German Economic Team Georgia

in cooperation with

ISET Policy Institute

Policy Studies Series [PS/01/2017]

Towards strong and balanced growth: Georgia's economic policy priorities in 2017-2020

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Berlin/Tbilisi, April 2017

About the German Economic Team Georgia

The German Economic Team Georgia (GET Georgia) advises the Georgian government and other Georgian state authorities such as the National Bank on a wide range of economic policy issues. Our analytical work is presented and discussed during regular meetings with high-level decision makers. GET Georgia is financed by the German Federal Ministry for Economic Affairs and Energy. Our publications are publicly available at our website (www.get-georgia.de).

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Acknowledgements

The authors are extremely grateful for highly insightful comments and input from Robert Kirchner, Veronika Movchan, Georg Zachmann, Stephan von Cramon-Taubadel, Giorgi Mzhavanadze and Davit Keshelava. Excellent research assistance was provided by Anne Mdinaradze.

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1. Introduction

In October 2016, the “Georgian Dream” coalition won a large majority of the seats in the Georgian Parliament, permitting it to form a stable government and effectively implement policy during the four years of the current term until 2020. In the economic policy field, much has been accomplished during the past years. Georgia’s economy has grown remarkably consistently and the country has acquired the reputation of a model country within the region for economic and institutional reform.

Yet, the development challenge remains large. GDP per capita, a good approximation of prosperity, is higher than in Moldova or Ukraine but less than a third of Poland and only one ninth of the EU average. Hence, the government should use the strong parliamentary majority to implement an economic policy agenda tailored to delivering strong and sustainable growth for Georgia.

Currently, the following economic policy strategies and plans exist:

- “Georgia 2020”, announced in 2012, is a broad agenda directed at long-run growth of most economic sectors with validity beyond the 2020 date
- Before the elections, the government announced a “4 point plan” of economic measures to be implemented after the election
- This plan has been extended to 10 points after the election, largely in order to refinance fiscally costly reform proposals

This paper is intended to be complementary to these agendas. Its structure is as follows: We first conduct a SWOT (strengths, weaknesses, opportunities, threats) analysis of the Georgian economy, from which we conclude the broad economic policy priorities Georgia should tackle in the present legislative term. We then make suggestions on policy priorities, first in macroeconomic policy fields and finally for priority sectors in order to achieve more balanced growth.

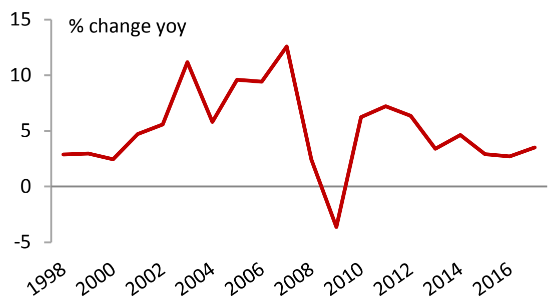
2. Analysis

2.1 Strengths

Georgia is perceived in many regards as a model case for governance and the rule of law among transition countries. A number of strengths emerge:

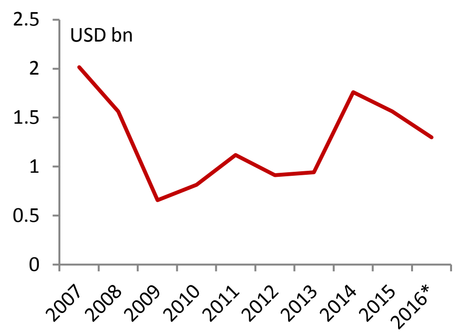
- **Stable, reliable institutions and solid rule of law**. Georgia exhibits a modernised public sector with low bureaucracy burdens for citizens and companies and low corruption.
- Georgia has scored excellent results in international comparisons of **business environment** such as the World Bank's "Doing Business" ranking, in which it achieved rank 16 of 190 countries.
- Georgia has a reputation for **good macroeconomic governance** due to a strong and independent central bank, good supervision of the financial sector and traditionally low public deficits demanded by constitutionally protected fiscal rules.
- The economy has followed a remarkably **stable growth path.** Except for 2008 – when the country was at war – real GDP growth has been above 2% ever since 1997.
- Georgia has attracted sizable **inflows of foreign direct investment (FDI)** in a very stable manner during the last decade.
- A **competitive wage level** renders Georgia attractive for investment, particularly in labour-intensive sectors.
- Georgia's **image** abroad is positive, associated with beautiful nature, a grand cultural tradition, hospitality and good governance.

Figure 1: GDP growth



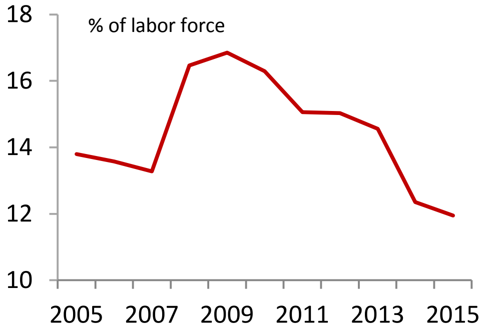
Source: IMF

Figure 2: Inflow of FDI



*Source: Geostat; *Preliminary data*

Figure 3: Unemployment rate



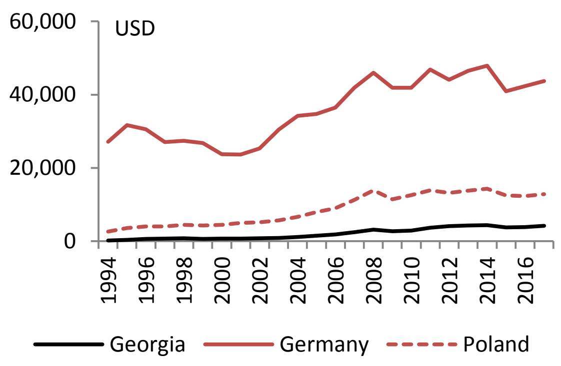
Source: Geostat

2.2 <u>Weaknesses</u>

Although pronounced strengths exist in institutions, stability and the business environment, Georgia's growth rates remain relatively low. Weaknesses of the Georgian economy are:

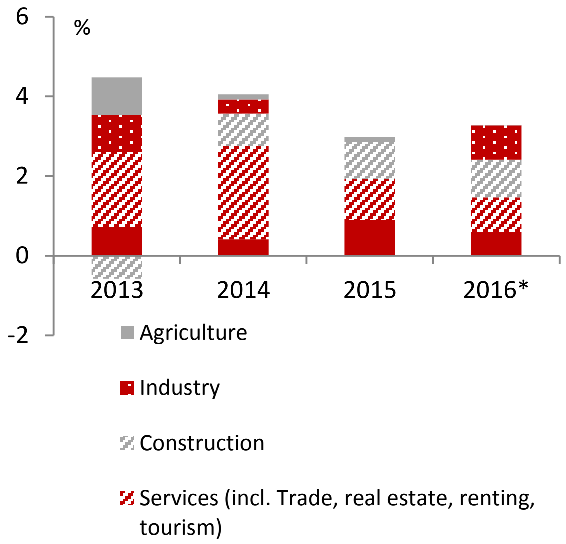
- The current **growth rates** of 2-5% p.a. are, although stable and positive, not sufficient to ensure a speedy convergence with the prosperity levels of benchmark countries (see Fig. 4).
- **Unemployment**, although falling in recent years, remains high at above 10% of the workforce.
- **Unbalanced growth:** The main sources of growth in the past were the services sector (including tourism, transport, real estate and finance) and construction. A growth model depending exclusively on few sectors implies a large dependency on and exposure to shocks affecting these sectors. Industry and agriculture have not strongly grown and have only absorbed relatively small shares of FDI.
- **Weak export structure**: Due to the weak industrial and agricultural sectors, Georgia's export portfolio remains highly concentrated on a relatively small number of goods and services. Furthermore, most of the export goods are commodities with low value added and exposure to volatile world-market prices.
- **Lack of scale**: Both the Georgian domestic and the regional markets are small and hence often not attractive enough for investments in production for domestic use.
- **Lack of qualified workers**: Skilled labour especially in technical or crafts professions is very scarce in Georgia and is often cited as a constraint for investment or growth by companies.
- Although government institutions are stable and reform-minded, **policy synchronisation** (i.e. working on joint priorities) between ministries working on economically relevant issues has been lacking in the past, leading to reform activity not maximising its economic impact.

Figure 4: GDP per capita in selected countries



Source: IMF

Figure 5: Sectoral contribution to GVA



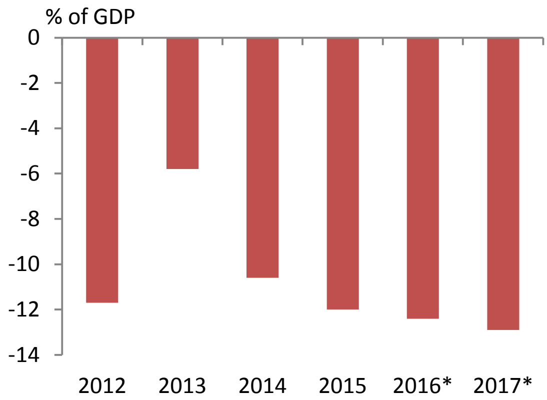
*Source: Geostat, *Preliminary data*

2.3 Threats

Georgia faces the following threats to its economic growth:

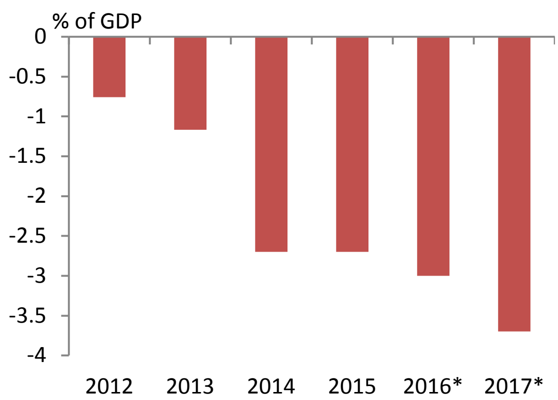
- A high **structural current account deficit** in excess of 10% of GDP per year. Although a moderate current account deficit is normal and indeed often necessary for emerging or transition economies due to the need for capital imports, the magnitude of the current account deficit qualifies it as threat.
- At the end of last year, an expansion of the deficit to 4.7% was expected in 2017. Due to consolidation measures undertaken by government, the growth of the **fiscal deficit** has been limited to 3% in 2016 and 3.7% in 2017. This consolidation confirms the commitment to fiscal discipline, which was recognised by the IMF with the approval of the new programme. This commitment must be maintained in order to prevent the emergence of twin **deficits** in the external and public sector. These would sharply constrain the space for policy and would constitute a serious threat to macroeconomic stability.
- Due to its weak export structure, Georgia is heavily exposed to **fluctuations of commodity prices** for its key export goods.
- **Exposure to regional economic weakness** due to strong trade links with economically vulnerable neighbours.
- **Dollarisation of the Georgian economy**, especially the large share of credits in USD, creates a downside to exchange rate fluctuations.

Figure 6: Current account deficit



*Source: IMF, *Estimates*

Figure 7: Budget deficit



*Source: IMF, *Estimates*

Note: We use the programme definition of the deficit

2.4 Opportunities

Several opportunities exist that economic policy should aim to leverage:

- Georgia stands out as an **appropriate place to invest and do business in the South Caucasus region** and might even be a suitable base for business ventures and operations directed at the markets of the Central Asian countries or Iran across the Caspian Sea.
- Georgia has signed several **free trade agreements**, especially with the EU and recently with China. Apart from permitting local businesses to grow their exports after removal of customs, these FTAs enable Georgia to attract investment in production aimed at exports to these respective markets ("export platform" approach).
- **Large potential for cost-effective hydroelectricity** exists in Georgia. Low costs of electricity generation can be a crucial location factor for industry and especially electricity intensive businesses ranging from server parks to aluminium production.
- Ongoing **investment in infrastructure**, including the Georgian East-West Highway, the construction of a new deep water port in Anaklia and activities related to the Chinese "New Silk Road" initiative lead to the improvement of transport connections within and out of Georgia, hence reducing transport costs for Georgian export goods.

2.5 Implications for policy priorities

Economic policy in Georgia should focus on two key points: Preserving macroeconomic stability and rebalancing growth by focusing on priority sectors in goods production. The first focus mainly requires the continuation of present activities and maintaining a very good track record. Rebalancing growth is necessary to prevent the risks and downsides from sectoral growth being highly focused in services, including tourism. To this end, it is necessary to broadly identify, which goods-producing sectors in Georgia hold potential and to unlock this potential by setting appropriate general conditions.

3. Preserving macroeconomic stability: Precondition for long-term growth

The strategic macroeconomic priority of Georgia should be to ensure stability and protect its reputation for macroeconomic and institutional stability.

3.1 Fiscal policy

Key issues: *The Georgian government has implemented fiscal measures to keep the fiscal deficit at reasonable levels. This commitment to fiscal discipline is crucially important to prevent the emergence of twin deficits in the public and external sectors and to reassure potential investors in Georgia.*

Recommendations:

- The **public sector deficit should stay at or under 3% of GDP in the medium term**. The government has already undertaken measures to consolidate the budget to a deficit of 3.7% of GDP in 2017. If necessary, further measures on the revenue or expenditure side should be taken to ensure that the deficit does not rise in the current year and is returned to 3% or below in future years.
- The **ceiling for public deficits of 3% of GDP** enshrined in the "economic liberty act" should be kept. The debt ceiling functions as a key credibility device for donors and investors.
- **Public revenues should mainly be raised in the form of regular taxes or excises** rather than using "alternative" revenue sources such as fees for activities undertaken by government agencies. Tax policy should be subject to careful analysis before reforms are undertaken to ensure that economically harmful distortions are minimised.
- The announced **refocusing of public expenditures on investment**, especially by removing infrastructure bottlenecks, will be conducive to economic growth but should not lead to a creeping growth of the deficit.
- The government should attempt to **cut expenditures** in the following order: 1. **Inefficiencies** in public expenditures. 2. **Consumptive expenditures** such as subsidies, public employment. Cutting public investment should only occur in areas where the investment can and would also be undertaken by the private sector.

3.2 Monetary / exchange rate policy

Key issues: *Monetary policy should ensure domestic price stability and external sector sustainability. The National Bank of Georgia (NBG) ensures price stability by adopting a strategy of inflation targeting whilst the floating exchange rate of the Lari has allowed accommodation of external shocks. As Georgia's current account deficit remains large at 12% of GDP, this issue is of key relevance.*

Recommendations:

- An independent NBG should continue to implement **inflation targeting**, as this strategy has internationally proven to be a successful model of monetary policy.
- Consistent with inflation targeting, the **flexible exchange rate of the Lari should be maintained**. A flexible exchange rate ensures that external shocks do not translate into unsustainable reactions of the current account deficit.
- The **current account deficit** is high and will remain high for the coming years. At present, the deficit is essentially financed by FDI inflows amounting to 11.5% of GDP in 2016. Monetary policy should not attempt to bring the current account into balance, but instead monitor the deficit and ensure its sustainability.

4. Promoting strong and balanced growth of the economy

Economic policy in Georgia should focus on providing conditions that contribute to faster and more balanced growth. As set out in the SWOT analysis, the one-sided growth of services sectors in the recent past exposes Georgia to risks and constrains future growth potential. Priority sectors should feature a high growth potential through utilising comparative advantages of Georgia as well as the potential for upgrading towards producing higher value-added goods. We identify two priority sectors:

1. **Light industries:** Georgia features a highly attractive wage level, whilst a lack of a skilled workforce in technical professions exists. The light industry, comprised of labour-intensive subsectors such as food processing, textiles, some machine-building activities etc., provides an opportunity to leverage the wage level to attract investors that do not require many highly qualified workers from the outset, but will gradually contribute to a build-up of skills and a move towards higher value-added and capital intensive industry branches. Apart from the competitive wage level, the excellent business environment and customs-free access to many markets should render Georgia an attractive place to invest for these industries.
2. **Agriculture:** Georgia has excellent and diverse climatic conditions for agriculture. However, Georgia's large agricultural sector at present is highly unproductive and limited to few export products. Solving the productivity problem – largely originating in the fragmentation of agricultural land and a linkage between social and agricultural policy concerns at present – will unlock great potential for growth in agriculture and downstream food processing industry.

Growth in the services sectors should be welcomed, but should not be the key target of economic policy at this time. Growth in in the priority sectors will contribute to combating Georgia's greatest vulnerability, its small basket of often low value-added export products. To promote growth in these sectors, key impediments to growth should be addressed by policy and investment attraction and other policy areas should focus on these sectors. However, government should take care not to interfere in business decisions by using outdated industrial policy instruments such as specific tax breaks or subsidies.

4.1 Industrial development

Key issues: *Although Georgia did not officially have an industrial policy under previous administrations, a business model based on investment in energy, tourism and transport/transit was pursued. A modern approach to industrial and innovation policy for the priority sectors should focus on overcoming obstacles to growth especially for the priority sectors.*

Recommendations:

- It should be considered to enhance the industrial policy process by supporting the establishment of a network of industry-led and owned **cluster institutions** in the different, existing and competitive clusters of light manufacturing such as the textiles industry or the agri-food sector. Cluster institutions are built around companies in related, locally concentrated value chains and include relevant local research and education institutions as well as local economic policy institutions. Cluster policy leads to a strengthening of clusters due to better internal coordination and cooperation of the companies, strengthened external marketing of the cluster and its products and better conditions due to an ongoing policy dialogue. The implementation of a cluster programme could be supported by experience from the EU or its member states.
- **Government institutions aimed at private sector support** such as the Entrepreneurship Development Agency or the Georgian Innovation and Technology Agency should focus on helping to establish Georgian products on new markets. This implies focussing activities on assisting entrepreneurs and SMEs in developing and bringing to markets new products with relatively limited financial requirements (standards implementation and product innovation) rather than attempting high-end technology innovation.
- **Contemplate the relaunch of existing or new industrial parks**: Although past projects were not very successful due to lack of infrastructure provision at designated sites, such projects could be contemplated if investors see a need. Such parks must be geared towards the needs of potential investors and bring on board a solid base of "founding" investors before launching projects. Investor needs must be given priority over regional development objectives in determining the sites. Industrial parks should attract investors through infrastructure provision and networks, not through tax breaks.
- **Business climate:** Although Georgia has achieved remarkable improvements of its business environment in past years, there remains room for improvement in corporate dispute resolution, bankruptcy law and intellectual property rights. Achieving progress on these issues can be facilitated by using the insight provided by existing donor projects in these fields (e.g. USAID or GIZ) and could unlock significant investments.

4.2 Investment attraction

Key issues: *Foreign direct investment (FDI) will remain an essential driver of growth. Apart from bringing physical capital, FDI also lead to imports of knowledge and technology. Although FDI to Georgia has been strong throughout the past years, relatively little has flown to industry and agriculture*

Recommendations:

- **Targeted investment attraction**: Invest in Georgia should liaise with the key ministries involved in the industrial development in order to determine where potential for FDI exists within the priority sectors, then seek out and approach potential investors.
- This requires a **better integration of "Invest in Georgia"** with other economic policy actors in order to ensure that the agency possesses the relevant information about government programmes (such as "produce in Georgia") and that experience from investment attraction is fed back into such programs and policies.
- Although the state should not draft investment proposals, it should be clearly **communicated to potential investors where Georgia's potential and comparative advantages lie**. For both priority sectors, competitive wages, the business environment and specifically the excellent access to EU and Chinese markets should be leveraged.
- The **potential to use Georgia as an export platform** for exports to the EU or China should be exploited by approaching suitable investors. By producing in Georgia, duty-free access to these markets is possible, while still inputs from other countries can be used to varying degrees in the production process. This is particularly relevant for investors from countries without favourable market access to the EU.
- Once established, **successful cluster organisations should be leveraged for investment attraction**. Successful clusters are a highly credible proof that suitable conditions for developing a business in the domain of the cluster exist in Georgia, such as specific service providers and a relevant workforce. Furthermore, the information that cluster managers can communicate to potential investors is highly relevant for these investors and often goes beyond what public agencies can provide.

4.3 Trade and export promotion policy

Key issues: *Georgia has been highly successful in negotiating and signing free trade agreements. Apart from the DCFTA with the European Union, FTAs with China and the European Free Trade Association (EFTA) have recently been signed. The main objective of trade policy should now be to reap the benefits of these agreements. The focus of policy should hence be on implementation, such as transposition of standards required by the EU-Georgia DCFTA and aiding companies in applying these standards. Furthermore, Georgia should further develop its infrastructure of export promotion institutions and improve its trade facilitation infrastructure. Relatively weak rankings of Georgia in the "trading across borders" section of the "Doing Business" ranking and in the Logistics Performance Index of the World Bank (rank 54 out of 190 in 2017) indicate that deficits in the trade facilitation infrastructure continue to exist.*

Recommendations:

- **Intelligent DCFTA implementation** in cooperation with the EU should be continued: As is already the case, the approximation of product standards and regulation with EU standards should be prioritised in sectors where the capacity for exports to the EU is largest. In the domain of food products, this implies a focus on facilitating the certification process for non-animal and selected animal origin food products.
- Georgia's **trade facilitation infrastructure** should be improved. This applies both to physical infrastructure such as ports or border crossings and soft infrastructure such as border or customs procedures. Difficulties and bottlenecks should be identified and remedied in cooperation with the relevant institutions overseeing the specific infrastructure items. The Ministry of Economy and Sustainable Development will have to communicate and mediate between private sector actors and government agencies such as the Revenue Service or the Ministry of Regional Development and Infrastructure. International financial institutions (IFIs) might be able to support this process.
- **Further develop export promotion institutions:** A **structured information and consultancy service for companies contemplating exports** to new markets should be set up in cooperation with donor organisations and international partners.
- Georgia's new **export credit agency** should be developed in line with international best practices in order to maximise its benefit and uptake of services. Export credit insurances are a vital ingredient in helping companies to manage the risks associated with exports, especially when breaking into new and sometimes difficult or unknown markets. German experience could be used to further develop the export credit agency.

4.4 Agricultural policy

Key issues: *The root cause of the lack of productivity of Georgia's large agricultural sector is not the lack of capital, but the existence of structures inhibiting capital investment to occur. Hence, agricultural policy should not foster conditions conducive to investment rather than directly targeting investment. One key impediment to growth is the small structure, the lack of available land to expand large-scale production of primary agricultural goods and the lack of a functioning land market. Remedying this will require disentangling agricultural from social policy in order to permit small farmers to sell their land, which can then be put to more productive use. Once land consolidation progresses, measures should be undertaken to allow a broadening and upgrading of the product palette as well as promoting the improvement of the skills of the agricultural workforce.*

Recommendations:

- **Separation of social policy from agricultural policy:** Currently, many people are registered as self-employed farmers who are owners and users of small plots. In fact, most of these people are not commercial farmers in any meaningful sense, but low-income, quasi-retired individuals using their land as a source of extra income. Social policy rather than agricultural policy (price stabilisation measures etc.) should be used to stabilise their incomes. Incentives to sell or let land to more productive users should not be reduced and indeed encouraged.
- **Promoting the consolidation of agricultural land**: The government should work together with donor organisations active in the agricultural field in order to develop a strategy to enable land consolidation. It could consider using incentives to induce small farmers to sell or let their land to commercial farming entities of larger scale or to form or join proper farming cooperatives. These incentives could for example focus on inheritances.
- **Expedite the completion of the cadastre**: Developing an efficient land market is a necessary condition for land consolidation. The cadastral process should hence be completed as soon as possible. Incentives for individuals to register their land should be positive.
- **Encourage the improvement of value chains:** The government could address weaknesses of current value chains through encouraging the foundation of **Productive Alliances (PAs)** of producers in single value chains, potentially as part of a larger cluster initiative. PAs can enable actors to overcome quality and aggregation problems with agricultural products by self-organisation. The German GIZ or the World Bank could possibly support this endeavour.
- **Encouraging and supporting innovation and experimentation**: Once consolidation of agricultural land is under way and enough land is available to scale up production, innovation in products and processes should be encouraged in order to aid diversifying and upgrading the value structure of agricultural production as well as providing more opportunities for value chain creation in the agri-food sector. As Georgia does have relatively limited land areas, breaking into smaller niche markets can be a successful strategy to diversify the export basket and increase its value-added intensity.
- **Developing education in agriculture, including agricultural business**: The skills base of the agricultural labour force should be developed through vocational and academic education. The current cooperation of the Ministry of Education with EU donor institutions (e.g. Germany for vocational education) should be continued. Agricultural education institutions

should be comprehensively overhauled. This may require the closing down of institutions unfit for modernisation.

4.5 Energy policy

Key issues: *Georgia's energy sector development in the past decade has been a success story with significant foreign and domestic investments into new power plants and power lines. Georgia has also become an important and reliable energy transit country. In the coming years we see four challenges: Firstly, lower than anticipated revenues from electricity exports to Turkey, putting in doubt the electricity export strategy governing the development of the energy sector in previous years. Secondly, accommodating increasing domestic energy consumption will require investments into production and networks. Thirdly, the fiscal burden from hydropower plant and transmission investments due to the power-purchase agreements signed will increase. Finally, Georgia's recent membership of the Energy Community obliges it to transpose significant proportions of the EU energy sector legislation.*

Recommendations:

- **More cost-reflective energy tariffs**: Georgia's household electricity and gas prices are still low by regional standards and are characterised by cross subsidisation from industry consumers to households. Making tariffs more cost reflective – including a sensible investment component – would enable and encourage the necessary investments and lead to higher fiscal revenues, while at the same time encourage more efficient energy usage.
- A new electricity strategy focused at **meeting the growing domestic demand at reasonable cost**[1] instead of electricity exports. Growing demand should be met economically by increasing domestic generation by a smart mix of hydropower and combined cycle gas turbines and some imports.
- Carefully **improving regional integration of the energy markets**. Georgia should strengthen its ability to import electricity in winter and export electricity in summer to and from its different neighbouring countries in order to diversify the corresponding economic and political risk. This will require a thorough analysis of the cost and benefits of the corresponding infrastructure as well as, negotiations with the partner countries on proper cost-sharing and terms-of-trade before investment decisions are taken. The German KfW may be a suitable partner in this project.
- Georgia should take a **very careful approach towards power purchase agreements**: The government should not become liable for market or other risks that the government cannot properly control. Hence, investments into new generation assets should not be incentivised by publicly-guaranteed prices, but by a stable and market framework.
- Georgia should intensively negotiate with the European Commission and the **Energy Community** on how to adapt their rules so that they fit the specific Georgian context (e.g., being not directly connected with any other signatory country).

[1] See German Economic Team, PP/02/2016, Options for balancing Georgia's electricity supply and demand

- Georgia should **highlight its low energy generation costs and enable combined ownership and operation of hydropower and industrial plants** in order to attract investments in energy intensive industries[2].

4.6 Infrastructure policy

Key issues: *Vast infrastructure investment is underway and has been partially completed in Georgia. Energy transmission networks are in a good shape now and major road investments have made transport in Georgia faster and easier. Nevertheless, both road and railroad systems and the electricity distribution grid remain in need of further investment. Transporting goods in and out of Georgia still is relatively difficult and expensive, limiting the attractiveness of the country for investors intending to produce and possibly export goods. As trade beyond the immediate region will be a focus of industrial development, completing main transport arteries, further improving international transport links and improving the reliability of the electricity distribution grid for corporate consumers will be of great importance for Georgia's future*.

Recommendations:

- **Focus the ongoing extension and improvement of infrastructure towards needs of emerging light industry and agri-food sectors**: Infrastructure development should be continuously informed through the industrial development policy process of the needs of existing companies and likely investors. As at present, IFIs including the World Bank and EBRD will be able to support the continuous upgrading of Georgia's infrastructure.
- **Improvement of physical trade facilitation infrastructure**: Policy should aim at identifying and remedying aspects of physical trade facilitation infrastructure that contribute to the still existing high transaction cost for exports.
- **Ensure that FDI in transit infrastructure also serves Georgia's domestic needs**: Much FDI is currently flowing into infrastructure projects in Georgia. The South Caucasus Pipeline and investments related to the Chinese "One belt, one road" initiative are main examples. For each new project, Georgia should identify in what ways the project can contribute to development of domestic industry and agriculture and carefully negotiate towards these objectives.
- **Complete the construction of a deep-water port**: Better ship connections for goods transport with the EU and the rest of the world will be important in reducing transport costs and time to and from Georgia. Enabling bigger ships to reach Georgia directly will be an important step in this direction. It should be ensured that port facilities are suitable for handling a relatively wide range of products.
- **Finance the modernisation of the railway network**: Profits of the railroad company, owned by the Georgia Partnership fund, should be used for modernising the railway network and rolling stock to be able to cope with increasing loads.

[2] See German Economic Team, PP/02/2015, Can low electricity prices be a comparative advantage for Georgia?

4.7 Education policy

Key issues: *In spite of a high unemployment rate in Georgia, qualified labour especially in technical professions is often scarce. Georgia faces a triple difficulty: Firstly, many citizens' qualifications are outdated, often after long unemployment spells. Secondly, the education system in technical fields such as engineering or crafts is on average deficient. Finally, a cultural preference for academic versus vocational education and for arts or social science over technical or science fields creates a mismatch between the qualifications of young Georgians entering the labour market and the requirements of the private sector.*

Recommendations:

- **Introduce and promote a new system of vocational education**: As the government already announced, a system of vocational education provided by the cooperation of government and private sector companies should be introduced and promoted. The system should ensure that up-to-date skills are taught. Furthermore, private sector actors should be consulted to infer what skills are needed most urgently to enable the development of the priority sectors. Given Germany's recognised expertise in this field, the assistance of the German cooperation institutions should be sought for this project.
- **Academic education should be focused more strongly towards technical education**: Education in the technical fields should be developed and modernised in a similar way as described above for vocational education by partnering e.g. with EU member states. The concentration should lie on educating more practical minded engineers rather than striving for top scientists at this moment. This will require the targeted use of funds in the education system for the technical subjects. Capacity limits for student enrolment should further help canalise education towards those courses with excellent employment perspectives.
- **Academic education in industry and agriculture-related fields should be modernised**: In tune with the refocusing of academic education, research and education institutions should be comprehensively overhauled. To this end, cooperation and partnerships with international top institutions such as Göttingen University in Germany, Wageningen in the Netherlands or UC Davis in the USA should be sought, financed by a donor institution such as the World Bank, to develop degree programmes and recruit new teachers. It should be ensured that active teaching staff is adequately trained in the state of the art in their respective fields. Where qualifications of teachers are entirely outdated, they should be taken out of active teaching roles.
- **Retraining of middle-aged de-facto unemployed individuals**: Due to the vast transformations the Georgian economy has undergone, many Georgians of middle age have lost their original jobs and are currently in low-income situations due to lack of an adequate qualification. Research should be undertaken, on what form of retraining could enable them to find better employment again in emerging industries. Potential partners: Germany, Sweden and the UK have good experience with active labour market policies.
- **Give individual research and education institutions freedom and incentives to cooperate with local business clusters:** Especially if cluster organisations emerge, the ability to design joint projects with local research and education institutions can often be a strong driver of local economic development, solving the specific issues and shortages facing a cluster.

4.8 Financial sector regulation

Key issues: *Georgia has a well-regulated and stable banking sector. Reducing dollarisation remains the largest challenge for financial sector regulation. Due to the relatively small volume of domestic savings, exchange rate risks will remain a reason for elevated interest rates for corporate credits. Priorities should be to create access to finance beyond bank credits and raising the volume of Lari deposits in order to gradually decrease interest rates for Lari credits.*

Recommendations:

- **Persevering in efforts towards de-dollarisation:** No fundamental reason exists for dollarization of the financial sector. The Lari is a stable, well run currency. Instead, for borrowers in USD credits, large exchange rate risks prevail. De-dollarisation efforts should be continued in cooperation with the IMF, focused on creating incentives to gradually raise the Lari share both in new credits and deposits through cautious measures.
- **Promoting the development of the financial market beyond bank credits**: Georgia's banking sector is stable and solvent, ensuring that adequate access to credit exists for companies. However, beyond bank credits, the options for financing corporate growth are rather limited. Hence, regulation should be reformed using assistance provided by the EBRD and other donors active in financial market development in order to promote the emergence of other, secure forms of corporate finance including both credit and equity instruments.
- **Improve oversight of the non-banking sector:** Although the banking sector is well-supervised, oversight of the non-banking sector encompassing the smaller non-bank credit institutions is lacking. Improving oversight of these institutions will aid confidence in the financial sector and investments by SMEs.

4.9 Natural resources policy

Key issues: *Natural resources policy must strike a balance of protecting the environment for future generations without inhibiting an economically sensible use of natural resources. At present, mining is a small sector in Georgia, but mining products are at the core of key export goods such as ferroalloys. The sector has developed slowly in the past due to an outdated regulatory regime.*

Recommendations:

- A **comprehensive reform of the regulation of mining**: A reform package should contain a fully-fledged national mining strategy and differential regulation of different sectors, in particular differentiating between natural resources destined for the domestic market such as construction materials and high-value metallic minerals. The new regulatory system for the mining of metallic minerals should contain easier access to information on sites, a modernised auctioning of site licenses without minimum prices and a two-stage royalty system to ensure that the country fully reaps the fiscal benefit from additional resource extraction[3].

[3] See German Economic Team, PP/05/2015, Removing obstacles to investment in Georgia's mining regulation