and Services	Current Account Balance	Current Account Balance (GDP %)	Net Foreign Direct Investments	Portfolio Investments	Change in Gross International Reserves	International Reserves by Import Months	Total Foreign Debt (GDP %)
2000	-386.3	-161.2	-5.3	131.7	2.7	-23.3	1.4	50.9
2001	-479.6	-221.4	-6.9	109.9	2.0	50.2	1.8	50.0
2002	-447.5	-197.6	-5.8	163.3	0.0	38.5	2.3	51.5
2003	-582.0	-369.5	-9.2	336.3	0.0	-6.7	1.6	45.9
2004	-858.6	-346.9	-6.7	489.5	-13.1	192.0	2.3	34.2
Q1	-181.7	-100.5	-10.2	117.5	0.0	20.0	1.3	38.6
Q2	-159.3	-58.5	-4.7	117.1	0.0	63.2	1.6	36.2
Q3	-238.8	-98.3	-7.1	131.3	0.0	90.1	2.2	33.9
Q4	-278.7	-89.6	-5.8	123.6	-13.1	18.7	2.3	34.2
2005	-1140.8	-690.0	-10.8	539.3	15.5	91.4	2.1	27.1
Q1	-195.9	-117.8	-8.9	86.7	5.6	-2.1	1.7	28.8
Q2	-216.1	-134.0	-8.7	198.1	2.9	56.6	2.0	27.4
Q3	-322.5	-182.5	-10.8	75.6	7.0	9.6	2.0	27.2
Q4	-406.4	-255.7	-13.9	178.9	0.0	27.3	2.1	27.1
2006								
Q1	-315.9	-189.4	-12.1	133.8	0.0	5.6	2.0	22.9
Q2	-481.4	-322.2	-17.3	294.2	0.1	57.6	1.7	23.1
Q3	-567.4	-364.1	-17.6	283.6	-3.4	81.6	1.8	22.4

Source: Department for Statistics, Ministry of Economic Development
*Note: *Verified data*

In Q3, 2006, the current account balance deteriorated yet again compared to both the corresponding period last year and the previous quarter. A high rate of deficit growth persisted as well, doubling the negative balance, compared to the corresponding period in 2005. In the reviewed period, the appreciation of the Lari, a fast growth of credits to the economy and the government's expenditure policy in the run up to the elections created favourable conditions for the inflow of imports. Export volumes significantly declined as a result of Russia's embargo on Georgian wine, mineral waters and agricultural produce. According to the balance of payments, the export growth rate declined to 7.7 percent whilst the value of imports increased by 41.2 percent. The USD 273.2 million deterioration of the trade balance, then, was not offset by the USD 91.2 million increase in revenues from current transactions. As a result, the current account deficit increased in the third quarter and comprised 17.6 percent of the GDP.

The seasonality factor, as well as notable improvements in resort infrastructure, resulted in a significant growth of revenues from tourism. Net foreign revenues from business and personal tourism made up USD 50 million in the third quarter whereas the same indicator last year comprised USD 27 million. At the same time, net revenues from the transport service plummeted mainly because of a sharp increase in spending on road and rail cargo transportation which soared in proportion to the growth of imports. As the imports grew so did Georgia's spending on cargo insurance. The total turnover in the communications service halved compared to the same period in 2005 although net revenues increased. Given the fast enhancement of the banking system, the foreign financial service activity stepped up in the accounting period bringing Georgia an additional USD 8 million. As a result of this and other transactions in the sphere of service, Georgia's net revenues more than doubled and reached USD 52.5 million.





Source: Department for Statistics, Ministry of Economic Development

Despite improvements in the balance of services, Q3, 2006 saw a sharp deterioration of trade deficit in goods and non-factor service which comprised 27.5 percent of the GDP.

In the third quarter, compared to the same period in 2005, the USD 11 million decrease in current spending on foreign investment service and the USD 21 million increase in remuneration of workers from foreign sources led to a sharp increase-more than doubling-of income account. It reached USD 59 million as compared to USD 27 million in the same period last year.

Remittances from abroad continued to be one of main income sources in the third quarter. Their annual growth comprised USD 27 million; that is, 34.4 percent. Since the beginning of the year, remittances made up USD 278 million thus comprising 5 percent of the GDP*. The improvement of the current transfers account was facilitated by an upward dynamics in government grants, which increased by USD 7 million compared to the previous quarter, and by USD 3 million compared to the previous year's corresponding period.

The largest part of the financial account in the reviewed period came in the form of direct investments, comprising USD 283.5 million of which 88 percent accounted for investments in share equity. Georgia received USD 56.3 million in relation to the Shah-Deniz gas pipeline. Of further note is the rather high volume of long-term loans in the banking sector which comprised USD 150.9 million in the third quarter. At the same time, USD 102.8 million was spent in this sector for covering liabilities on loans taken in previous periods. Capital operations have been stepped up since 2006 which brought the country USD 35 million in the form of capital grants in the third quarter. USD 27.5 million of this amount was granted to the public sector. As a result of these operations, Georgia's international reserves increased by USD 74.7 million in the third quarter and by USD 128.2 million since the beginning of the year.

Table 23: Imports Structure by Main Commodity Groups

	Total Imports		Oil Products		Motorcars		Oil, Gases and Hydrocarbons		Wheat and Meslin		Medication		Sugar		Telephone, Radio and TV Equipment		Other	
	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%
2000	709.4	100	71.8	10.1	15.5	2.2	50.3	7.1	29.2	4.1	45.8	6.5	25.4	3.6	17.0	2.4	454.5	64.1
2001	753.2	100	87.7	11.6	13.1	1.7	48.8	6.5	14.4	1.9	53.6	7.1	24.1	3.2	9.0	1.2	502.5	66.7
2002	795.5	100	88.8	11.2	21.9	2.8	52.4	6.6	20.1	2.5	62.0	7.8	34.7	4.4	17.3	2.2	498.3	62.6
2003	1141.2	100	104.8	9.2	46.5	4.1	66.0	5.8	28.0	2.4	62.9	5.5	53.0	4.6	14.7	1.3	765.3	67.1
2004	1845.6	100	186.2	10.1	116.3	6.3	80.1	4.3	75.0	4.1	78.0	4.2	50.8	2.8	16.2	0.9	1242.9	67.3
Q1	328.7	100	28.3	8.6	18.1	5.5	26.0	7.9	10.5	3.2	17.3	5.3	6.2	1.9	2.6	0.8	219.7	66.8
Q2	438.4	100	41.1	9.4	21.1	4.8	14.4	3.3	20.2	4.6	17.9	4.1	16.5	3.8	6.3	1.4	300.9	68.6
Q3	488.1	100	56.8	11.6	30.4	6.2	12.2	2.5	27.9	5.7	15.3	3.1	13.3	2.7	4.1	0.8	328.1	67.2
Q4	590.3	100	60.0	10.2	46.7	7.9	27.5	4.7	16.4	2.8	27.4	4.6	14.7	2.5	3.2	0.5	394.4	66.8
2005	2490.0	100	336.3	13.5	178.5	7.2	90.8	3.6	45.1	1.8	92.5	3.7	78.2	3.1	27.1	1.1	1641.4	65.9
Q1	454.2	100	56.8	12.5	28.6	6.3	28.4	6.3	8.2	1.8	23.3	5.1	16.7	3.7	4.3	0.9	287.9	63.4
Q2	527.3	100	74.0	14.0	36.5	6.9	19.2	3.6	9.9	1.9	28.0	5.3	13.1	2.5	7.1	1.3	339.5	64.4
Q3	687.6	100	104.1	15.1	48.1	7.0	14.4	2.1	12.3	1.8	18.4	2.7	19.6	2.9	9.4	1.4	461.4	67.1
Q4	820.8	100	101.4	12.3	65.3	8.0	28.9	3.5	14.8	1.8	22.8	2.8	28.7	3.5	6.3	0.8	552.6	67.3
2006	2593.2	100	345.4	13.3	208.4	8.0	142.7	5.5	64.5	2.5	82.0	3.2	49.8	1.9	39.2	1.5	1661.3	64.1
Q1	682.7	100	80.8	11.8	65.5	9.6	57.4	8.4	16.9	2.5	25.4	3.7	11.0	1.6	8.1	1.2	417.7	61.2
Q2	887.2	100	122.5	13.8	72.8	8.2	44.7	5.0	20.7	2.3	31.1	3.5	16.4	1.8	12.5	1.4	566.6	63.9
Q3	1023.3	100	142.1	13.9	70.2	6.9	40.6	4.0	26.9	2.6	25.5	2.5	22.4	2.2	18.6	1.8	677.0	66.2

Source: Department for Statistics, Ministry of Economic Development
*Note: *Verified data*

According to officially registered trade data, the value of imported goods in the third quarter exceeded USD 1 billion thus showing a 48.8 percent growth of the import indicator as compared to the previous year's corresponding indicator. It should be noted that the value of imports for the first three quarters in 2006 already exceeded the indicator for the entire year 2005. Along with a high economic growth rate,

* *GDP for three quarters.*

which created an excess demand on investment, intermediate products and the consumption of consumer goods also grew mainly due to an increase in bank loans and improved accessibility. As agricultural production declined compared to 2005, the import of agricultural produce sharply increased.

Compared to the same period last year, the import of oil and oil products went up by 37 percent whilst its share in total imports decreased. Nevertheless, it remained the largest import category for Georgia. Moreover, due to a rise in world oil prices, the demand on cheaper and relatively low-quality Azeri and Turkmen oil was again increased. European oil was primarily imported from Romania, Bulgaria and Greece.

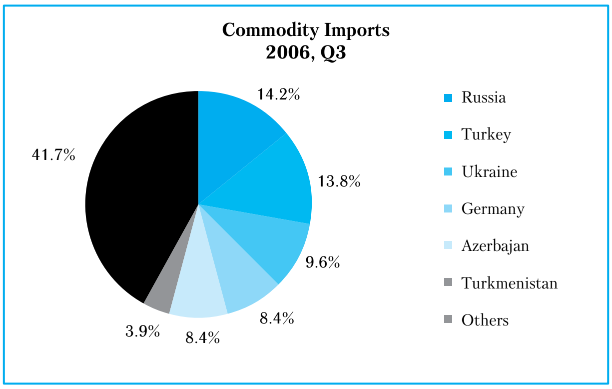
Motorcar imports showed a 45 percent annual growth although car prices notably increased on average in the same period. The share of motorcars in aggregate imports did not change compared to the same period in 2005. The demand on German automobiles remained high although imports of those from Japan increased as many as five times and continued throughout the year. German, Japanese and American motorcars met 67 percent of the demand on Georgian market.

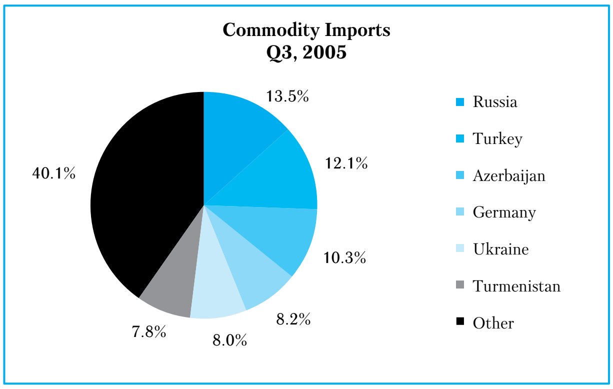
Russia remained the near sole supplier of gas in the reviewed period. This category imports tripled compared to Q3, 2005.

Wheat imports sharply increased (more than doubled) as well with this trend having been observed since the beginning of the year. The indicator for the first three quarters already exceeded the previous year's annual indicator by 43 percent. Such a dynamic was partially the result of unfavourable weather conditions. The legalisation of imports, however, can be named as one of the reasons as well. 85 percent of wheat was again supplied by Russia whilst the rest mainly purchased from Kazakhstan and Ukraine.

The nominal value of pharmaceutical imports increased in Q3, 2006 compared to Q3, 2005. Along with a sharp growth of imports, however, the share of pharmaceuticals decreased gradually and showed the lowest indicator over the last few years.

Sugar remained amongst the largest import commodities although a supplier structure was changed. Brazil's share went down from 86 to 42 percent compared to Q3, 2005. The list of importers was extended to include Belarus with its 27 percent share. The third largest importer was Azerbaijan. These three countries supplied 87 percent of sugar to the Georgian market.



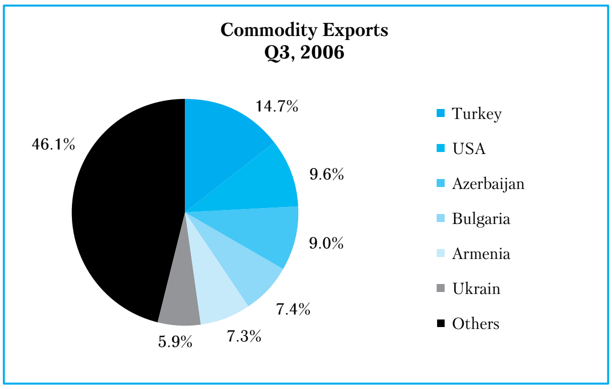


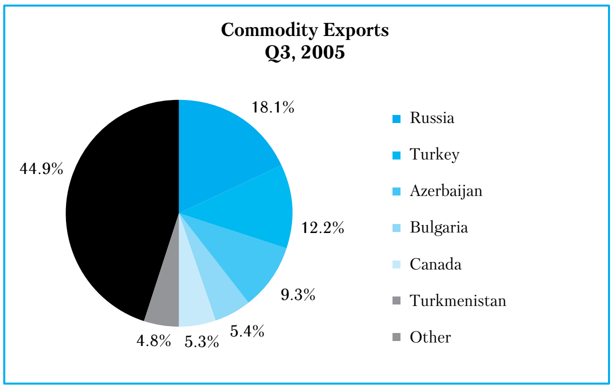
Source: Department for Statistics, Ministry of Economic Development

Irrespective of the complicated relations with Russia, the Georgian market was still open to products from this country. Imports from Russia showed a 52 percent annual growth, however, Turkey also emerged as first amongst importers due to the simplification of trade rules. An annual growth of imports from this country comprised 74 percent. Additionally, whilst imports from Russia were somewhat focused on a certain number of goods (oil products, natural gas, electricity and wheat comprised 50 percent of total imports), products from Turkey were quite diverse.

In the reviewed period, China appeared amongst Georgia's main suppliers for the first time ever and occupied a ninth-place position. The imports from this country increased more than twice compared to Q3, 2005. The imports from Germany were quite dynamic as well which can be explained not only by an increasing demand for German made motorcars but also for special construction-related machinery.

In Q3, 2006 compared to the same period last year, 15 countries left and 14 new countries entered the list of importers to Georgia.





Source: Department for Statistics, Ministry of Economic Development

The loss of a significant segment of the Russian market dealt a serious blow to Georgian exporters. Compared to Q3, 2005, nominal revenues from exports grew by only 10.7 percent. It is true that alternative markets were found for the sale of some products originally intended for Russia but the scale of export diversification remained limited.

In the reviewed period, the top seven export commodities differed qualitatively from the commodity structure of the same period in the previous year. This time, the focus was rather on the export of raw material and manufacturing products such as ferroalloy, copper ore, nitrogen fertilisers, unprocessed gold, etc.

Table 24: Exports Structure by Main Commodity Groups

	Total Exports		Ferroalloy		Copper Ore, Concentrates		Black Metal Scrap		Motorcars		Nitrogen Fertilisers		Unprocessed Gold		Copper Metal Scrap		Other	
	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%	mln USD	%
2000	322.7	100	13.6	4.2	9.8	3.1	39.0	12.1	0.3	0.1	16.2	5.0	-	-	4.3	1.3	239.4	74.2
2001	317.6	100	17.6	5.5	9.6	3.0	33.1	10.4	0.5	0.2	4.9	1.5	12.5	3.9	7.6	2.4	231.9	73.0
2002	345.9	100	15.5	4.5	13.2	3.8	36.5	10.5	0.6	0.2	12.0	3.5	28.6	8.3	4.6	1.3	234.9	67.9
2003	461.4	100	26.1	5.7	23.4	5.1	60.1	13.0	1.1	0.2	18.4	4.0	20.3	4.4	8.7	1.9	303.3	65.7
2004	646.9	100	42.5	6.6	31.8	4.9	95.9	14.8	3.8	0.6	28.8	4.4	18.8	2.9	8.3	1.3	416.9	64.4
Q1	95.5	100	10.1	10.6	5.5	5.7	18.4	19.2	0.5	0.6	4.8	5.0	-	-	1.4	1.5	54.8	57.4
Q2	199.8	100	11.7	5.9	11.4	5.7	22.6	11.3	0.5	0.3	5.3	2.6	10.5	5.2	2.2	1.1	135.7	67.9
Q3	157.9	100	6.9	4.3	10.2	6.4	21.5	13.6	1.2	0.8	5.8	3.7	4.7	3.0	2.7	1.7	104.9	66.4
Q4	193.7	100	13.8	7.1	4.9	2.5	33.4	17.3	1.6	0.8	12.9	6.7	3.6	1.9	2.0	1.0	121.5	62.7
2005	865.5	100	80.2	9.3	36.4	4.2	84.2	9.7	17.9	2.1	35.8	4.1	34.7	4.0	11.5	1.3	564.7	65.2
Q1	170.0	100	21.4	12.6	14.0	8.2	28.0	16.5	1.5	0.9	4.9	2.9	6.3	3.7	2.2	1.3	91.6	53.9
Q2	202.7	100	16.5	8.1	8.0	3.9	24.5	12.1	2.6	1.3	7.9	3.9	9.6	4.8	3.3	1.6	130.3	64.3
Q3	224.7	100	20.3	9.0	9.3	4.1	19.2	8.5	5.4	2.4	9.1	4.1	9.6	4.3	2.9	1.3	148.9	66.3
Q4	268.1	100	22.0	8.2	5.2	1.9	12.5	4.7	8.5	3.2	13.9	5.2	9.3	3.5	3.1	1.1	193.8	72.3
2006	705.8	100	69.9	9.9	54.8	7.8	53.3	7.6	29.5	4.2	32.5	4.6	35.5	5.0	21.0	3.0	409.2	58.0
Q1	221.1	100	19.6	8.9	10.2	4.6	13.5	6.1	4.5	2.0	10.0	4.5	11.1	5.0	3.8	1.7	148.4	67.1
Q2	236.0	100	20.1	8.5	23.0	9.7	20.3	8.6	9.5	4.0	9.0	3.8	11.8	5.0	8.0	3.4	134.2	56.9
Q3	248.7	100	30.2	12.2	21.6	8.7	19.5	7.8	15.5	6.2	13.5	5.4	12.5	5.0	9.3	3.7	126.6	50.9

Source: Department for Statistics, Ministry of Economic Development

Ferroalloy ranked the first in the export structure with 57 percent of this commodity exported to the USA and 24 percent to Russia (that is, 54 percent of all the Georgian exports to Russia).

The export of copper ores and concentrates more than doubled in annual terms. 73 percent of revenues from the export of this commodity category accounted for Bulgaria.

The demand for copper and black metal scrap was still large although the share of the latter in total exports showed a downward trend over the past few years. Scrap metal was again mainly exported to Turkey. China and India can also be singled out amongst other countries importing scrap metal from Georgia.

In the accounting period, as compared with Q3, 2005, the export of motorcars tripled. This fact, however, is not connected with the country's export potential and, given the specification of customs regimes, is rather in line with the growth of car imports. The main points of destination for motorcars were neighbouring countries such as Turkey, Azerbaijan and Armenia.

Mineral fertilisers were primarily sent to US and European markets. Exports of this product showed an annual 47 percent growth.

The export of unprocessed gold was marked with stability in all the three quarters in 2006 and was almost entirely bound for Canada.

Despite a sharp drop in exports of large commodity categories, such as wine and mineral waters due to Russia's embargo, the third quarter witnessed a notable export concentration with the share of main seven commodities making up 50 percent of total exports.

Table 25: Georgia's Foreign Trade with the CIS (million USD)

	Imports			Exports			Total balance		
	Total	CIS	Other Countries	Total	CIS	Other Countries	Total	CIS	Other Countries
2000	709.4	229.3	480.1	322.7	128.5	194.3	-386.6	-100.8	-285.8
2001	753.2	254.0	499.3	317.6	144.3	173.3	-435.6	-109.7	-325.9
2002	795.5	292.2	503.3	345.9	168.7	177.2	-449.6	-123.5	-326.1
2003	1141.2	370.1	771.1	461.4	224.8	236.6	-679.8	-145.3	-534.5
2004	1845.6	654.9	1190.6	646.9	327.6	319.3	-1198.7	-327.3	-871.4
Q1	328.7	123.0	205.7	95.5	35.5	60.0	-233.2	-87.5	-145.7
Q2	438.4	142.2	296.2	199.8	119.8	80.0	-238.7	-22.4	-216.3
Q3	488.1	166.7	321.3	157.9	81.4	76.4	-330.2	-85.3	-244.9
Q4	590.3	222.9	367.4	193.7	90.9	102.9	-396.6	-132.1	-264.5
2005	2490.0	996.8	1493.2	865.5	407.2	458.3	-1624.5	-589.6	-1034.9
Q1	454.2	180.7	273.5	170.0	62.1	107.9	-284.3	-118.7	-165.6
Q2	527.3	210.3	317.0	202.7	110.1	92.6	-324.5	-100.2	-224.3
Q3	687.6	287.1	400.5	224.7	97.3	127.4	-462.9	-189.8	-273.1
Q4	820.8	318.7	502.2	268.1	137.7	130.4	-552.8	-180.9	-371.8
2006	2593.2	1010.7	1582.5	705.8	301.3	404.5	-1887.5	-709.4	-1178.0
Q1	682.7	265.7	417.0	221.1	113.2	107.9	-461.6	-152.6	-309.1
Q2	887.2	346.6	540.7	236.0	106.2	129.8	-651.2	-240.3	-410.9
Q3	1023.3	398.5	624.8	248.7	81.9	166.8	-774.6	-316.6	-458.0

Source: Department for Statistics, Ministry of Economic Development

In the accounting period, the foreign trade activity was basically geared to meet domestic demand. The decline in exports to Russia decreased the value of products to the CIS by 15 percent whereas the exports to other countries increased. Whilst the market lost due to Russia's embargo, it was primarily compensated by other CIS countries in the previous quarter with excess imports now being shifted towards other countries.

From the beginning of 2006 to the end of September, the state debt of Georgia grew by USD 14 million and reached USD 1748.6 million. In the accounting period, however, the debt decreased by USD 7.3 million. The country's liabilities to bilateral as well as multilateral creditors decreased whilst a debt taken under guarantee increased insignificantly. New disbursements on the World Bank's investment credits made up USD 11.9 million within various projects. As regards foreign debt payments, they totalled USD 46.6 million which is more than the payments in Q3, 2005m by USD 20 million. USD 40.2 million of this was paid by the government as the principal and USD 6.5 million as interest.

6. EU-GEORGIA ECONOMIC RELATIONS

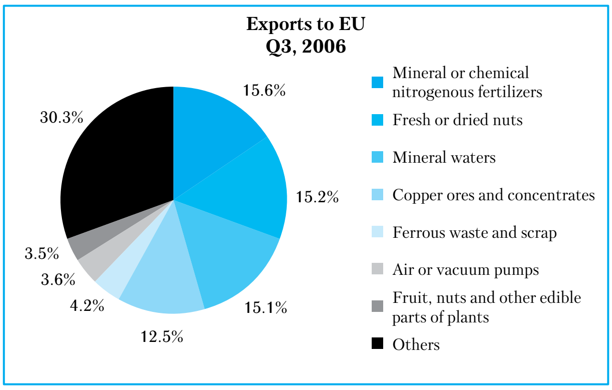
Table 26: Main Indicators of Economic Relations between the EU and Georgia*

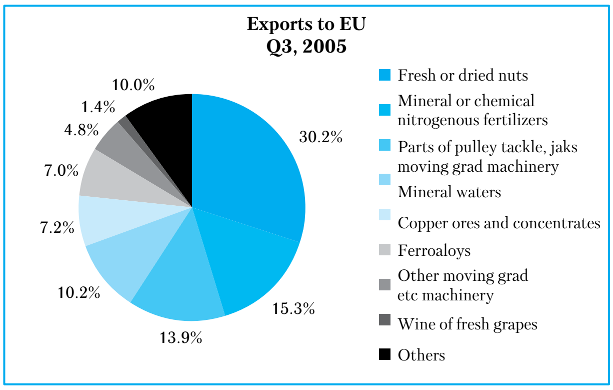
	Trade						FDI by EU Countries	
	Turnover (thousand USD)	Exports (thousand USD)	Share in Total Exports (%)	Imports (thousand USD)	Share in Total Imports (%)	Balance (thousand USD)	Volume (thousand USD)	Share in Total FDI (%)
2000	264559	76389	24	188170	22	-111781	39780	30
2001	302451	61605	19	240846	34	-179241	69812	64
2002	295474	63220	18	232254	29	-169034	58446	35
2003	512750	81590	18	431160	38	-349570	95823	28
2004	728911	111363	17	617548	33	-506185	195622	39
Q1	127845	15414	16	112431	34	-97017		
Q2	199630	31543	16	168087	38	-136544		
Q3	184268	28717	18	155551	32	-126834		
Q4	217168	35689	18	181479	31	-145790		
2005	829410	165271	19	664139	27	-498868	243710	54
Q1	155123	32483	19	122640	27	-90157	38673	43
Q2	168749	23957	12	144792	29	-120835	44246	42
Q3	220999	52208	23	168790	26	-128605	49841	66
Q4	272439	56584	21	215855	26	-159271	110949	62
2006								
Q1	209292	34265	16	175027	26	-140762	36352**	27
Q2	266438	38462	15	227976	25	-189514	106676**	36
Q3	302322	34751	14	267581	26	-232829	88657	31

Source: Department for Statistics, Ministry of Economic Development
*Note: * To avoid possible discrepancy, the data for all the periods include indicators of 25 EU member states*
*** Data verified by the State Department for Statistics*

Following Russia's ban on Georgian imports, the development of trade relations with EU member countries has become of utmost importance. The process of trade diversification mainly affected imports in Q3, 2006 and, consequently, the trade turnover with the EU increased by 36.8 percent compared to the same period last year. The EU share in total trade turnover, however, remained almost unchanged. All the 25 EU member states were engaged in trade with Georgia.

In the accounting period, the exports to EU countries showed a sharp 33 percent drop compared to the corresponding period in 2005. Walnut exports decreased threefold and the export of lifting, grading and other machinery and equipment and their spare parts by seven times. The export of ferroalloy and drilling and extracting equipment, which a year before comprised about four and three million USD respectively, stopped completely.





Source: Department for Statistics, Ministry of Economic Development

The largest commodity category exported to the EU was nitrogen fertilisers which more than doubled compared to the previous quarter although fell by 32 percent compared to the corresponding period in the last year. It should be noted that the demand on fertilisers in the third quarter significantly increased from other non-EU countries as well. As a result, the EU countries accounted only for 40 percent of this commodity exports compared to 88 percent a year ago.

Walnut exports were a bit lower than the fertiliser exports indicator. This commodity category, however, showed a quarterly and also a yearly decrease in exports to the EU, as well as to other countries, which assumedly is connected with a significant drop in the production of walnuts in Georgia. The main consumers of Georgian walnuts were Italy and Germany.

Mineral water with sugar, the demand of which was quite stable, again ranked third in the commodity structure of EU exports. Given a rather sharp decrease in Georgian exports to the EU, the share of mineral waters increased by 5 percent compared to the same period last year.

The demand on ore and copper concentrates from the EU was lower that than from the CIS and other countries. Although the export of this commodity category to EU countries showed an annual 16 percent increase, its share in total exports of this product fell from 40 to 20 percent.

Table 27: Exports from Georgia to EU Countries (thousand USD)

	2005				2006		
	Q 1	Q 2	Q 3	Q 4	Q 1	Q2	Q 3
Total Exports to the EU	32483	23956	52208	56584	34265	38462	34751
Of which:							
Austria	-	244	180	621	1344	6	107
Belgium	705	1248	1815	1307	929	2240	3501
Cyprus	22	81	31	108	40	432	36
Czech Republic	891	185	2099	3457	1204	1239	1019
Denmark	43	-	1	175	556	6	1
Estonia	1040	275	601	865	1026	239	182
Finland	-	-	-	-	1	1	26
France	2417	291	5887	2950	429	2899	4249
Germany	4351	3810	6599	13664	6868	10890	6805
Greece	2477	1921	3711	2302	326	193	1670
Hungary	-	-	24	7	-		0
Ireland	-	5	414	523	6	9	3
Italy	4814	3980	8409	16351	7274	6288	2757
Latvia	201	229	248	1067	347	418	921
Lithuania	119	343	254	256	253	854	367
Luxembourg	-	-	-	29	-	-	-
Malta	1	6	4	1	2	-	-
Netherlands	4549	2533	2566	1737	722	1520	1509
Poland	390	135	166	45	210	133	385
Portugal	188	2	22	-	155	181	345
Slovakia	216	166	892	1625	484	121	84
Slovenia	-	-	3	16	-	-	1
Spain	3786	1742	6621	2089	2662	4934	7020
Sweden	-	8	5	134	-	8	1
UK	6272	6749	11656	7253	9429	5852	3764

Source: Department for Statistics, Ministry of Economic Development

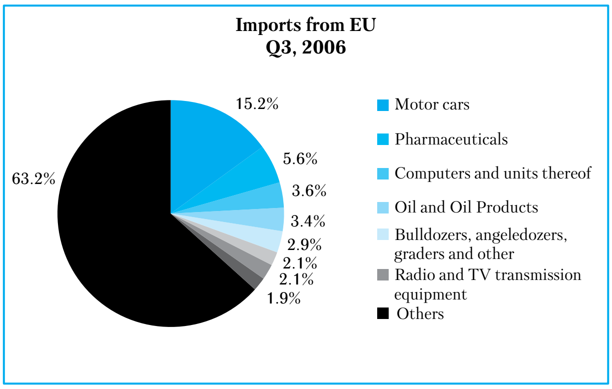
Although exports to Spain were up by a mere 6 percent compared to Q3, 2005, its share in total exports increased with the country becoming Georgia's largest trade partner amongst EU countries. The main commodity categories were copper ore and mineral fertilisers which comprised 78 percent of Georgian exports to Spain. Unlike previous quarters, 1 million USD worth of air pumps were exported to Spain for the first time ever.

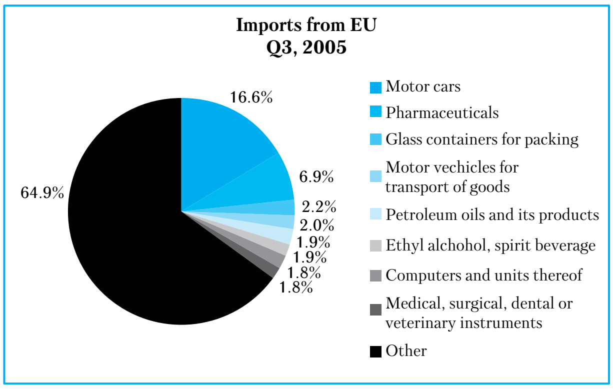
The exports to Germany showed an insignificant increase as compared with the same period in 2005. Germany was the second largest by volume of Georgian exports amongst EU countries. The main commodity to Germany was walnuts although its export sharply decreased.

The main export commodity to France was nitrogen fertilisers which accounted for 79 percent of all the Georgian exports to this country. It is noteworthy that the export of this commodity to France dropped by 17 percent in annual terms.

Georgian exports to the UK dropped three times compared to the same period in the previous year. The export of mineral waters more than halved although the main cause of the drop in exports to the UK was a significant decrease in the demand on spare parts for lifting and drilling and grading machines. It is noteworthy that the consumption of Georgian mineral waters increased in Belgium with this product comprising 80 percent of exports to this country.

The accounting period saw a notable annual and quarterly drop in Georgian exports to Italy and Greece, both of which had been amongst Georgia's larger trade partners. In particular, walnut exports to Italy, compared to Q3, 2005, dropped more than three times and, compared to the previous quarter, by two times.





Source: Department for Statistics, Ministry of Economic Development

The commodity structure of imports from the EU was quite diversified. Consequently, ten main commodities, excluding motorcars, represented only 25 percent of total imports. Motorcars were again in the lead, the import of which was characterised by a stable upward trend. In annual terms, it increased by 45 percent and reached USD 41 million.

Pharmaceuticals imported from the EU were up by 29 percent compared to the corresponding indicator last year. Given a rather sharp increase in imports from the EU, however, the share of this commodity decreased significantly. It is noteworthy that 58 percent of pharmaceuticals imported to Georgia were produced in the EU.

Georgia continued with the construction of new parks and recreational centres in Q3, 2006, and, as a result, the imports of amusement rides, merry-go-rounds and other similar equipment from the EU occupied the third place in the structure of EU imports.

The accounting period also saw a notable quarterly and annual increase in imports of European transmission equipment and computers.

Although total import of oil products went up by 36 percent, European oil imports showed a somewhat modest growth. Its share slightly increased in percentage terms, however, which can be explained by improvements in qualitative indicators of the car park.

Similar to the previous quarter, Q3, 2006 was again marked with a high demand on special construction and industrial equipment.* As a result, the share of this commodity category in total imports from the EU was quite large; that is, two times higher than the corresponding indicator of Q3, 2005.

Table 28: Imports to Georgia from EU Countries (thousand USD)

	2005				2006		
	Q 1	Q 2	Q 3	Q 4	Q 1	Q2	Q3
Total Imports from the EU	122640	144792	168790	215855	175027	227976	267581
Of which:							
Austria	3474	4530	5796	5212	4690	8075	9808
Belgium	4651	6101	6216	8612	8362	9257	8856
Cyprus	572	196	669	297	203	833	592
Czech Republic	1680	4766	6839	7268	6177	5327	18361
Denmark	1192	2770	1417	1685	1221	4396	1836
Estonia	116	102	843	83	161	171	408
Finland	2971	4397	2496	3387	4932	5060	8063
France	11911	14528	17755	35089	15967	17854	20240
Germany	34202	46737	56504	69310	68063	92230	86296
Greece	4856	2582	5346	5809	3820	6551	6616
Hungary	1480	4423	4752	3685	4595	3283	5495
Ireland	493	916	977	1944	1066	1469	1897
Italy	11390	12767	20178	20088	15106	23452	33686
Latvia	1268	1282	2459	1186	1288	1464	1226
Lithuania	1182	882	1337	1613	901	1927	4310
Luxembourg	89	392	184	275	131	53	329
Malta	-	-	-	-	-	0	261
Netherlands	10725	10230	11395	20735	13905	18151	20969
Poland	3193	3609	3288	3567	3480	4242	5622
Portugal	643	1075	673	748	731	581	766
Slovakia	888	391	455	1216	978	855	1256
Slovenia	616	1179	643	1616	1009	1463	1293
Spain	1173	2190	2356	2732	2877	4157	3948
Sweden	4662	990	3275	696	601	1764	8824
UK	19214	17757	12938	19002	14763	15361	16621

Source: Department for Statistics, Ministry of Economic Development

* *According to commodity codes 84-85 of the harmonised commodity classification.*

All the EU member countries, save Latvia and Estonia, contributed to an almost USD 100 million increase (compared to Q3, 2005) in imports from the EU. Germany maintained its leading position by import volume and absolute increase indicator. 37 percent of USD 86 million worth imports from Germany accounted for motorcars. Construction equipment also comprised a high 20 percent share. The composition of other imports, supplied from Germany in comparatively smaller volumes and at lower prices, was quite diverse.

The second largest importer in the reviewed period was Italy, sending to Georgia amusement rides, merry-go-rounds and other similar equipment. The import of approximately USD 4 million worth of technical equipment for producing wine at a new winery, "Badagoni," is also worth mentioning. Compared to the same period last year, the import of footwear and furniture from Italy sharply increased.

The Netherlands and France had almost equal shares in the import structure from the EU. The Netherlands was one of the largest computer suppliers with imports accounting for 35 percent of personal computers and blocks. Motorcars were also supplied to the Georgian market by Dutch exporters. Total imports from the Netherlands increased by 84 percent in annual terms.

Imports from France were more diversified. The leading commodity category was blends for producing beverages. The structure of other imports was the same as in previous quarter and included spirits, alcoholic drinks, pharmaceuticals, motorcars, etc.

Table 29: Direct Investments by EU Countries in Georgia (thousand USD)

Countries	2003	2004	2005				2005	2006		
			Q1	Q2	Q3	Q4		Q1	Q2	Q3
Total	340070	499107	89366	105944	75618	178857	449785	133833	294233	283572
EU	95823	195622	38673	44246	49841	110949	243710	36352**	106676**	88657
Austria	18108	23157	4563	3046	618	6505	14732	3662	1952	2330
Czech Republic	250	277	57	38	620	565	1280	1097	12170	1335
Denmark	0	0	0	0	319	0	319	7133**	3542**	21788
UK	37670	87875	11779	20989	24593	75591	132952	8823	52057**	17098
Germany	4145	5141	945	631	1234	2222	5032	1552	669	2347
Ireland	37	41	9	6	317	262	592	343	79	330
Italy	15896	32480	3858	6469	6770	5742	22838	1933	16926	18306
Cyprus	676	21333	14538	9705	9028	14265	47537	8499	16840	11440
Luxembourg	250	277	57	38	214	244	553	116	73	44
Netherlands	0	0	0	0	275	217	492	732	65	157
Poland	0	0	0	0	164	130	294	246	39	192
Greece	1967	2178	449	299	490	979	2217	522	294	628
France	16709	22863	2418	3025	5040	3901	14383	1301	1906	12633
Sweden	81	0	0	0	160	0	160	152	21	12
Hungary	34	0	0	0	0	327	327	242	43	20
EU share (%)	28	39	43	42	66	62	54	27	36	31

Source: Department for Statistics, Ministry of Economic Development
*** Data is verified by the Department for Statistics*

Foreign Direct Investments from EU member countries in the third quarter was almost twice as much as in the corresponding period last year. Despite a nominal growth, however, the EU share in total investments sharply dropped in both annual and quarterly terms. This can be explained by the fact that the South Caucasus (Shah-Deniz) gas pipeline entered the final phase of its construction. It is noteworthy that a sharp rise was observed in Kazakh investments which exceeded the total FDI from EU countries by USD 9 million.

In the reviewed period, a Danish company took over the management rights of the Georgian shipping company. As a result, Denmark occupied the first position amongst European investors in Georgia. Italy occupied the second place after having invested in the wine-producing factory Badagoni. As mentioned above, the UK's share in total investments decreased because of a decline in British Petroleum's investments but the country maintained its third-place position. France was also amongst Georgia's larger investors. Capital inflows from Cyprus to the Kulevi oil terminal construction continued and the country ranked fifth in terms of investment volumes amongst EU countries. The listed top five countries accounted for 29 percent of all investment inflows to Georgia and 92 percent of inflows from the EU.

Part II. Economic Trends and Policy Analysis

1. GEORGIAN INDUSTRY: SITUATION AND PROSPECTS FOR DEVELOPMENT

Christophe Cordonnier, Professor of Economics, GEPLAC Economic Expert;
Rostom Gamisonia, PhD of Economics, GEPLAC Economic Expert

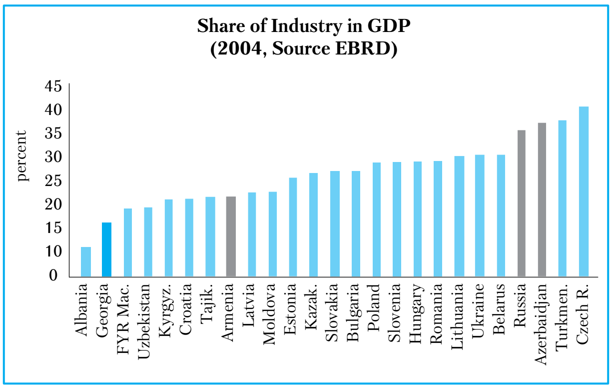
Introduction

The conception of this article was first based on the desire to investigate the apparent contradiction between the high reported rate of growth of Georgian industry and the still low figures of investment in productive assets. To this end, the GEPLAC team conducted a survey. Both the survey and the general analysis show that Georgian industry, long considered moribund or without real importance for the development of Georgia, can play a very positive role in what should be more than a "hotels and restaurants" economy. Without a rebirth of industry, Georgia will have difficulties to keep its most skilled citizens at home. In addition, as international experience shows, there is absolutely no contradiction between a high-tech service economy and a high-tech industrial economy.

The article suggests some policy measures to help industry enter into a new cycle of growth which will be less dependent on factors such as the still low utilisation rate of productive capacities inherited from FSU. It focuses, in particular, on the necessity for the banking sector – largely linked to IFIs (EBRD, IFC) – to concentrate more on the financing of production and less on that of consumption. It also includes recommendations for a better linking of Georgia with the global industrial economy including, inter alia, the launching of new industrial zones.

Is it Relevant to Concentrate Much Attention Today on the Industrial Development of Georgia?

To a large extent, it may appear useless to concentrate much attention on the prospects for development of industry in Georgia. As a matter of fact, Georgia is, apart from Albania, the transition country where industry plays the lowest economic role. In 2004, it accounted for only 13.2 percent of output and 4.7 percent of employment.



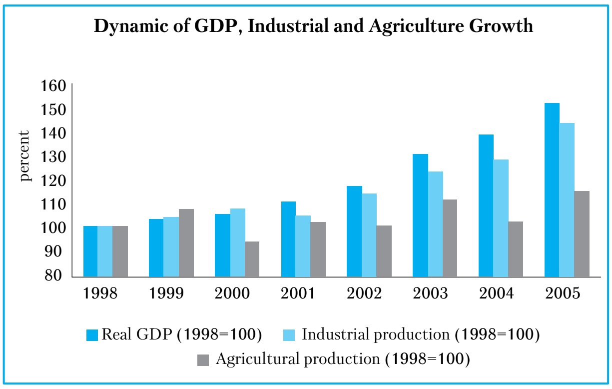
Source: EBRD

This situation is only partly explained by the relatively big role of agriculture which still employs most of the workforce and contributed, in 2004, to 16 percent of the GDP. It mainly reflects the fact that Georgia is first of all a "service economy" similar to a certain extent to small transit countries with tourist potential. This is the case, for instance, of Croatia (where industry and agriculture account for only 26 percent of the GDP against 29 percent in Georgia), Latvia (26 percent) or Estonia (28 percent). In 2005, for instance, value added in transport and communications in Georgia was 47 percent higher than in manufacturing and 32 percent higher in hotels and restaurants.

That being said, the dynamism of Georgian industry has been quite good in recent years despite the lack of any specific industrial policy implemented by the State. This suggests it may have comparative advantages. This upsurge has been particularly impressive since the Rose Revolution with growth figures in 2005 as high as 94 percent for machinery and equipment, 88 percent for electrical machinery or 35 percent for food, beverages and tobacco.

We shall obviously remain cautious in the use of official statistics as this impressive growth largely reflects the inclusion into the formal economy of activities previously conducted in the grey economy. Interviews conducted by the GEPLAC team among 34 companies accounting for 11 percent of total manufacturing output in 2005, however, also show a positive mood amongst most industrial leaders despite the fact that they were conducted at a time when tensions with Russia – Georgian's largest client for manufactured goods – were quite a strong motive of preoccupation for many companies.

In the same interviews, nearly all our interlocutors testified to the positive evolution they experienced in their day-to-day life in terms of the business environment. In this respect, our empirical study confirms that of the World Bank, which has recently upgraded Georgia from 112 to 37 rank in terms of ease of doing business, making it the best transformer between 2005 and 2006 [1]. The results of our survey also show, however, that this factor is not considered decisive in the willingness to invest of Georgian-based firms either because there is still much work to be done in this field or because its impact is overestimated by analysts.



Source: IMF

Why Should Georgia Have an Industrial Development Strategy?

In most cases, the same industrial managers who were quite positive, vis-à-vis the achievements of the Rose Revolution for their businesses, complained that they felt left alone by the State because they considered it has no industrial strategy.

There is some ambiguity in this concept of industrial strategy, both amongst the potential beneficiaries and the policy makers. For many, industrial strategy or policy means special privileges such as subsidies, tax exemptions or specific tariff protection. This is legitimately anathema for the new administration as most of its action and successes have been associated with the elimination of such privileges and a process of simplification of administrative procedure. In this respect, there should obviously be no turn back.

Most developed countries, however, have some kind of industrial policy of their own: in the US, for instance, the Federal government plays a large role for the promotion of local high-tech industry as it spends 150 bn USD per year in the procurement of military equipment and research. In Eastern Asia, co-ordination between the State and industry has historically been very close with an aim to strengthen the technological content of industry first by catching-up with more developed countries and then by developing specific know-how. Following the example of Japan and Korea, China has, for instance, become an impressive technological hub with expenses of R and D, mainly financed by the State, reaching 102 bn EUR in 2006, a figure which is higher than that of Japan (97 bn EUR) and second only to those of the USA (248 bn EUR) [2].

In all these countries, the role of the State is a well-designed combination of support to the development of positive externalities (investment in education, fundamental research and technological infrastructures) and of specifically targeted support on technological sectors considered vital. In the EU, for instance, this has been the case for aerospace technology with Airbus and Arianespace becoming leading firms on the global stage in less than three decades as a result of appropriate public-private partnership.

Being a rather small and poor country, Georgia cannot – and obviously should not – dream of playing a leading role in global technology. We further believe, however, that it cannot consider its future only as a provider of low-tech services whilst writing off all of its industrial potential because of the sheer neglect of a pole of activity cared for by most of its competitors on the global stage. In fact, we have to consider that, in the current World, the very idea of a "service economy" makes no sense if it does not integrate an industrial component into the minds of its promoters. In the economy of today, we know, the traditional opposition between a primary sector (agriculture), a secondary sector (industry) and a third sector (services) is conceptually irrelevant.

In the Soviet economy, there was a clear opposition between the three aforementioned sectors. The growth of industry had to be made at the "expense" of agriculture which had to provide it with an accumulation of physical and human capital. In today's Georgia, as well as in most countries of the World, this approach – which may have been effective at that time – has become totally irrelevant. There is absolutely no reason to oppose the development of industry to that of other activities such as, in particular, services because industry does not currently compete with other sectors but is intertwined with them.

As Georgia is still faced with large underemployment, there is no competition on the labour side between industry and other sectors of the economy. This situation is obviously particularly acute in the country as only 20 percent of the persons of working age are employed in the formal economy. At the same time, Georgia is not an exception. Today, there are extremely few States which can be considered to have reached the level of full employment as defined, for instance, in Keynesian literature. Either they have a high structural share of their population officially unemployed, as it is the case in many continental EU states, or they have a combination of real employment and masked underemployment with big differences of output per worker between highly productive poles of activity and the rest. In China, for instance, industry geared towards the international market has much stronger output per employee than farming in central regions with salaries differing by a huge margin. By controlling administratively the exodus of farmers to the cities, authorities are able to fine-tune the level of employment in the modern pole to avoid any excessive increase in its remunerations. In the US and in countries like the UK, this fine-tuning is made by the so-called labour flexibility which paradoxically does not lead to a unified labour market but to a bipolarised labour market combining a market for very well-paid insiders in the highly productive activities and for poorly-paid outsiders in the rest of the economy [3]. The efficiency of these Anglo-Saxons systems is linked nearly exclusively to their capacity to make their high poles of activities globally competitive.

Another major difference with the situation which prevailed in FSU, but also in Western economies prior to the financial revolution of the 1980s, is that there is no competition between industry, agriculture and services for capital inputs. As Georgia is an open economy, it can receive large flows from abroad to finance its development provided that opportunities of investment exist and offer good yields and limited risks to investors.

Finally, one should add that there is no environmental crowding-out effect of industry vis-à-vis tourism, for instance. It is certain that Rustavi, with its industrial legacy of FSU is not the best place for spending holidays, but most modern industries have no negative impact on their environment.

Not only there is no contradiction between industry and services in Georgia, but there are real complementarities as a sound development of industry is a key ingredient of any long term sustainable national development strategy.

As we have seen in the global economic pattern, the key feature is the competitiveness of the high poles of activity whether they are in the production of goods or services. Further, the main factor of competitiveness is the capacity of these "knowledge economies" to train, attract and keep high-tech people. In a World with an over-amount of capital and a low-skilled workforce, the only really scarce productive item is the availability in significant amounts of these high-tech people. Industry plays a leading pulling role in this field as it usually captures most expenses in R and D and generates a strong demand for high-tech services, in particular in Information Technology (IT).

If Georgia remains devoid of this pull factor and keeps being a "hotels and restaurants," economy, then why should young Georgians bother to follow difficult and costly studies in the country or abroad? Moreover, why should they stay at home as they will have no opportunity to make use of their talents?

There is no doubt that this qualitative factor of development has been insufficiently taken into account by policy makers in Georgia since the beginning of the new transition. We believe, however, that it is a key feature which should be high on the agenda of the State because it is linked to the future of the nation as such. The human cost of the exodus of many of its brightest elements for Georgia has already been too high [4] and one of the priority tasks of the State should be to help attract skilled people back to the country and provide attractive perspectives for those currently being trained.

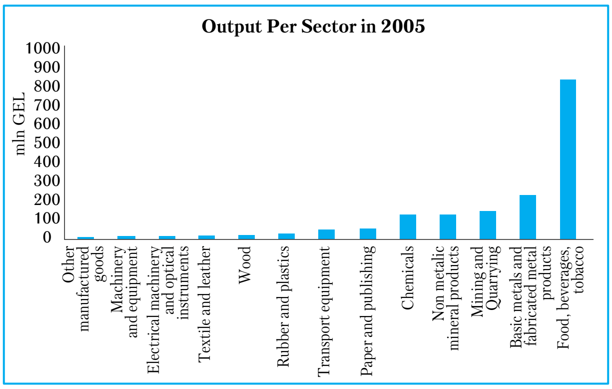
What is positive in this field is that Georgia has real comparative advantages for the new global pattern of industry. In terms of network, it may take advantage of its excellent geographical situation between Europe and Central Asia, the latter of which is currently the fastest growing region in the World. Its local industry may in particular benefit directly from the current wave of investment in transport infrastructures (roads, ports, airports, railways), not only in Georgia itself but also in neighbouring countries (TRACECA).

In addition, Georgia could potentially become attractive for foreign direct investors as it combines an exceptional natural and historical endowment (the Toulouse or California factor) with a potential capacity to train a large pool of skilled workforce and to lure back Georgians having emigrated abroad and nostalgic of their homeland. As in China, Georgia could also make use of its very large availability of low-skilled and low-paid workers.

It is certain that for these potential comparative advantages to become effective ones, some preliminary steps must be done. Despite the strong recent improvement in the business environment, there is still much room for improvement such as, for instance, in the efficiency of customs and in the neutrality of the tax police. A decisive improvement in the relations with Russia is also a requirement for many potential investors. In addition to these general elements, Georgia will most probably have to launch some innovative measures to attract an initial mass of foreign investors which then subsequently may make the development process lead by its own dynamic. What, then, can be done in this respect taking into account the current situation of Georgian industry?

What is the Situation of Georgian Industry Today?

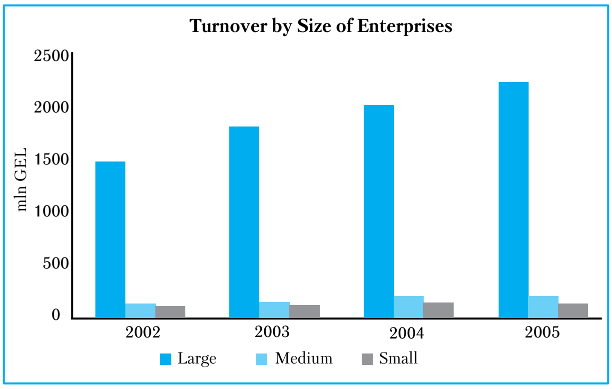
Georgian industry is still largely dominated by food processing and former Soviet heavy industry in terms of employment and output. According to national statistics, out of 83000 persons employed in industry in Georgia in 2006 (first quarter), 9 percent were working in mining an quarrying, 29 percent in supply of electricity, gas and water and 62 percent in manufacturing with 26 percent in the food, beverages and tobacco industry. In output, this sector had an even higher share of 38 percent followed by basic metals with 10 percent.



Source: Department for Statistics, Ministry of Economic Development

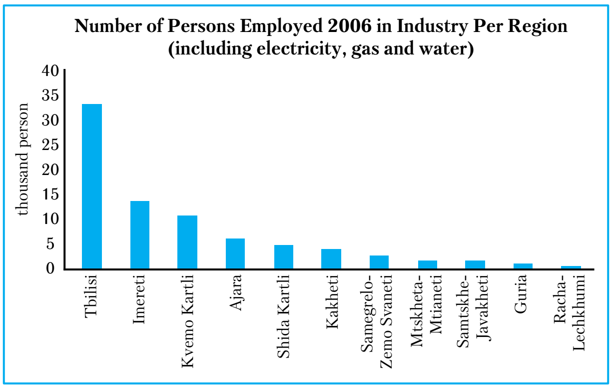
One striking feature of Georgian industry is the extremely high share of large enterprises in total output. It is true that official statistics tend to underestimate the relative share of SMEs as it is easier to hide their activity in the grey economy than that of big firms. In any case, the real picture is probably not very different from that given by figures. Contrary to many countries in transition, Georgia has not yet developed a large pool of industrial SMEs which play a very important role as subcontractors in advanced economies.

It is also somewhat puzzling to see that, at this stage, large firms have benefited more from the recent economic evolution than small enterprises: between 2002 and 2005, their share in total industrial turnover increased from 85.9 percent to 86.9 percent. In 2006, they account for 68.8 percent of total industrial employment against 17.4 percent and 13.9 percent for medium and small enterprises. In 2002, the figures were respectively 64.3 percent, 18.8 percent and 16.9 percent. One should have expected exactly the contrary because SMEs are generally the main beneficiaries from any improvement in the business environment not to mention the fact that the recent tax and social security reforms should have pushed them to switch more into the formal economy.



Source: Department for Statistics, Ministry of Economic Development

This still post-Soviet dimension of Georgian industry is also quite present in its geographical pattern. In 2005 Tbilisi, Kutaisi and Rustavi, homes of traditional Soviet industry, accounted for 65 percent of output and 72 percent of total employment. The share of regions perfectly positioned in the East-West dimension of the new Georgian economic strategy is often negligible. This is in particular the case of Guria and Samegrelo where the key TRACECA port of Poti is located.



Source: Department for Statistics, Ministry of Economic Development

Another very peculiar feature is the extremely high interregional differences for wages. In the first quarter of 2006, wages were nearly twice higher in Tbilisi than in Imereti with a tendency of Western regions to have the lowest wages despite the fact that they have probably the highest potential comparative advantages because of their proximity with the EU and Turkey.

Table 1: Monthly Wages, Q1 2006

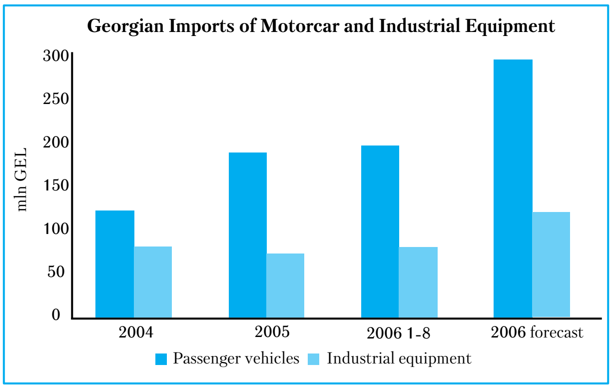
Georgia	278
Tbilisi	330
Mtskheta-Mtianeti	382
Samtskhe-Javakheti	372
Kvemo Kartli	318
Ajara	279
Racha-Lechkhumi	263
Kakheti	203
Samegrelo-Zemo Svaneti	178
Shida Kartli	173
Imereti	173
Guria	136

Source: Department for Statistics, Ministry of Economic Development

This still post-Soviet dimension of Georgian industry is also related to the rather high share of State-owned companies in total employment. Despite the acceleration in the privatisation process which followed the Rose Revolution, State-owned companies still employed 30 percent of the labour force in industry at the beginning of 2006. Compared to best performers in transition countries, the role of foreigners remains secondary for employment (14 percent) but it is already substantial in terms of output with a relative contribution of 30 percent against 20 percent for SOEs and 50 percent for private companies owned by residents.

One key handicap faced by Georgia in its integration in the global economy is the way its industrial firms have been privatised in the 1990s. Allegedly for fear of transferring assets to the organised bandits who blossomed during the civil wars of early 1990s, the State chose to sell many companies to their former red directors. In nearly all cases, they proved totally unable to adapt to new market conditions and they led their firms to a progressive collapse. As of now, these red directors still control some valuable assets such as good industrial buildings and some equipment. Most of this equipment, however, has often been sold for scrap metal (scrap has been the first export item of Georgia for years).

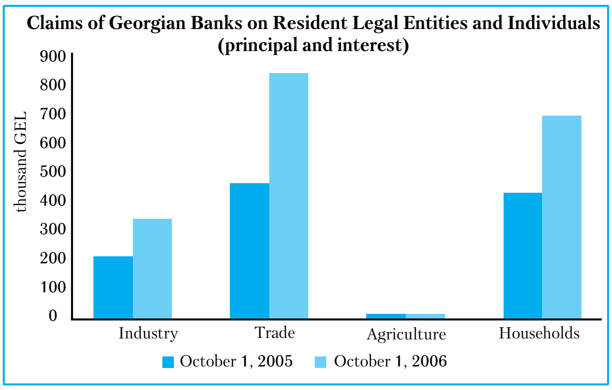
The fact that there are still many "frozen" assets badly managed by former red directors has been a blocking factor in the past but could well provide good news in the future. When visiting many companies in different sectors, we arrived easily at the conclusion that the most profitable of them were those which could make an intelligent use of former Soviet assets combined with the modern standards of Western industry. A leading producer of chicken, for instance, bought out former Soviet farms for low prices and invested a relatively small amount of money in upgrading them whilst concentrating most of its investment in the building of a new slaughterhouse with new Western equipment. The same story was repeated many times in the Georgian wine industry and even in metal working.



Source: Customs Service, Ministry of Finance

As this first stage of rebound of Georgian industry, good managers are able to mobilise this unused capacity by investing only at the margin. This explains largely why Georgia has achieved high rates of industrial growth despite low levels of imports of industrial equipment which can be considered an accurate proxy of current investment in medium and long term assets in industry as most new equipment is imported from abroad. In 2005, these imports of industrial equipment represented only 1 percent of the GDP (1.5 percent of the GDP forecast in 2006), a figure impressively lower than total Gross Fixed Capital Formation which was 26.3 percent of the GDP in 2005.

But negative factors play their role, too. If the imports of capital goods for industry are so low, it is also because of a lack of support to productive activities from banks. In this respect, one must unfortunately question the impact of their extremely quick growth on the Georgian economy as more and more of their credits are granted to traders and households with this credit boom translating directly into imports – in particular, of motorcars – with dubious positive effects on Georgian growth and obvious negative effects on the excessively high current account deficit of the country. For economists with experience of emerging countries, this consumer boom driven by a banking spree is somewhat reminiscent of the pre-crisis situations of some Latin American or South-East countries in the 1990s.



Source: NBG

What Could be Done to Foster the Development of Georgian Industry?

The first area of recommendations to make in order to consolidate the current growth of industry is to finalise the transition process by privatising the industrial assets still under State control and by fostering the restructuring of companies which have been acquired by their "red directors" and their employees in the 1990s. These companies lack financial resource but, even more, also management skills to perform efficiently. One practical solution to infuse these skills could be to launch a State-sponsored programme of recruitment in industry of young skilled specialists in management and business administration. This programme, similar to a certain extent to the one successfully implemented for apprentices (all the persons interviewed confirmed they were positive vis-à-vis this recent Government initiative), would help wake-up some of these companies from their current lethargy.

Bankruptcy procedures must be used each time these companies are unable to pay their debts. Meanwhile, there is a need to develop market information on sale/acquisition of industrial firms and of their assets (buildings and equipment). This information could, for instance, be put on the website of the National Agency for the Promotion of Investment and Exports and on that of the Georgian Chamber of Commerce and the Georgian Federation of Businesses.

In advanced countries, banks and financial markets play this role of brokers-dealers for the optimal restructuring of industry. Georgia, however, lacks any form of financial markets and its banks – including, unfortunately, those where IFIs have a substantial stake – prefer to concentrate on credits to households or small traders rather than on productive activities. One simple idea, for instance, to foster the reallocation of credit to legal entities of the productive sector would be to submit all bank interests to VAT payment. This approach was chosen, in particular, by Brazil after the Mexican crisis of 1995 at a time when its financial institutions were becoming too much addicted to consumer credits. In such a scheme, interest rates for individuals would increase by 20 percent but legal entities paying VAT would benefit from this measure as they deduct VAT paid to their suppliers from their VAT bill. Such a measure would also help the development on a large scale of leasing, currently hampered by a negative tax regime as the interests included in the rent paid by the lessee are fully submitted to VAT.

In the longer run, the State should play an active role to help develop the local financial market. As we stated in a recent article [5], the best way to do that would be to develop a new pension scheme based on capitalisation and which could be managed by the private sector under a strict regulatory framework. Part of the assets of the privately managed pension funds would be available for investment in equity in local firms. This would kick start the development of a new business and management culture targeted not to the ownership of assets but to the maximisation of their income.

The second area of recommendations of policy advice would be to better link Georgian industry with the global markets. In this sphere, we would suggest specific measures such as State and or donors co-financing for international certification (ISO) of Georgian enterprises and products. This would greatly help Georgian companies take full advantage of WTO and GSP Plus with the EU and Turkey knowing that today this cost is too high for many of them because certification agencies have no presence in Georgia. As such support would mechanically increase the number of Georgian companies able and willing to enter into the certification process, it may eventually lead these companies to set up their offices in Georgia instead of sending their teams from Russia or Ukraine.

Finally, we believe that there is still ample margin for fostering the interest of foreign direct investors for Georgia. As it is still a country poorly known by them, with the obvious exception of businessmen from Russia and other former Soviet Republics, there is a need to develop a critical mass of investors who will then after multiply naturally as FDI is always associated with non linear herd effect. This means concretely that Georgia should accept the idea of providing them initially some financial incentives which would be subject, obviously, to their capacity of bringing to the country recognised technological and managerial know-how. To a certain extent, the subsidies provided by Millennium to local and foreign investors may play this role. We also believe, however, that Georgia could be more imaginative in this field by, for instance, implementing the conversion of public debt (Paris Club) into equity for the privatisation of industrial assets or for the development of strategic projects.

One such strategic project could be the launching and promotion of a special economic zone patterned on the model of the Mexican maquiladoras or the Chinese Special Industrial Zones which played in both cases a pioneer role to bring in foreign investors attracted first by cheap labour for the relocation of part of their own industrial process.* The region of Poti, plagued with high unemployment and low income and perfectly located on the Traceca, could be ideal for such a project. Provided the project would be well prepared with a preliminary analysis based on comparative studies, the risks of fraud would remain limited. Further, if it were well marketed with a partnership with IFIs which could reallocate part of their financial support (on-lending for instance) to the productive economy, it could bring in many foreign investors targeting the nearby European market as Georgian salaries are currently comparable to those of China and much lower than the ones of EEC countries, such as Hungary, that benefited from a first wave of relocation of EU industry in the mid-1990s. [6]

Source: European Foundation for the Improvement of Living and Working Conditions

That being said, such a special economic zone would be designed mostly for its short to medium term effects as Georgia today urgently needs to mop up its excess low-skilled labour at a time when it must restructure its inefficient agriculture and when migration abroad, to Russia and elsewhere, is strictly constrained. In the long run, however, because of the high level of education and culture of its population, it has no vocation to remain a screw-driver economy.

For this reason, we would recommend in parallel the active promotion of Georgia as a relocation country for high tech industries. Various measures could be adopted in this field. First, Georgia should aggressively make use of the European Programmes of Research (PCRD) from which it can now benefit within the ENP. This would help reactivate many of its teams in scientific institutes but, also as we discovered with pleasure during our investigation, in surviving micro high-tech firms. We believe that, as it was the case during the Soviet period, Georgian scientists could develop many marketable innovations as they often combine two rare qualities: high technological education and creativity.

Another measure would be, as we recommend for the certification of firms, to co-finance the registration of patents abroad for Georgian inventions and innovations.

Finally, Georgia could launch its technological hub with the help of donors and IFIs and or make use of debt conversion techniques. An obvious location for such a pilot high-tech industrial park would be within the existing area of the Tbilaviashemi aircraft plant which provides currently one-third of Georgian exports and nearly all its high-tech exports and which still has large available space to create a cluster of high-tech firms. In the long run, it would help Tbilisi to regain a leading regional role for high-tech production knowing that the city combines many advantages which would make it quite attractive for high skilled Georgians as well as for foreigners. A specific programme to launch a high-tech industrial park could be prepared with the EU with an idea to efficiently combine the various instruments of the ENP.

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* *At the time of finishing this article, President Saakashvili has hinted at the same idea of launching a pilot industrial zone in Poti. We can only welcome this proposal.*

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2. SECURITY OF THE TRANSIT CORRIDOR IN GEORGIA: GEO-ECONOMIC ASPECTS

Zurab Garakanidze, PhD of Economics

Introduction

Georgia is a hub of the East-West transit corridor. The promotion of the corridor means the development of not only a new transport infrastructure connecting Europe and Asia within the EU-supported TRACECA project, but a number of energy projects aimed at diversifying energy supply to Europe. The use of Caspian energy resources, which represent an alternative to Russian gas and oil for Europe, may ensure the regional security of the Central Caucasus [1]. For its part, Russia seeks to extend the corridor to the north by reopening the Abkhaz section of the Trans-Caucasus railway but, given political problems, the prospects of this endeavour appear too bleak. This paper examines the challenges and threats related to the operation of the transit corridor and pipelines.

Parameters of the Transit Corridor

Following the experts' assessment, an annual cargo turnover between Europe and Asia comprises USD 700 billion [2] with China accounting for over half of this volume. According to estimates, this indicator will reach a trillion USD by 2010. Up to recent times, a main part of Asian cargo bound for Europe was transported via Russia. The Caucasus transit route, however, has become a strong alternative to the Russian one. China, as well as the Central Asian countries, has a real opportunity to reach Europe not only through Russia but through the Caucasus, too. The cargo transferred via the TRACECA corridor in 2005 made up 46 million tons [2] including 3.2 million tons of Kazakh oil. In six months of 2006, the TRACECA corridor carried 24.2 million tons of cargo including a million tons of Kazakh oil [2].

The commissioning of the Baku-Tbilisi-Ceyhan oil pipeline [BTC] significantly weakened the importance of the Russian transit route. Later on, the Baku-Tbilisi-Erzerum pipeline, completed at the end of 2006, was put into operation. Meanwhile, the demand increased on the so-called dry cargo and container transfer. It is advantageous for Turkey that these cargoes are shipped by rail from Azerbaijan via Georgia. According to experts' estimates, an annual cargo turnover within TRACECA will go up by 20 million tons after the Kars-Akhalkalaki-Tbilisi-Baku railway is put into operation. The former President of Turkey, Suleiman Demirel, refered to the high efficiency of this project when he said several years ago that "…in any case, the Kars-Akhalkalaki-Tbilisi-Baku project will be implemented" [3].

It should be noted that apart from Russia, some other forces in the region are against the operation of the Kars-Akhalkalaki-Tbilisi-Baku rail route. It must be the lobbying of these forces that influenced the US Congress's decision to prohibit the US Eximbank to co-finance the project [4]. Nevertheless, Georgia, Azerbaijan and Turkey decided to proceed with the project themselves but the parties do not rule out that some interested countries, namely China and Kazakhstan, may get involved in the implementation of the project at a later stage. The issue of funding of the project was decided in January 2007 with the design of the 104 km-long Kars-Akhalkalaki section being drawn up. The Georgian Ministry of Economic Development estimates the cost of this section at 422 million USD. A logical extension of this railway would be a further development of the Poti-Baku-Aktau-Almaty container route, launched in 2005, in which China became involved following a meeting of Georgian, Azeri, Kazakh, Chinese and Turkish government delegations in Astana (June 2006). This maght indicate that it is also in China's interest to bypass the Russian route.

Given such a great interest towards the TRACECA, it is natural that the following question emerges: who will benefit from the resumption of the Abkhaz section of the Trans-Caucasus railway; that is, the "North-South" route until the time that Georgia regains its territorial integrity? In addition to the separatist regime, it will benefit Russia, first and foremost, which will gain access to the main transport routes of its strategic partners, Armenia and Iran. Moreover, Russia will be re-connected to the Georgian railway and, given annual quotas imposed on oil shipments by tankers through the Bosporus-Dardanelle Strait (ecological restraints), this will allow Russia to supply excess oil products to Europe by road via Georgia. It is also in the interest of Russia and Armenia to resume the Baku-Tbilisi-Giumri-Kars route, instead of Baku-Tbilisi-Akhalkali-Kars, and to be linked from Giumri not only to Turkey but also to Iran [5].

The resumption of the Baku-Tbilisi-Akhalkali-Kars route was put on the agenda after Russia's closure of roads between Georgia and the North Caucasus resulted in the decrease in shipments along the North-South route which, first and foremost, adversely affected Armenia's economy. Because of unresolved tense relations with Azerbaijan, Armenia has, in fact, dropped out of Caucasian integration processes; that is to say, it is left beyond the corridor [6].

Geo-economic Challenges

Although shipments within TRACECA show an upward dynamics (see Table 1), Georgia's transport potential is still not fully used. Whilst in 1990 Georgia's rail cargo transportation was 50 million tons, in 2005 it comprised only 18.9 million where the redirecting of oil products towards Batumi prevailed.

Table 1: Dynamics of the Main Transport Indicators in Georgia

Transportation		Unit	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
	Freight	mln t	14.1	19.7	24.1	25.9	30.1	33.2	37.4	40.8	41.1	45.8
	Cargo Turnover	mln t/km	7484.7	56047.1	10474.6	9091.7	5027.8	5101.6	5795.4	6143.4	5548.2	6853.3
	Passenger Transfer	mln pass.	144.3	178.1	207.5	228.1	237.4	242.2	251.2	259.4	263.2	267.0
	Passenger Turnover	mln psg/km	2956.6	4141.9	4777.9	5011.0	5190.7	5405.7	5617.9	5945.8	6297.3	6468.0
	Cargo Handling	mln t	3.0	5.3	7.1	11.4	15.4	17.6	19.7	21.5	20.6	24.0
Of which:												
Railway	Freight	mln t	4.8	7.2	8.5	9.5	11.5	13.2	14.9	16.3	15.4	18.9
	Cargo Turnover	mln t/km	1141.4	2006.2	2573.7	3160.4	3912.1	4480.6	5074.5	5447.8	4855.8	6145.6
	Passenger Transfer	mln pass.	3.0	1.9	2.3	1.9	2.3	2.1	2.1	2.2	3.0	3.6
	Passenger Turnover	mln psg/km	380.3	293.7	396.9	355.1	452.9	400.9	400.6	395.5	614.0	713.1
Road	Freight	mln t	8.8	12.2	15.0	16.0	18.5	20.0	22.5	24.5	25.7	26.9
	Cargo Turnover	mln t/km	131.3	303.5	385.0	420.0	475.0	520.0	543.0	562.0	570.0	578.0
	Passenger Transfer	mln pass.	141.0	176.0	205.0	226.0	235.0	240.0	249.0	257.0	260.0	263.1
	Passenger Turnover	mln psg/km	2049.9	3400.0	3910.0	4310.0	4500.0	4764.3	4920.0	5150.0	5200.0	5252.0
Air	Freight	mln t	0.003	0.003	0.004	0.002	0.0013	0.0012	0.0013	0.0014	0.0016	0.0016
	Cargo Turnover	mln t/km	80.0	66.0	94.0	51.0	29.0	27.0	29.6	42.1	49.3	50.0
	Passenger Transfer	mln pass.	0.3	0.2	0.2	0.17	0.12	0.11	0.137	0.187	0.23	0.26
	Passenger Turnover	mln psg/km	526.2	447.0	471.0	345.9	237.8	240.5	297.3	400.3	483.3	502.9
Sea	Freight	mln t	0.6	0.3	0.6	0.4	0.06	0.03	0.35	0.02	0.03	0.03
Shipping	Cargo Turnover	mln t/km	6132.0	3671.4	7421.9	5460.3	611.7	74.0	80.5	91.5	73.1	79.7
	Passenger Transfer	mln pass.	0.002	0.01	-	-	-	-	-	-	-	-
	Passenger Turnover	mln psg/km	0.2	1.2	-	-	-	-	-	-	-	-
Cargo Handling	Poti Port	mln t	1.7	2.3	2.5	2.3	3.6	3.4	4.0	4.9	6.1	6.1
	Batumi port	mln t	1.3	3.0	4.6	5.9	6.9	8.4	9.5	10.4	8.2	11.0
	Supsa port	mln t	-	-	-	3.2	4.9	5.8	6.2	6.2	6.3	7.0

Source: Department of Transport, Ministry of Economic Development

Since the commissioning of the corridor, Georgia's budget revenues from transit have kept increasing on average by 10 million USD annually. Over the past years (since 1999), oil transit revenues have made up 20 million USD in total (including revenues from Baku-Supsa oil pipeline which became fully operational in 2002). The BTC oil pipeline was launched in 2006 and is expected to bring 50 million USD to the budget by 2010. On top of that there are fiscal revenues from imports for the construction of the oil infrastructure as well as revenues from rail, road, sea and air transportation. The value of free gas to Georgia in return for the transportation through Baku-Tbilisi-Erzerum [BTE]; that is, the South pipeline, will increase from 10 million USD in 2007 to 44 million USD in 2012. For the purpose of comparison, the budget of Ukraine receives 2.3 billion USD for the transit of oil products by East-West pipeline [7].

Given the above data, there emerges another question of whether or not the Kars-Akhalkalaki-Tbilisi-Baku railway will turn Georgian ports into blind alleys (in terms of competition) if Eurasian cargoes are redirected towards Turkish ports. It should be noted, however, that such a threat exists. Most of Georgia's rail and road transit cargoes are currently loaded in Armenia and Azerbaijan with the volume of freight from Central Asia, consequently, decreasing. Freight potentially lost by TRACECA amounts, as experts estimate, to 15 million tons annually [8]. Because of the high "handling" costs in Georgian seaports, the profits of Turkey's Black Sea ports, which are being actively reconstructed, may increase in proportion to losses by two Georgian ports. After the commissioning of the Kars-Akhalkalaki-Tbilisi-

Baku railway, the only Georgian road connecting Central Asia with Europe will be complemented with a TRACECA alternative route towards Turkish ports via Kars.

Although Europe regards TRACECA as a priority transit route towards the Caspian Sea, there are two other corridors through Russia and Iran-Turkey which are being developed under the UN SPECA project. Transport lines running to Iran and Turkish ports via Russia and Kazakhstan are constantly upgraded. These ports apply a more flexible tariff policy than Georgian ports. Because of the competitiveness of Georgian ports in oil exports by tankers towards the Black Sea, for example, the Russian Ministry of Transport decreased the transportation tariff along the Crimea-Caspian line by 20 percent since 1 July 2006 [9]. If not for conflict between the USA and Iran and other political issues, therefore, these routes may have harshly competed with Georgian ports.

On the one hand, Georgian ports transport mainly Azeri, Kazakh and Turkmen oil products with the amounts from Turkmenistan being rather insignificant. Since September 2006, Azeri oil (Azeri light) has also been carried from the Azeri-Chirag-Guneshli oilfield through BTC. Only Exxon-Mobile continues with its oil shipments (2.5 million tons) from Batumi which means that the transportation of Azeri oil via Batumi is reducing by half because the so-called "large oil volumes" are still coming from the above-mentioned oilfield in Azerbaijan. According to the BP survey "World Energy Statistics Review. June, 2006," the confirmed Azeri oil reserves make up 7 billion barrels which is enough to be exported over a period of 42 years [10]. Currently, Georgia seeks to expand its transit capacity. To this end, the company Channel Energy is constructing a new oil terminal in Kulevi with a capacity of 12-15 million tons.

On the other hand, there are some problems in the transportation of Kazakh oil. Since 1996, Kazakhstan exports its oil through the Aktau-Baku-Batumi route. The initial oil volumes did not exceed 2 million tons. In 2001, however, it comprised 3.8 million tons. Most of this oil was extracted mainly from the Kumokol oilfield in Kazakhstan, shares of which were purchased by the Chinese state oil company (CNPC) in late 2005. A Kazakh-Chinese oil pipeline was launched in May 2006 and it is assumed that all the Kumokol oil will be required to fill it up.

The competition is growing strong for Caspian oil and gas transit flows. Iran has reconstructed the Caspian Sea-Necka pipeline. Moreover, Iran is establishing close ties with Kazakh and Turkmen oil companies and entering into so-called Swap contracts* with them. Russia has stepped up its activity, too, by extending the Makhachkala oil terminal which is the point for redirecting oil purchased from Asia. A dim outline of Turkish-Armenian co-operation is also looming. In 2006, the Turkish and Armenian media outlets repeatedly released information about the two countries' diplomatic activity regarding border issues. Three secret meetings were held on the reopening of the closed border section of the Kars-Giumri-Tbilisi-Baku railway. The most recent closed summit was held in Vienna in May 2006 [11]. It is interesting, too, that at a recent CIS summit in Minsk in 2006, the presidents of Belarus, Azerbaijan and Ukraine agreed to set up a working group on the establishment of a "Consortium of oil and gas exporters, importers and transmitters" from the Caspian Sea coast to European markets. This envisages the participation of Azeri companies and Belarusian oil processing companies in the Eurasian oil transportation corridor through the Odessa-Brody-Polotsk oil pipeline which bypasses Russia. Georgia should step up its diplomatic activity to become involved in the above-mentioned consortium in order to avoid a geo-economic expansion of Russian "energy giants" into Georgia.

Involvement of Russian "Energy Giants"

The strategy of Russian energy companies is, first of all, influenced by direct and indirect state control turning these entrepreneurial subjects into active defendants of Russian geo-economic interests. In this respect, the relationship between the Russian monopoly JSC Gazprom and the ITERA Corporation deserves special attention since ITERA, camouflaged under the status of an international company, has been playing an important role on the post-Soviet gas market for years. Proof of a privileged relationship for the above-mentioned energy giants is the fact that in 1995, at the initiative of Gazprom, the Turkmen government made ITERA a key operator of Turkmen natural gas in Ukraine, Armenia and Georgia. Effective gas contracts within the CIS are implemented by the ITERA International Energy LLC which was jointly founded by Gazprom and the ITERA Group of Ireland in May 1996. In 2001, the EBRD even suspended credit to Gazprom (250 million USD) until such time that informal relations between ITERA and Gazprom had been finally clarified. It is true that the Chamber of Accounts of the Russian Federation found nothing suspicious in this relationship although facts were revealed that ITERA was

* *Such a contract envisages the purchase of oil from these countries to process it in plants in northern Iran in return for the delivery of the same volumes of crude oil for export to southern ports.*

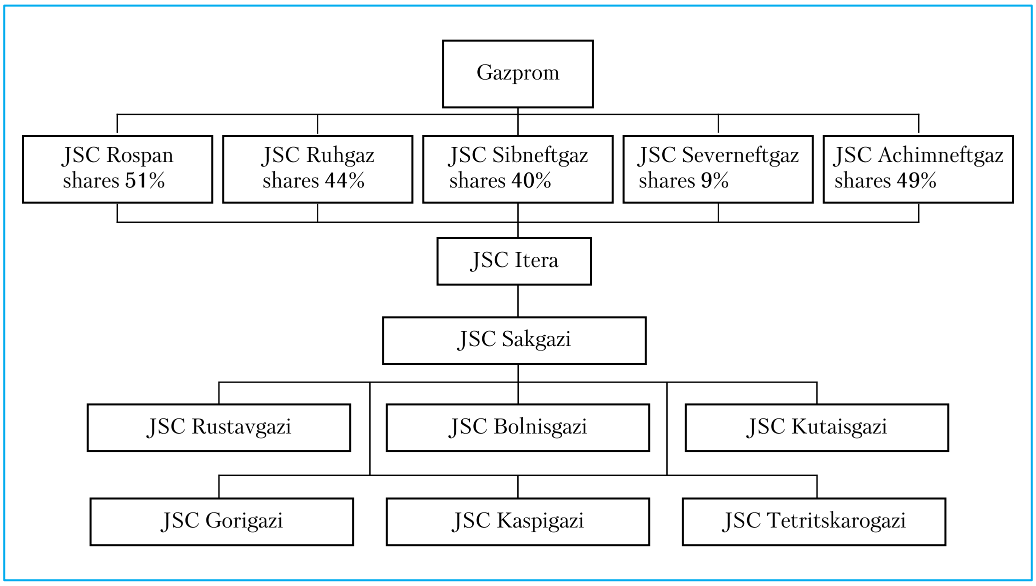
receiving revenues at places where Gazprom was loosing them. ITERA was gaining on markets which Gazprom surrendered to it voluntarily. Gazprom's minority shareholders believe that majority stakeholders in ITERA are Gazprom's top managers or their representatives. This can be proved by the fact that in 1999-2000, Gazprom unnoticeably transferred approximately 2 trillion cubic meter gas fields to ITERA's various private subsidiaries. These volumes of gas can meet the whole of Europe's demand over the five year period. Moreover, Gazprom allowed ITERA to use its trunk pipelines.

As a gas supplier, ITERA appeared in Georgia in 1995. In 1998, it already made an attempt to impose control on local energy companies when Sakgazi (ITERA's subsidiary, the former JSC Intergaz) was set to buy 76 percent of the shares in Tbilgazi through an investment contest. Due to a failure to fulfil assumed obligations, however, the results of the contest held by the Ministry of State Property Management were declared null and void. It is noteworthy that Sakgazi had until recently been denying any links with ITERA.

JSC Intergaz is established by Interpak Ltd., a company founded by an offshore company Channel International Ltd. The Channel itself is founded by an offshore-registered company Alsotransinternational LTD with the ITERA group providing support. It was precisely Sakgaz which acquired majority shareholdings in Georgia's regional gas distribution companies.

Throughout its activity in Georgia, therefore, ITERA has been pursuing Russia's geo-economic interests. Gazprom, through "murky privatisation deals," transferred several assets to ITERA and, afterwards, managed to "launder" part of the gains received from these deals in Georgia's gas distribution network by means of seizing and buying JSCs Rustavgazi, Bolnisigazi, Kutaisgazi, Gorigazi, Kaspigazi, Tetritskatogazi at court auctions (see the scheme). Gazprom is applying a similar scheme in the post-Soviet space.

Russian Trace in Georgian Energy Companies



The Dilemma of Trunk Gas Pipeline Privatisation

The signing of an agreement between the Belarus government and JSC Gazprom in early days of 2007 put an end to the Russia-Belarus "gas war." Under this agreement, Belarus will receive a thousand cubic meters of gas for 110 USD in 2007. If JSC Beltransgaz gives 50 percent of the gas distribution network to Gazprom, however, Belarus will receive its gas for free [12]. The above said means that the Russian energy giant is geared up to impose its direct control on gas distribution companies in the CIS. When privatising Georgia's energy facilities, therefore, one should consider not only a fiscal side of the transaction; that is, expected privatisation (capital) revenues but also its geo-economic aspect in that an alternative gas supply factor should be considered. There are several interesting studies in this regard by such experts as L. Jervalidze, D. Eliashvili, and T. Gochitashvili [13]. Nevertheless, current geo-political reasoning (of influential political circles both ruling and opposition parties), unfortunately, results in trivial conclusions. It does not matter who owns a "trunk pipeline" or a "unified distribution company." What matters, instead, is the fact that the source of resources is outside the country and that it is easy to exert political pressure by "turning off the tap."

The efforts of the Georgian government to find alternative energy sources are aimed at not only ensuring energy security but also at commercialising/de-monopolising the energy market. It is also of utmost importance that the diversification of energy supply provides, in general, guarantees for regional security. Some recent developments, however – in particular, a possibility to receive gas from Iran – can be viewed as a herald of certain changes in equilibrium of geo-strategic interests. These changes, at first glance, are expressed in the prospects of outlining the North-South line (Iran-Armenia-Russia) as a counterbalance to the West-East energy corridor. It is related to the transit of large flows of gas which is Russia's top export commodity and which also shows a growing share in exports of Iran over the past few years. Both countries possess 40 percent of observable world gas supplies and meet growing demands of Western Europe and south-east Asia.

In this respect, one should single out two important events in the geo-economic policy of the Georgian government: the first is that Georgia has talked about the possibility of using its territory for the transit of Iranian gas towards Europe and the second is that the Russian gas monopoly Gazprom has put it openly that it wants to purchase the Trunk Gas Pipeline.

The first statement about the possible transit of Iranian gas via Georgia was made by President Saakashvili during his visit to Iran in July 2004. It is obvious that, given an intensive construction of a new Russia-Baltic gas pipeline, Georgia will not obstruct an Iranian gas transit bypassing Russia. There are two potential transit routes from Iran to the EU:

- Iran/Armenia/Georgia/Ukraine gas pipeline, or the so-called "North" route, which has been developed since 1992. It was drawn up especially for the purpose of bypassing Russian territory. It is designed to run near Anaklia, then through neutral waters and finally to join the Ukrainian gas network near Feodosia. This route is geared towards settling the problem of country's territorial integrity because it is possible to get the Abkhaz side to become interested as well.
- The existing Georgia/Armenia gas network which can either be upgraded and redirected or newly built and which will join Russia's gas network in the North Caucasus.

Many countries, including France, Ukraine, Poland and even China, support the first route. This project, provided that it is implemented, will help to diversify and commercialise the gas supply of Russian gas-dependant Europe. This project, however, is suspended because the EU gas market is monopolised by Russia until 2010 with the new Russia/Europe pipeline, to run through the Baltic Sea, being entirely under Russia's control. That is why Russia obstructs any construction of an alternative gas pipeline outside of its territory. The stepping up of diplomatic activity of Armenia, Ukraine and Iran provides the ground to assume that the above-mentioned project will again be put on the agenda regardless of Russia's efforts to block it by all possible means.

Gazprom, therefore, has decided to use the Georgia/Armenia gas network as an alternative transit route (the second route) for Iranian gas to Europe. This is precisely the reason which explains Gazprom's growing interest in acquiring the Trunk Gas Pipeline. No other reason can be found to explain Gazprom's interest in a high-capacity underutilised pipeline (not even half of the 1 200 mm main and 700 mm reserve pipes is utilised. The installed throughput of the pipeline is 18 million cubic meters but, because of the drop in consumption after the break up of the Soviet Union, it carries only 9,5 million cubic meters per year) which carries Russian or Turkmen gas to Georgia and Armenia. That is why Gazprom backed the construction of the pipeline from Iran to Armenia. Moreover, it expressed the readiness to co-finance the gas pipeline construction which allowed the parties to take a 140 million USD loan from Gazprom for the construction of the 120 km-long Armenian section.

In 2003, Gazprom entered into a 25-year agreement with the then government of Georgia on using the Trunk Gas Pipeline for transit. This agreement says nothing about the direction and point of destination of transit.

One may agree with the opinion that Gazprom needs our pipeline to transport gas to Turkey. Half of Turkey's market is already supplied by Gazprom by the Progress pipeline in Bulgaria and the Blue Stream running though the Black Sea.

At the same time, Russia is actively involved in the extraction from the Iranian South Pars gas field. It owns 30 percent of the shares and is building a 56-inch gas line towards northern Iran. If Gazprom privatises the Trunk Gas Pipeline running through Georgia, then, this means that it will have its own gas (extracted in Iran) and a pipeline (that is, our Trunk Gas Pipeline) to redirect gas to Europe. Besides, as the 1998 Law of Georgia on Privatisation of Non-Agricultural Land stipulates that any state property shall be sold together with its land, Gazprom will possess the pipeline together with adjacent land. This, in its turn, will give the opportunity to Russia to demand, referring to security concerns, that certain military contingents be deployed at any point along the pipeline. In 1999, in fact, the International Gas Corporation with Trunk Gas Pipeline, included in its authorised capital, was initially created for the establishment of a joint Russian-Georgian entity (the word “international” appeared in the title for this purpose). The Georgian-Russian electricity enterprise, Sakrusenergo, was also established under a similar scenario. On the part of Russia, Sakrusenergo’s authorised capital was to include the construction of the Zestaponi-Akhalkalaki power transmission line to be subsequently extended towards Kars with the final goal of creating a unified Middle East/Russia energy system.

The privatisation of energy facilities, therefore, must be treated with extreme caution. It was not just an incidence that emended paragraph L, Chapter 4 of the Law on Privatisation of State Property prohibits the privatisation of the Trunk Gas Pipeline. By privatising the gas line and redirecting the gas flow, Russia will strengthen its role of a monopolist in Europe because, after the pipeline has been laid through the Baltic Sea to Europe, it will-due to existing pipelines (Friendship and Progress) and the Iranian route-gain considerable and lasting geo-political clout within Europe. Besides, it will make Armenia and Iran, as strategic partners, more dependent on it. We believe, therefore, that the entry of Iranian gas into Georgian territory is a positive development for the country’s energy security and commercialisation of the energy market provided that the trunk gas pipeline is retained by the state.

Conclusions

Strategically, the Kars-Akhalkalaki-Tbilisi-Baku railway is no less important than the BTC oil pipeline and the BTE; that is, the so-called South gas pipeline. Gas and oil may become depleted in 40-50 years whilst the regional railway will retain its international importance for a long time. This route will connect the European transport system with that of Asia by means of the tunnel being constructed through the Bosporus Strait which is why international financial institutions and the EU show a great interest in it [14].

Given the above-mentioned, Georgia’s role in the corridor should be enhanced in order to attract Central Asian cargoes. In particular:

1. To keep TRACECA competitive, it is recommended to constantly co-ordinate the work with the countries of the South Caucasus and Central Asia and to implement an agreed tariff policy. The decrease of rail freight in 2004, compared to the previous year, reveals some negative tendencies (see Table 1).
2. The Poti and Batumi seaports are 100 percent state-owned enterprises. Although the first part of the former transport minister’s decree #42 was abolished in 2006, giving the seaports the right to independently regulate tariffs for handling services, the state can use the right of a partner to revise port service tariffs toward the decrease in order to make them competitive with tariffs applied by Turkish and Russian ports along the Black Sea coast.
3. Georgian ports should further diversify the cargo turnover in order to compensate, at least partially, expected losses from the decrease in oil and oil product shipments with the increased dry cargo and container transfers.
4. Georgian diplomacy should become more involved in the group of founders of the “Consortium of Oil and Gas exporters, Importers and Transmitters” initiated by the presidents of Belarus, Azerbaijan and Ukraine at the CIS summit in Minsk (2006).
5. Privatisation of the Trunk Gas Pipeline would harm national interest of Georgia.

Given the new geo-economic realities at the turn of millennium, Georgia has for the first time ever been given a chance to participate in regional economic integration processes [15]. This objective can be successfully fulfilled if the security of the South Caucasus transport and communication space is ensured and geo-economic interests of the country are harmonised.

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PART III. ECONOMIC REFORM AGENDA

FOREIGN DIRECT INVESTMENT TO GEORGIA: CAN ACTIVE INVESTMENT PROMOTION POLICIES MAKE A DIFFERENCE?

Michael Shmidt, PhD of Economics, GEPLAC Economic Expert

Introduction

Over the last few years, the Georgian Government has taken considerable efforts to improve the country's business environment. The new tax code, passed in 2005, reduces tax rates and the number of types of taxes imposed on business and individuals. The customs code, passed in 2006, reduces the impediments to trade by decreasing the number of customs categories and overall tariff levels for exports and imports. Similar liberalisation has been undertaken in the areas of licensing and permits and labour regulations. In many of these areas, most notably labour regulations and the trade regime, Georgia has now one of the most liberal policy framework in the world.

This article builds upon previous contributions to the GET that analysed the structure and dynamics of foreign direct investments (FDI) in Georgia [1] and the importance of attracting export-generating investments to improve Georgia's trade performance [2]. Most politicians and analysts agree that FDI play an important role in the restructuring of the economy and that increased inflows of FDI are an important policy objective. Why then – given its progress on legal reforms that has been confirmed and encouraged by several studies and international institutions, such as the World Bank/IFC, the EBRD or the Heritage Foundation – has Georgia not become a primary destination for investments? Will investments be automatically attracted by a favourable investment climate or are there other constraints to investments beyond Georgia's control? Last but not least, and this is the main issue of this article, what is the role of active government policies and the institutional set-up in triggering more investments?

In order to approach the topic, we will first briefly analyse the global trends in FDI. Based on the changing pattern and motivation for companies to internationalise and to establish affiliates abroad under their control through long-term investments,* we will briefly assess Georgia's record and potential for attracting FDI. After this, we will comment critically on the existing laws and policy framework that directly affect investments in Georgia. Based on best-practices in other transition countries in Central and Eastern Europe (CEE) and South Eastern Europe (SEE), we will then illustrate the positive role of investment promotion policies and other supplementing policies in stimulating investment to Georgia.

Global Trends in FDI

According to UNCTAD 2006 World Investment Report [3] FDI flows in 2005 amounted to 916 billion USD, an increase of 29 percent as compared to the year before. The bulk of these investments can be explained by an increased Mergers and Acquisitions between highly developed countries. At the same time, investments from developing and transition countries are constantly on the rise as competition and economic growth in Asian and other emerging economies force companies to expand abroad. Outflows from developing countries amounted in 133 billion USD, 17 percent of the total, in 2005.

The share of transition and developing countries in inflows of FDI is also increasing. For the region of SEE and the Commonwealth of Independent States (CIS), this figure amounted to 40 billion USD, or 4 percent of the total, in 2005. FDI in this region, that also includes Georgia, was highly concentrated with over 75 percent of all inflows going to just three countries; namely, Russia, Ukraine and Romania.

The motivations and driving forces for FDI vary from country to country and between industries. Generally, CEE is becoming increasingly targeted by higher value added production in industries such as electronics and the automobile industry that are characterised by clusters, proximity to end-producers and high demands on quality control. SEE, and also Turkey, are targets for market-seeking investments and more dispersed industries such as textiles and food-processing but also the service sector. In other words, locations with markets that are less integrated into the EU and geographically more remote from industrial centres tend to attract investments that are more of a local or regional type rather than being part of highly specialised global production chains with a large degree of intra-industry trade between

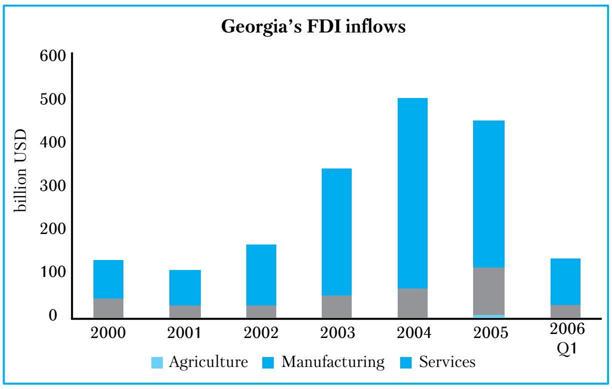
This is the official definition of FDI. According to UNCTAD, the parent company should have at least a 10 percent share in the affiliate in order to have sufficient control to qualify as FDI. Private equity investment, which is increasingly important, with a time-horizon of five to ten years, is also considered to be FDI.

countries. Transport costs, trade barriers and a lack of implementation of quality standards in line with international and EU norms are, therefore, all limiting factors to this type of investment to countries like Georgia.

The increasing role of transition and developing countries as source countries for investment is explained by the increased pressures from globalisation which force companies to compete in home and foreign markets and the need to reduce costs and to acquire new assets through so-called asset-augmenting investments. UNCTAD [3] also observes that transition and developing countries are more likely to invest in other countries of this type and that their investments tend to be important factors for development as they apply similar technologies and more labour-intensive production modes. The upshot of this is that Georgia has much to gain from investments from neighbouring emerging markets such as Turkey, Russia or Ukraine.

Georgia's Record and Potential to Attract FDI

It is generally assumed that Georgia is becoming an attractive location for investments based on the increased volume of investments over the last three years.



Source: Department for Statistics of the Ministry of Economic Development of Georgia

The chart also illustrates that the services sector by far has been the dominant choice of investment from within the broad composition of foreign investments. In order to assess the potential for investment and the policy options for attracting more investment, it is important to understand the motives of companies that are investing in Georgia. In other words, one has to look at the micro-foundations of FDI flows as the total and aggregate figures are often misleading and give rise to incorrect policy prescriptions. It is important to note, for example, that most of the investment since 2003 can be attributed to the exceptional influence of the construction of the BTC pipeline and, more recently, the construction of the gas pipeline. The international consortia involved estimate that they contributed 75 percent to these inflows in 2005 with the prospect of a 60 percent share in 2006 and 50 percent in 2007. This is also reflected in Table 1 which illustrates that the pipeline investments are a key determinant in the ranking of source countries over the period from 2000 to 2006.

Table 1: Countries' Share in the Stock of FDI (2000-2006)

Country	Volume (mln USD)	% of total
USA (incl. btc)	319	22%
UK (btc)	298	20%
Azerbaijan (btc)	172	12%
Russia	146	10%
Turkey	140	9%
Cyprus	102	7%
Italy (btc)	92	7%
France (btc)	80	6%
Norway (btc)	77	5%
Virgin Islands	62	4%

Source: Department for Statistics of the Ministry of Economic Development of Georgia

Another factor to consider when analysing the structure of investments in Georgia is the fact that they are driven by privatisations in network industries (telecom, energy generation and distribution, ports, oil terminal, media), real estate (hotels) and basic industries or resource extraction (ferrous metals, magnesite, fertilisers, copper, cement). Investment inflows from privatisation are by nature a one-off occurrence except when they lead to substantial follow-up investments. Real estate, basic industries and resource extractions contribute relatively little to the economy as they do not increase productive capacities and, especially in the case of resource extraction, have limited employment and spill-over effects in the economy as a whole. Investment in real estate and network industries positively impact on the infrastructure of the country but contribute little in terms of production and exports.

To summarise, the current investment inflows to Georgia are exceptional and probably not sustainable. In the medium term, they will have to be complemented by more investments in job- and export-generating manufacturing. There are positive developments in industries such as food processing (wine, hazelnut, mineral waters/glass production) and isolated cases of export processing investments in the textile sector. Generally, Georgia has achieved little in terms of competing for new greenfield investments; that is, investments that are globally mobile and that can locate in many different destinations. Ongoing investments are either determined by local factors, such as market demand, availability of resources, or special occurrences such as the pipeline construction.

Georgia's Investment Laws and Policy Framework

The most important laws directly regulating investment activities are the 1996 Law on Investment Activity and Guarantees, the 2006 Law on State Promotion of Investments and the 2002 Law on the Georgian National Investment Agency. In addition, there are various laws on privatisation, land acquisition, concessions and permits and licensing that are relevant for investors.

The 1996 investment law establishes national treatment (foreign investors cannot be treated worse than domestic companies), the right to repatriate profits, ten-year guarantees against adverse legislative changes and recourse to international dispute settlements. Investors rights are further specified in Georgia's bilateral investment treaties (BITs) with 21 treaties in force. The network of BITs is mainly incomplete and does not cover several EU member countries. The same applies for Georgia's network of treaties to avoid double taxation. The lack of treaties on double taxation is based on the demand (by bigger investors) for regulation in this area. Tax treaties follow standard procedures and are easily implemented. More problematic is the relatively slow progress on BITs because international arbitration, which offers investors recourse to neutral and fair judiciary, is developing rapidly under the Convention of the International Centre for the Settlement of Investment Disputes (ICSID)[**] and becomes increasingly sophisticated. Provision in the law could be expanded to include 'fair and equal treatment' and more sophisticated dispute settlement mechanisms. Article 7 of the law states that investments can be expropriated by the State "by Court decision and on urgent necessity established by organic law and only with appropriate compensation." The compensation amounting to the "actual value" is granted according to Article 8. Recent 'voluntary' handovers of properties in Tbilisi (restaurants, baths), albeit only affecting domestic businesses, are a form of indirect expropriation without compensation and do not bode well for the protection of investments generally.

The 2002 law on GNIA outlines the role of the Agency and some programmes for the support to foreign and domestic enterprises. It needs to be noted that the programmes have long expired and functions assigned to GNIA in the law do not fully correspond with its current status and capacities. The mandatory registration of investments above 100000 USD with GNIA and annual follow-up reporting of investment plans, for example, have never been implemented. In 2002-2003, the 'Fund of the President' was used to stimulate investments, mainly by domestic companies, by giving subsidies and support to bank guarantees. This implies that there are currently no policies in place to support investments.

The 2006 Law on the State Promotion of Investments seeks to refine the procedures of investment promotion. GNIA is to represent investors vis-à-vis administrative authorities during the permitting process. For this, the Agency will charge fees that are to be determined by the Ministry of Economic Development. No fees apply for the category "investments of special importance," investments over 8 million GEL or over 2 million GEL in case the investment is undertaken in the highlands of Georgia. The Law further outlines the procedures of issuance of preliminary licenses and or permits whilst clearly stating GNIA authority and the obligations of municipalities and state authorities to inform investors about the procedure in a timely manner. In practice, these provisions can create confusion amongst investors as they are not backed by secondary legislation (for example, the tariff system for GNIA services has not been elaborated) and so far are not implemented. Even if implemented, the procedures for granting special investment status are too vague and not practical. It is doubtful, for example, that a serious investor would like his investment plans or agreement with the Government to be published as envisaged by paragraph 4, Article 10. Moreover, few investors would agree to submit an investment guarantee totalling 2 percent of the investment value or an equivalent bank guarantee as this is associ-

** *Whilst there were only five state-investor disputes pending in 1995, the number of ICSID procedures had increased to 249 in 2005.*

ated with additional costs and financial risks. The Government, for further example, might consider that an investor infringes its agreement and retain the deposit. In short, the 2006 Law over-regulates the permitting process in an area where no institutional capacities and secondary legal act are yet in place. Moreover, some provisions make the whole process relatively unattractive for foreign investors. Secondary legislation and administrative capacities need to be put in place as soon as possible.

The 2006 Law also further specifies administrative procedures relating to privatisation (sale of state property) in addition to what is foreseen by the 1997 Privatisation Law. More specifically, it outlines the procedure for direct sale which speeds up the process of privatisation for investors. The criteria for direct sale are fairly broad and an important role is attributed to the President. This allows for quicker sale but also leaves ample room for administrative discretionary treatment of investments.

Allowing private sector participation in the provision of public services and infrastructure is another possible source for investment in Georgia. The 1994 Law on Concessions displays several deficiencies [4]: it discriminates against the domestic investor, limits the scope of application to natural resources and related activities, does not specify which authorities may issue concessions, does not specify eligibility of projects and insufficiently defines modes of selection. This indicates that Georgia's legal framework on concessions does not comply with international standards and that amendments or a wholly new law could help to trigger further private sector participation in important projects in infrastructure, mining and tourism.

The role of an Investment Promotion Agency

Today, there are over 180 national investment promotion agencies (IPAs) and over 300 at the subnational level. It is subject to much debate to what extent these agencies are able to influence investors' decisions. Research has shown that the effectiveness of the Agency depends on the environment in which it operates [6]. An Agency operating in a poor investment climate is less effective in attracting investment. Due to the reform efforts in the legislative area over the last few years, Georgia should, therefore, be in a position to be successful at attracting investments by an active investment promotion strategy.

Second, the scope of activities that the Agency undertakes influences its performance. Empirical data indicate that agencies devoting more resources to policy advocacy are more effective as these activities affect all investments (domestic and foreign). Investment generation and targeting can be risky and expensive, especially in countries with poor investment climate. Moreover, institutional links to highest policy level (reporting to President or Prime Minister) or to the private sector increase efficiency. These links are important because they increase the Government's commitment as well as reinforce the Agency's credibility and visibility. For example, the feedback mechanism whereby CzechInvest, the Czech IPA, annually contributed to the policy reforms of the country on the highest level, was an important element for timely adjustments in policies to accommodate investors concern.

Investment policy comprises all government regulations and laws that govern private investment and, more particularly, transparency, property protection and non-discrimination. Reform of the investment climate is complementary to this and comprises wider policy areas and improved administrative structures and practices in the field of taxation, trade, competition policy, human resources development (education and VET), anti-corruption efforts and regulatory reform. The first role of an Investment Promotion Agency in Georgia could be to co-ordinate and drive the wider effort of improving the investment climate. The IPA could establish a dialogue and feedback mechanisms between the authorities and business (established and potential investors) in fostering reforms. The first efforts of this have already been undertaken by GNIA and the newly established Business Information Centre (BIC). The EBRD is determined to support the establishment of an Investment Council for this purpose. For an IPA to fulfil the difficult function of co-ordinating and pushing reforms forward, high-level and sustained political support is indispensable. In the case of the Investment Council, it is envisaged to secure the backing of the Prime Minister's Office. Government, the donor community and business associations are currently supporting the first function of policy advocacy of GNIA [5]. Policy advocacy is crucial and expedient in the absence of other resources for investment promotion. Typical activities of policy advocacy of an IPA include surveys of the private sector, participation in task forces, policy and legal proposal and also lobbying.

Another important function of an IPA is image building; that is, efforts to create a perception of a country as a good investment location. Activities in this field include focused advertising, PR events, generation of favourable news and stories. GNIA has been active in this area by organising and financially supporting "Investment Forums" in countries such as China, India and the USA. These activities were mainly focused on the general image of the country, its tourism potential the promotion of Georgia's traditional exports to new markets. Feedback from the business community confirms that these events were not directly targeted at investors. Brochures such as an Investor's Guide have been developed and financed by donor organisations. Best practices from other transition countries show that PR activities and promotional materials need to be well-targeted, professionally managed and part of a medium-term promotion strategy.

The establishment of the BIC in Georgia, which has temporarily been stalled due to a lack of financing and staffing, was a step in promoting the function of investor facilitation and servicing, providing a wide range of services to assist investors in analysing investment decisions, establishing a business and maintaining it in good standing. This function usually includes activities such as information provision, a "one-stop shop" service to speed up permitting processes, assistance in obtaining sites, partners and access to utilities. In Georgia, this crucial function was formally devolved to the BIC. In practice, BIC has no long-term planning horizon and adequate resources to handle these tasks. It currently only partly fulfils the function of information provision. The support to the permitting process, as envisaged in the 2006 Law on State Promotion of Investments, is not clarified by by-laws and GNIA/BIC does not have the mandate and authority to assist investors in this respect. More importantly, BIC is not connected with other regions outside of Tbilisi – a network of co-operating institutions (see below) – to offer information on possible locations and local business conditions. Staff of BIC even have problems collecting basic information for investors from other state institutions. According to best practices from transition countries, information relevant for investors (incentives, labour costs, locations, investment climate, laws) is treated as public information; that is, available on the website of the IPA.[***] This allows staff of the Agency to devote more time to servicing investors.

The last function of an IPA identified by the seminal article by Wells and Wint [5], is investment generation. Investment generation implies the targeting of specific sectors and companies with view of creating investment leads. IPA staff, or outsourced companies, identify sectors and companies that are most likely to invest in Georgia. Potential investors are contacted through direct mailing, telephone campaigns, investor forums and seminars and individual presentations to targeted investors. This is the most sophisticated, costly and risky area of investment promotion. Investor targeting, particularly when it includes activities that are conducted abroad, is very costly and the competition is strong. If badly designed and implemented, such campaigns tend to backfire. For investment generation, the country needs a clear strategic vision on where it wants to compete and how it wants to compete. Without having ready 'products;' for example, incentive schemes, industrial parks, industry clusters and companies for privatisation in place that allow Georgia to stand out from its competitors, it makes little sense to attend highly-specialised industrial fairs or even more general investment fairs like Expo-Real in Munich (Germany) or MIPIM in Cannes (France).[****]

There are various elements to setting up an new IPA or restructuring an existing one and creating an effective regime for investment promotion [7; 8; 9]:

1. Understanding the role of FDI in Georgia's overall development strategy: As mentioned at the beginning of this article, it is important to understand the dynamics and structure of FDI flows and the potential of attracting investments to understand its possible impact on the domestic economy. Georgia needs to clarify in which industries and regions FDI is most needed and what type of investment it needs to attract to best complement its development policies.

2. Developing an Investment Promotion Agency: Based on the analysis for the need and potential of attracting FDI, Georgia should undertake primary steps to restructure GNIA or to set up a new Agency. Determining the organisational structure, scope of responsibilities, functions and staffing framework needed to undertake successful investment promotion that is suited to Georgia's unique environment. Ideally, this should be reflected in a new or revised law on the Georgian National Investment Agency. This law, for example, could also clarify whether or not the Agency is also responsible for taking up the functions of the disbanded Georgian Export Promotion Agency (GEPA). The statutes and laws should provide for a de-coupling of the operation of the Agency from political processes and to avoid excessive staff fluctuations, especially of top management. Best-practice evidence in developed and transition countries and recommendations, by organisations like FIAS or MIGA, suggest that a planning horizon of three years in terms of budget and staff is the minimum for a successful operation of the Agency. Georgia should strive to obtain donor assistance (financial and technical) at the start. In order to ascer-

*** See, for example, the website of the Czech Investment and Business Development Agency "Czech Invest" at http://www.czechinvest.org/

**** Expo-Real and MIPIM are the biggest investment and real estate fairs in Europe.

tain the sustainability of the Agency, donor support needs to be complemented by credible and medium-term financing commitments. In the case of Georgia, privatisation receipts and or pre-defined shares of incomes generated from pipeline transfers, estimated at around 80 million USD annually over the next years, could be used for this purpose. It is of crucial importance to match the mandate and responsibility of the Agency with long-term political commitments and adequate resources.

3. Creating an Investment Promotion Strategy: With an Agency in place, an evaluation of the strengths and weaknesses of the Georgia as an investment location, identification of sectors that best capitalise on its strengths, should be undertaken. Based on these priorities, it is possible to ensure that the Agency's activities, organisational functions, partnerships (see below) and budget reflect the industry and targets identified. If Georgia wants to implement an export-processing zone (EPZ) on the Black Sea, for example, it might develop direct partnerships with the relevant municipalities and target typical industries that tend to use such zones (electronics, textile, logistics). If tourism is one of the priorities, a close co-operation with the national tourist organisation and resorts is essential. Depending on the constraints for investments identified, the Agency could co-ordinate and initiate parallel strategies on human resource or infrastructure development.

4. Building Effective Partnerships: Due to the limited resources and reach of the Agency, a strategy on how the Agency will co-operate and interact with other relevant actors is important to improve its effectiveness and to avoid duplications. Usually, IPAs have a large network of partners comprising chambers of commerce, business associations, private consulting firms, real estate developers and a donor organisation. As in most transition countries, the Georgian IPA should also boost local and regional capacities to promote investments. Bigger IPAs in more advanced counties, such as in Hungary or the Czech Republic, have large staff and numerous regional offices to facilitate this interface. In the case of Georgia, it is more realistic if the Agency builds up a close working relationship with selected regions depending on the priorities chosen. In this case, the national Agency could train local authorities in dealing with investors. In many transition countries, this relationship can be made structured and professionalised by developing a "regional accreditation system" whereby regional partner organisations need to fulfil pre-defined criteria to become a partner of the IPA. The Georgian Agency will also need to find channels to be represented abroad, either by using diplomatic representative offices or other organisations. In the case of Georgia, for example, the newly established EU-Georgia Business Council, based in Brussels, could be included in the outreach activities of the Agency.

5. Strengthening Georgia's Image: This covers the key elements of image building, requiring an initial assessment of how investors view the location, identifying strength and weaknesses, and developing and action plan. Ideally the strategy is based on previous work in the other areas and a clear strategic approach to the attraction of investment. Georgia should probably avoid an over-reliance on tourism and traditional products, such as wine in campaigns, and focus more on hard facts such as business-relevant information (labour costs, customs and tax rates, human resources and infrastructure). Based on the strategy for the promotion of investments, an action plan on image building containing an effective mix of promotional tools should be developed to deliver messages to the target audience.

6. Targeting and Generating Investment Opportunities: One of the key elements of investment generation is the establishment and maintenance of a lead tracking database whereby investors can be followed-up and assisted in a timely manner. Such a tracking system is crucial to avoid the negative impact of fluctuation in staff. As mentioned above, direct contact and active promotion of investment opportunities and locations is a more risky and expensive method to attract investors. In practice, most agencies with limited resources should focus on those investors that have shown interest in the country and a particular location. At a later stage, wider investment campaigns, including those abroad, can be envisaged. Representatives of the well-known Austrian company "Schirnhofer," for example, which in the past intended to undertake a major investment in Georgia, confirmed that no one in the Georgian administration is currently contacting them to invest or to reconsider their decision to locate somewhere else. It is an important responsibility of an IPA to track such leads, to communicate with this type of potential investors and to stimulate them to invest in Georgia.

7. Servicing Investors: Georgia, like most transition countries, does not provide an infrastructure of business services and administration that fully covers the needs of (potential) investors. Private consultants and lawyers can only partly cover these tasks. Representatives of the IPA, therefore, usually step in to fill informational gaps and to provide an effective infrastructure for servicing investors. Most IPAs assign individual project managers to a potential investor who prepares their site visit, undertakes preliminary market research and ensures an adequate follow-up. In addition to potential investors, services

can also include support to already established investors. The IPA can in this way facilitate follow-up investments by companies already present.

8. Monitoring and Evaluating Results: Monitoring and Evaluating includes tools that are used to improve the management of the IPA. By setting up a clear system of monitoring and performance criteria, the Agency is in a much stronger position to demonstrate to Government and other funding organisations the benefits of its activities. Monitoring and Evaluating also offers senior management of the Agency effective tools to improve the organisational set-up, procedures, staffing and strategic planning of the Agency.

9. Utilising IT-Technology: For a relatively isolated and unknown country like Georgia, a professional internet presentation is crucial in generating interest by investors. Many companies start their analysis of potential locations for investment by simple internet research. An adequate content management, accessibility of information and effective promotional tools can trigger more detailed market research. Currently GNIA's website contains little updated and business-relevant information. A recent MIGA/ World Bank study compared inter alia the internet presentation by IPAs in 114 developing and transition countries [10]. This study revealed that IPAs in small countries, and on the sub-national level, with limited budgets can develop substantial capacities. The best performers in the survey use their website to communicate effectively with investors and to make them aware of costs and investment opportunities in their countries. More importantly, they use enquiries by investors as tools to continuously update the website and to establish direct communication channels with interested companies. One drawback of Georgia in this context is that most searches clash with Georgia State in the USA. More importantly, however, the content and feedback mechanisms of such websites are inadequate.

The importance of Supplementary Policies

Investment promotion is most easily implemented when it is incorporated into an overall national development strategy. Foreign investments should be an essential part of any strategy of regional, SME or general industrial strategy. The new EU Member States and candidates have a particular incentive to develop such strategies because they are important for the application for EU structural funds. Georgia currently does not pursue an active industrial strategy, nor does it even have a definition of SME. By focusing on the need to attract new Greenfield investment as part of an investment promotion strategy, Georgian policy-makers can combine pro-active policies in this area for the revival of the domestic industry with support for foreign investors. As Georgia is opening to trade and investment, investment promotion should be part and parcel of industrial policy because ultimately only those sectors that are competitive on a global, or at least regional level, will attract foreign investment. This link is clearly illustrated by the Czech Pilot Supplier Development Programme which combines the promotion of investments by large multi-national corporations (MNCs) with support to local SMEs and the electronics industry in general. The programme is summarised in Textbox 1, based on [11].

Textbox 1: The Czech Pilot Supplier Development Programme

This is a backward linkages programme for the electronics sector, introduced in September 1999 under the responsibility of CzechInvest, the foreign investment agency (a semi-autonomous arm of the Czech Ministry of Industry and Trade) and originally scheduled to run for 18 months. The project is run by five staff members.

The strategic process was overseen by a newly established high-level Steering Group which brought together representatives of Government, general managers of MNCs, presidents of business associations and managers from CzechInvest.

18 electronics MNCs and 45 Czech suppliers were selected to participate in the programme (of which 80 percent were nominated by MNCs).

Auditors identified and agreed areas where domestic companies were failing to meet MNC audit criteria. During the second round of audits, the improvement of companies was assessed and 20 most successful, those with the highest potential, were invited to the final stage of individually tailored help. 15 companies so far have gained new contracts through the programme. The new business created was worth 17 million USD per year (in 2003), consisting of contracts renewable on a 12-month basis, and amounted to 45 million USD for the period 2000-03. Ten of the selected companies were not supplying to MNCs prior to the programme. Out of those ten, seven confirmed that they found their first new MNC clients through the programme. The companies were selling typically 40 percent of their production to MNCs in the Czech Republic. On average, 26 percent of their revenues from business with MNCs accounted for final products, 62 percent were from selling parts or components and 12 percent from selling the packaging materials. More than half of the companies saw the value added of their supplied products increasing (57 percent).

Participating firms reported improvements in the areas of internal management, human resources management and client relationship management.

This example illustrates a general dilemma of investment promotion; that is, without large MNCs investing, it is difficult to start such broader programmes which foster forward and backward linkages to the domestic economy. Without a critical mass of MNCs investors, it is also difficult to justify a large investment promotion programme. For Georgia and other smaller economies that are no prime destinations for FDI, it nevertheless can pay off to start small pilot projects. Georgia, for example, potentially has a competitive advantage in the production of hazelnuts. The sector is currently characterised by inefficient and fragmented land possession and a lack of centralised hazelnut processing plants. The Government could support larger international investors in organising small-scale suppliers of hazelnuts in the future.

If the Government intends to support labour-intensive production in the country or some parts of the country because it wants to reduce unemployment, it can subsidise investors for jobs created. Serbia, for example, which traditionally has a large textile industry but was by and large circumvented by recent investments in this industry which mainly went to neighbouring Romania and Bulgaria, was able to attract several investors by issuing a decree on financial incentives. The resources for these financial incentives were financed out of privatisation receipts (see Textbox 2).

Textbox 2: Financial Incentives for Greenfield Investments in Serbia

Serbia offers financial assistance for future investments in the country. Based on the Serbian Government Decree adopted in late June 2006, the non-refundable funds will be assigned according to specified criteria for investment projects in all areas except for trade, tourism, hospitality and agriculture. Eligible companies are those involved in manufacturing activities, the internationally marketable services sector and the research and development sector.

Investments in manufacturing activities:

- Available funds: starting at €2 000 up to €5 000 per every new employee,
- The minimum investment amount: between €1 million and €5 million, depending on the unemployment rate in the municipality where the investment is made,
- The minimum number of new job positions: 50.

Investments in internationally marketable services sector:

- Available funds: starting at €2 000 up to €10 000 per every new employee,
- The minimum investment amount: €1 million,
- The minimum number of new job positions: 10.

Investments in the R&D sector:

- Available funds: starting at €5 000 up to €10 000 per every new employee,
- The minimum investment amount: €1 million,
- The minimum number of new job positions: 10.

Investment projects will be scored and evaluated based on the specific criteria:

1. investor's references, 2. participation of domestic suppliers in the final product and the investment effect on local companies, 3. investment's sustainability and viability, 4. the effect related to the R and D sector, 5. the effect on human resources, 6. environmental impact, 7. international turnover of services for investments in this area, 8. the effect on development of the local community and 9. municipality support related to providing all necessary permits and incentives.

Applications are to be submitted to the Serbia Investment and Export Promotion Agency (SIEPA). All necessary documentation will be available at the Agency's web-site (www.siepa.sr.gov.yu) after the invitation for application is published. Upon evaluation and scoring of investment projects, the funds for selected projects will be awarded in accordance with the number of points and paid out in four increments throughout the project's lifetime: 1st increment: after concluding the contract for sale or lease of land, 2nd increment: after obtaining the construction approval, 3rd increment: after obtaining the right-to-use permit and 4th increment: after achieving full employment envisaged by the investment project.

None of these programmes is perfect but they illustrate that both advanced and less advanced transition countries pursue active policies to attract internationally mobile capital. Most countries have made considerable progress in improving the investment climate. At the same time, policymakers are aware that they have to stand out from the crowd by providing special services to investors and giving them the feeling that their investment is supported by national strategies on industrial development and human resources.

Concluding Remarks

Georgia has made considerable progress on improving certain aspects of the investment climate. There are many areas, however, that still deserve attention, most notably the establishment of an efficient and fair judicial system, the fight against corruption and, linked to this, reforms of business-relevant administrations (tax, customs, inspections).

The establishment of an effective Investment Promotion Agency can assist in overcoming the political, institutional and technical problems of tacking cross-cutting reforms. Georgia is in the process of establishing a mechanism of private-public dialogue which will support the Government's efforts to remove existing barriers to trade and investment. At the same time, a well-designed IPA with sufficient political clout and resources, is also essential to promote Georgia as an investment location and to provide hands-on support to potential and established investors.

In addition to the laissez-faire approach to policies that have characterised liberalisations in a wide range of areas over the last years, Georgia needs more active policies of investment promotion to reap the fruits the reforms in terms of high-quality investments. Although investment policy is not enacted in European Directives, nor are there strict conditionalities imposed on Georgia by the recently adopted EU-Georgia Action Plan, success in the area of attracting investment is ultimately an important yardstick of European integration of the country.

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