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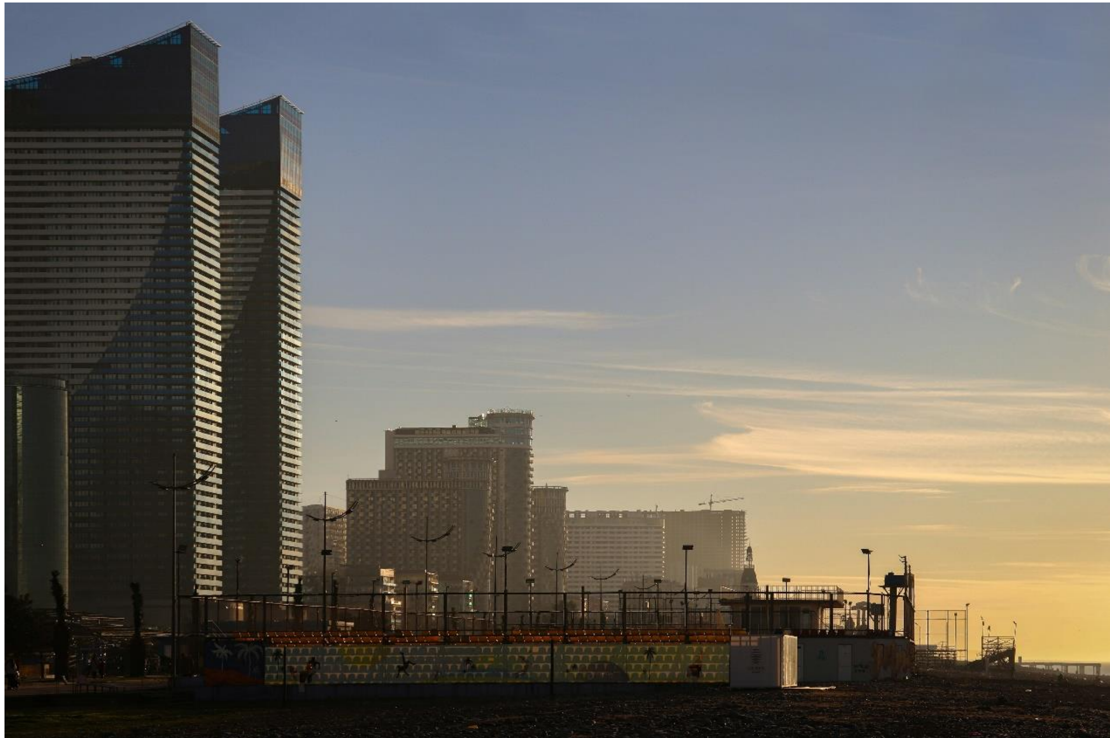
Country Report: Georgia

Ripple Effects: The Impact of the War in Ukraine on Georgia's Economy



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List of Abbreviations

AA – Association Agreement
ADB – Asian Development Bank
BCM – Billion Cubic Meters
BOP –Balance of Payments
CIS – Commonwealth of Independent States
CIT – Corporate Income Tax
DCFTA – Deep and Comprehensive Free Trade Area
DPOs – Development Policy Operations
EBRD – European Bank for Reconstruction and Development
EFF – Extended Fund Facility
EFTA – European Free Trade Association
EPRC – Economic Policy Research Center
EU – European Union
FDI – Foreign Direct Investment
FX – Foreign Exchange
GD – Georgian Dream
GDP – Gross Domestic Product
GEL – Georgian Lari
GFC – Global Financial Crisis
GHG – Greenhouse Gas
GNERC – Georgian National Energy and Water Supply Regulatory Commission
GOGC – Georgian Oil and Gas Corporation
GSE – Georgian Stock Exchange
GSP – Generalized System of Preference
GWh – Gigawatt Hours
HHI – Herfindahl-Hirschman Index
ICT – Information and Communication Technology
IFC – International Finance Corporation
IFI – International Financial Institutions
IFRS – International Financial Reporting Standards
IIP – International Investment Position
ILO – International Labour Organization
IMF – The International Monetary Fund
ISET – International School of Economics
KM – Kilometer
KTOE – Tonne of Oil Equivalent
kWh – Kilowatt Hours
LPI – Logistic Performance Index
MESD – Ministry of Economy and Sustainable Development
MoF – Ministry of Finance
NATO – North Atlantic Treaty Organization

NBG – National Bank of Georgia
NDC – Nationally Determined Contributions
NGO – Non-Governmental organization
NPLs – Non-Performing Loans
NREAP – National Renewable Energy Action Plan
NSGP – North-South Gas Pipeline
OECD – Organization for Economic Co-operation and Development
PPP – Purchasing Power Parity
RFE/RL – Radio Free Europe / Radio Liberty
SBA – Stand-by Agreement
SCP – South Caucasus Pipeline
SCPX – South Caucasus Pipeline Expansion
SME – Small and Medium Enterprises
SOCAR – State Oil Company of Azerbaijan Republic
SOE – State-Owned Enterprise
TANAP – Trans-Anatolian Natural Gas Pipeline
TAP – Trans-Adriatic Pipeline
TI – Transparency International
TJ – Terajoule
TWh – Terawatt Hours
UK – United Kingdom
UN – United Nations
UNFCCC – United Nations Framework Convention on Climate Change
UNM – United National Movement
US – United States of America
USD – United States Dollar
VAT – Value Added Tax
WEF – World Economic Forum
WEG – World Experience for Georgia
WITS – World Integrated Trade Solutions
WTO – World Trade Organization

Chapter 1. Introduction

Recent political and economic developments in Eastern Europe have increased the need for a deeper examination of the ongoing changes in the region. The objective of the country report is to diagnose Georgia's principal macroeconomic, structural, and institutional vulnerabilities with a particular focus on dependencies related to Russia.

The country report on Georgia offers an in-depth overview of both macroeconomic and microeconomic policies, tracking developments across a broad timeline from 2007 to 2023. In certain cases, the years of analysis have been adjusted based on the availability and reliability of data. The data used in this study has predominantly been sourced from international organizations and their platforms (detailed references are provided within the report). Additionally, where necessary, the report incorporates data from national statistical agencies and relevant local ministries to ensure a comprehensive and accurate portrayal of the country's economic conditions.

The country report has been written by the research team of the Economic Policy Research Center (EPRC). The research process has employed robust methodology, utilizing a set of secondary sources and internally available information. This approach ensures that the findings are grounded on a solid evidence base and reflect the most up-to-date and relevant information. The report also benefits from the expertise of EPRC's analysts, who have extensive experience in examining the economic, political, and social dimensions of Georgia's development. By providing a detailed analysis of Georgia's vulnerabilities, this report aims to contribute to the formulation of informed policies that can enhance the country's resilience in the face of external and internal challenges.

The country report is organized into the following structure. It begins with a general overview of domestic and international political developments that are pertinent to the research (Chapter 2). Chapter 3 delves into the macroeconomic conditions and recent developments in Georgia. Chapter 4 assesses the financial sector, highlighting its shortcomings and paying particular attention to recent changes in the wake of Russia's invasion of Ukraine. Chapter 5 offers an overview of various microeconomic sectors, with a specific focus on Georgia's international economic ties and partnerships with the global community. Chapter 6 critically examines Georgia's energy sector, evaluating the risks and challenges that it faces. Chapter 7 provides a concise summary of the key shortcomings in Georgia's economy and the challenges to its resilience. Finally, Chapter 8 presents a set of broad recommendations aimed at addressing these shortcomings and reducing the vulnerabilities that have been identified. This structured approach ensures a comprehensive analysis, guiding policy makers and stakeholders toward informed decision-making.

Chapter 2. Domestic and external political developments

Georgia regained its independence after the collapse of the Soviet Union in 1991. The early years of independence were marked by civil unrest and economic hardship, as the country grappled with the complexities of transitioning from a Soviet republic to an independent state with a market economy. Despite these initial challenges, the restoration of independence was a pivotal moment in Georgia's history. Georgia went through new waves of reforms in the early 2000s once the United National Movement (UNM) took over the government after the "Rose evolution." Reforms have led to increased economic liberalization and Georgia's further integration into the international community. In 2012, the Georgian Dream (GD) came to power with popular support.

Independent Georgia had to confront continuous pressure from its Northern neighbor, Russia. Since regaining independence, Georgia has lost two breakaway regions: Abkhazia in 1993, and South Ossetia in 2008. In both conflicts, Russia backed and enabled separatist movements. Russia has continuously tried to intervene in Georgia's domestic developments, either through means of economic pressure, direct threats, or statements from the political elite. However, until recently, such actions had failed to prevent Georgia from pursuing its goals to join and integrate with the European Union (EU) and the North Atlantic Treaty Organization (NATO).

The country officially made a commitment toward European integration in 2004 with its inclusion in the European Neighborhood Policy, followed by the 2009 launch of the Eastern Partnership initiative. A significant milestone for Georgia came in 2014 with the signing of the Association Agreement (AA), including a Deep and Comprehensive Free Trade Area (DCFTA), which came into full force in 2016. This agreement has substantially deepened Georgia's political and economic ties with the EU, facilitating reforms across various sectors. In 2022, amidst regional geopolitical tensions, Georgia applied for EU membership alongside Ukraine and Moldova. While the latter two were granted candidate status, Georgia received a conditional prospect, highlighting the need for further reforms, particularly in areas of democratic governance and the rule of law. Finally, it received candidate status in December 2023. However, recent negative rhetoric from the ruling party and a lack of willingness to take into account the recommended reforms have stalled the integration process (Civil.ge, 2024a).

The controversial law on "foreign agents" adopted in April 2024 was the most spectacular decision going against the conditions set by the EU. It requires NGOs with over 20% foreign funding to submit annual reports. This move aimed to strengthen the ruling party's position before the October 2024 elections. The GD sees NGOs as allies of the opposition, and accuses them, along with the United States (US) and EU donors, of interfering in domestic affairs and undermining the government (Avdaliani, 2024). Although the bill met with large domestic protests and harsh criticism from Western partners (Civil.ge, 2024c), the ruling party still adopted it.

One key factor redefining Georgia's attitudes in recent years has been the ongoing war in Ukraine. Most Georgians have shown support for the Ukrainian people, either through street protests demanding more decisive government assistance, or by mobilizing resources. GD has used the war as a dividing line between themselves and

the opposition, which they label as the “war party.” By positioning themselves as the party of peace, GD has garnered support among the electorate. Additionally, the economic spillover from the conflict, including the influx of funds and people, has provided mid- and short-term gains that may be reflected positively in GD’s support. However, if Georgia changes its direction and reduces its integration with Western partners, many of the economic gains made in the past decades will be at risk. Such a change in the policy vector is a real possibility if GD remains in power.

Consequently, Georgia stands at a crossroads. The elections in October 2024 might be among the most important in modern Georgian history. As Georgians cast their votes, they will be choosing not just a political party but also their place on the global landscape. Regardless of the results, Georgia will likely undergo significant post-election changes. The lack of trust in any political party further added to political anxieties, as most voters remained undecided just a few months before the elections (Civil.ge, 2023).

To sum up, the ongoing polarization and global reshuffling have impacted local politics. Georgian political and economic structures will be tested in the coming years, first through the elections and then through the resulting changes. The future of Georgia is yet to be defined, and the first step on this path will be taken by the people at the ballot box.

Chapter 3. Macroeconomic Stability in Georgia

3.1. Macroeconomic Policy Setup

Macroeconomic policy in Georgia is managed through a distributed delegation of responsibilities across several key institutions, each with distinct objectives and targets. The primary actors responsible for maintaining macroeconomic stability and growth are the National Bank of Georgia (NBG), the Ministry of Finance (MoF), and the Ministry of Economy and Sustainable Development (MESD). Additionally, several specialized agencies address niche economic sectors, although their capacity to intervene is limited and they operate under the guidance of the primary actors. The Georgian parliament takes on legislative duties and the oversight of policy implementation. However, its actions are not always guided by economic theory and frequently fall under the political will of the ruling party, leading to incohesive policy planning.

According to the *Government Program 2021–2024 – Toward Building a European State*, creating a stable macroeconomic environment is one of the primary objectives of the Georgian government. To achieve this, the government has committed to improving fiscal discipline, gradually reducing the national debt, stabilizing prices, increasing the independence of monetary policy, and reducing the budget deficit (Government of Georgia, 2020).

The MoF plays a key role in fiscal oversight, government budgeting, public debt management, and tax policies (Ministry of Finance of Georgia, 2016). The MoF's primary aim is to maintain fiscal discipline while supporting economic growth. The public debt-to-GDP ratio is a critical indicator used by the MoF to ensure that it remains manageable and does not pose risks to fiscal sustainability. According to the *General Government Debt Management Strategy 2024-2027* of the Ministry of Finance of Georgia (2024), efforts should be made to maintain the net government (public) debt ratio to GDP below 40%.

Along with the MoF, the NBG plays a crucial role in maintaining the country's economic stability through its independent conduct of monetary policy. The guiding document for the NBG is the *Resolution of Parliament: On the Main Directions of Monetary, Credit, and Currency Policy for 2023–2025* (Parliament of Georgia, 2022), which sets the inflation target at around 3%. On the other hand, the MESD is responsible for economic policy planning. The MESD works on policy strategies targeting international trade, investment, and sustainable development.

3.1.1 Central Bank Independence and Monetary Policy

The NBG first emerged in the early 1990s, and has undergone several major transformations since. Its current structure and functions are largely based on the law adopted in 2009, which grants the NBG independence in the formulation and implementation of monetary policy. This independence is vital for the bank's credibility, allowing it to make decisions free from political pressures that could lead to suboptimal economic outcomes. The NBG's structure enables it to focus solely on its mandate of price stability and financial sector health, without interference from short-term political objectives. Unfortunately, in the first half of the 2020s, there have

been signs of increasing political interference by the ruling party in the NBG's decision-making process.

The year 2023 was particularly challenging for the NBG's independence. It began with the appointment of the former Minister of Economy as the first vice-president of the NBG—a position newly created by parliament to overcome the deadlock in appointing the NBG president. The situation escalated with the "Partskhaladze case,"[1] which led to the resignation of three of the four NBG Vice-Presidents. This case gave clear signs that the ruling party was exerting a strong and direct influence over the NBG's decision-making, forcing the bank to alter its compliance rules to avoid sanctioning the ex-prosecutor and businessmen closely associated with the GD party. In 2024, the NBG continued to function under the guidance of the first vice-president, raising concerns that drastic reductions in the monetary policy rate might be influenced by upcoming elections and the turbulent political environment rather than long-term monetary policy projections.

Georgia operates a floating exchange rate regime, where the value of the Georgian lari (GEL) is determined by market forces without a fixed peg to any other currency. This regime provides the NBG with the flexibility to adjust its monetary policy independently of external influences, which is particularly important for a small, open economy like Georgia. However, the NBG does engage in foreign exchange interventions to prevent excessive volatility in the exchange rate that could destabilize the economy. These interventions are generally aimed at smoothing out short-term fluctuations rather than targeting a specific exchange rate level. Between 2014 and 2024, the GEL exchange rate to the United States dollar (USD) declined by approximately 35%. Notably, this decline ended in the early spring of 2020, when the GEL hit its lowest point in a decade. Since the post-COVID recovery, the GEL's value to the USD has been increasing, with frequent corrections. The invasion of Ukraine also resulted in a prompt weakening of the GEL, but since then the exchange rate has been strengthening. This phenomenon can be explained by the inflow of people and the accompanying monetary assets from the countries involved in the war.

As mentioned earlier, the main objective of the NBG monetary policy is to ensure price stability. Price stability involves maintaining a moderate and predictable rate of inflation over the medium term. The NBG believes that achieving an annual inflation rate of 3% over the medium term is crucial for maintaining price stability, serving as one of the key indicators of the health of medium-term monetary policy.

3.1.2 Fiscal Policy Targets

In 2023, the fiscal deficit, including budget lending, was 2.4% of GDP, outperforming the projected deficit of 2.8% due to higher-than-expected revenues. The 2024 budget aims for a deficit of 2.5% of GDP. This goal will be supported by increased revenues from corporate income tax (CIT) for banks and new gambling taxes, which will fund higher expenditures, including increased wages, social benefits, and capital investments. Public debt is projected to stay below 40% of GDP in 2024 and over the medium term. The inflow of Russian and Ukrainian migrants has positively affected

[1] Otar Partskhaladze, a former Georgian prosecutor general who was accused of violence and involvement in extortion, was sanctioned by the US. NBG changed procedure for implementing the sanctions regime and adopted an amendment to the order of the President of NBG dated August 4th, 2023, #208/04, that let Partskhaladze to retain access to accounts for a short period of time.

the fiscal deficit by increasing revenue streams. This trend is illustrated in Figure 1, which shows that the target indicators have outperformed the projections set by the MoF of Georgia. However, these external factors also pose a high risk, as the reversal of these phenomena remains a real possibility.

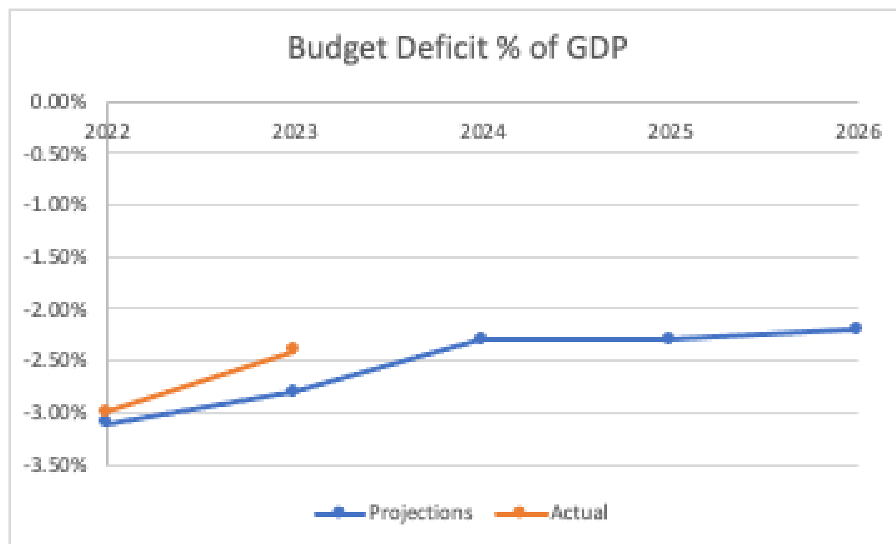

Figure 1: Budget deficit as a percentage of GDP 2022–2026 (Source: MoF)

Meanwhile, the public debt-to-GDP ratio in 2023 has been reduced to 40%, in line with the policy target outlined in the strategy, down from 62% in 2020. Notably, once Prime Minister Garibashvili took over the administration in 2021, one of his early controversial decisions was to refuse acceptance of EU macro-finance assistance packages designed to help manage increased state expenditure due to the COVID-19 pandemic. At the time of the decision, the debt-to-GDP ratio was at a historic high, and the decision was explained as a measure to counter the potential threat of increasing debt. Georgian President Salome Zourabichvili called the decision to refuse the EU loan incomprehensible for her and most Georgian people, stating the potential risks of affecting the country's future rating and foreign investors' mood (Georgian Public Broadcaster, 2021). Notably, even at 40%, the debt-to-GDP ratio is relatively high compared to historical levels, which have typically been closer to 30%, except for the post-war recovery period in 2009/2010, as shown in Figure 2.

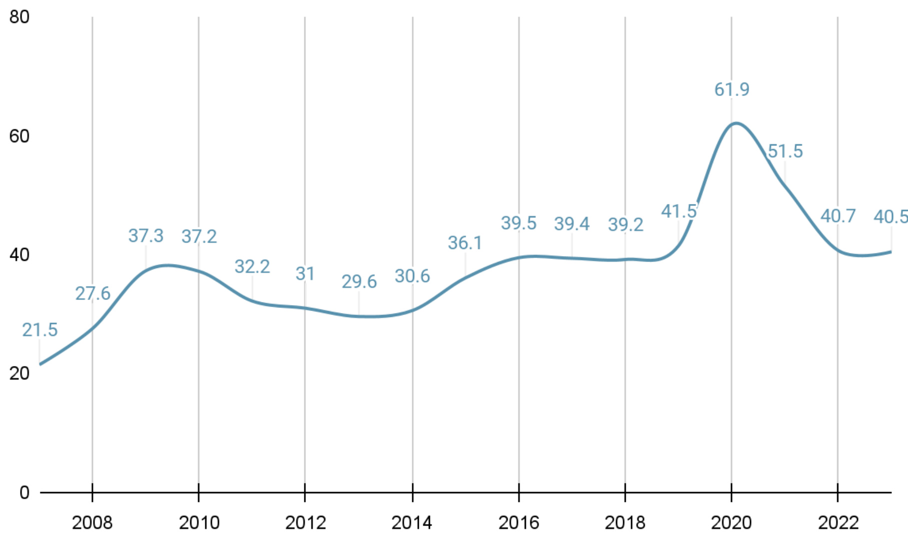

Figure 2: Public debt ratio (%) to GDP 2007–2023 (Source: MoF)

Effective coordination between fiscal and monetary policies is essential for achieving macroeconomic stability in Georgia. This coordination is facilitated through regular consultations and policy dialogues between the NBG and the MoF.

3.1.3 External Conditionalities

Georgia's macroeconomic policy has been shaped by external conditionalities imposed through international agreements and recommendations from global and regional organizations. This is a common trend among small developing economies as they seek to integrate with larger economic blocs. The International Monetary Fund (IMF) has had a significant influence, providing financial assistance and policy advice through programs such as the Stand-By Arrangements (SBA) and the Extended Fund Facility (EFF). These programs often include conditionalities aimed at maintaining fiscal discipline, enhancing monetary policy effectiveness, and implementing structural reforms.

The EU also exerts considerable influence, particularly through the AA and the DCFTA. These agreements require Georgia to align its regulations with EU standards, promoting trade, investment, and economic integration. The EU's assistance programs further support governance reforms and sustainable development initiatives. However, recent messages from EU representatives have been notably negative, especially in the context of the newly adopted "law on foreign agents." This could lead to reduced cooperation between the EU and Georgia, and diminish the influence of EU policymakers on the future development of the Georgian economy.

The World Bank's Development Policy Operations (DPOs) and technical assistance programs provide additional external conditionalities, focusing on public sector efficiency, social policy improvements, and infrastructure development. These programs encourage Georgia to pursue policies that enhance economic resilience and promote inclusive growth.

Finally, Georgia's commitments as a member of the World Trade Organization (WTO) require adherence to global trade rules and periodic policy reviews. These commitments promote trade liberalization, protection of intellectual property rights, and participation in the WTO dispute settlement process.

3.2. Macroeconomic stability: historical perspective and current situation

The Georgian economy has been on an upward trend since the early 2000s. This growth is not surprising, given the drastic backdrop following the collapse of the Soviet Union, which left ample room for improvement. Over the years, the Georgian economy has undergone significant transformations, eventually developing into a market-centered, open economy that is strongly integrated into the global economy. While openness has brought numerous benefits, it has also exposed the Georgian economy to the impact of external factors. Key phases in the development of Georgia's economy have often been shaped by the interplay of internal and external influences.

3.2.1. Economic growth

Being highly dependent on external factors, the Georgian economy has mirrored the economic tendencies of the rest of the world (Figure 3). Consequently, economic performance can be divided into four major phases.

Before 2008, Georgia recorded a high growth rate, outperforming the growth record of both advanced economies and emerging markets. However, the Russian invasion in 2008, even if it lasted less than a fortnight, severely damaged the Georgian economy by reducing inward foreign investments. The 2007–2008 global financial crisis (GFC) added to the already increased uncertainty, leading to a sharper dip in the Georgian economy compared to advanced and developing economies. Recovery from 2008 was swift, but the double-digit growth seen before the crisis was not recovered. The growth rate remained on par with emerging markets in the following years, with increased volatility mostly dictated by internal political developments. The Russian invasion of Ukraine in 2014 had little to no impact on the economic growth rate in Georgia. While it affected certain areas of the economy, the overall growth rate remained rather intact. One could argue that due to its smaller size and increased flexibility, Georgian markets have avoided negative spillovers from regional conflicts as long as international markets remain intact. On the other hand, the COVID outbreak had a very negative effect, as the Georgian economy shrank by 7% in 2020. However, recovery was swift, recording double-digit growth rates in 2021 and 2022. Lately, growth has stabilized and reduced to the mean, but according to the IMF it is projected to remain higher than the global average.

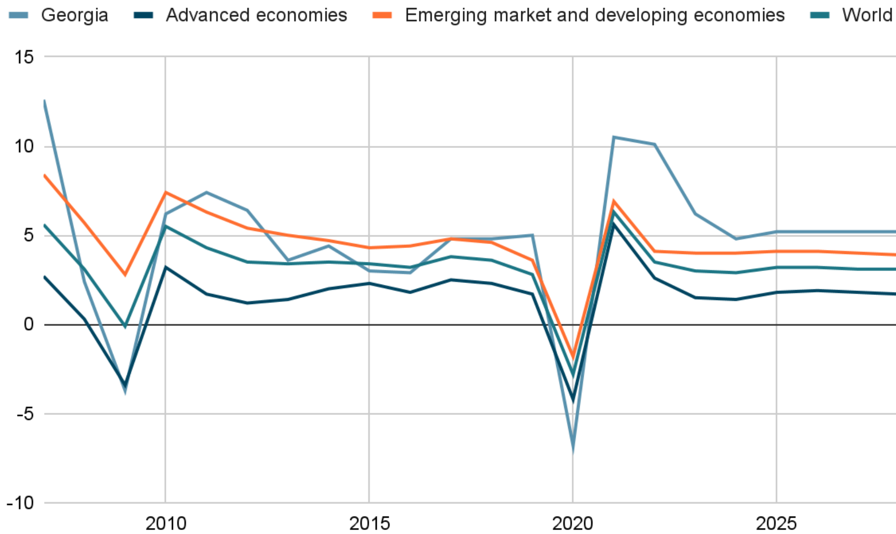

Figure 3: Economic growth: Real GDP growth, annual change (%) 2007–2028 (Source: IMF)

Post-COVID recovery has been recorded in all sectors, but it has been led by the service sector (Figures 4 and 5). The rapid increase in the number of foreign citizens in Georgia contributed to the increased output of services, positively affecting the construction industry as well (NBG, 2024). However, starting in 2023, growth has stalled in the industrial sector, and the Georgian economy has increasingly relied on its service sector with no signs of improvement in industry and agriculture. The data from the first quarter of 2024 shows positive signs, as the output of the industrial sector has increased. Meanwhile, the growth of the service sector remains positive but slowed down compared to the same period in the past three years.

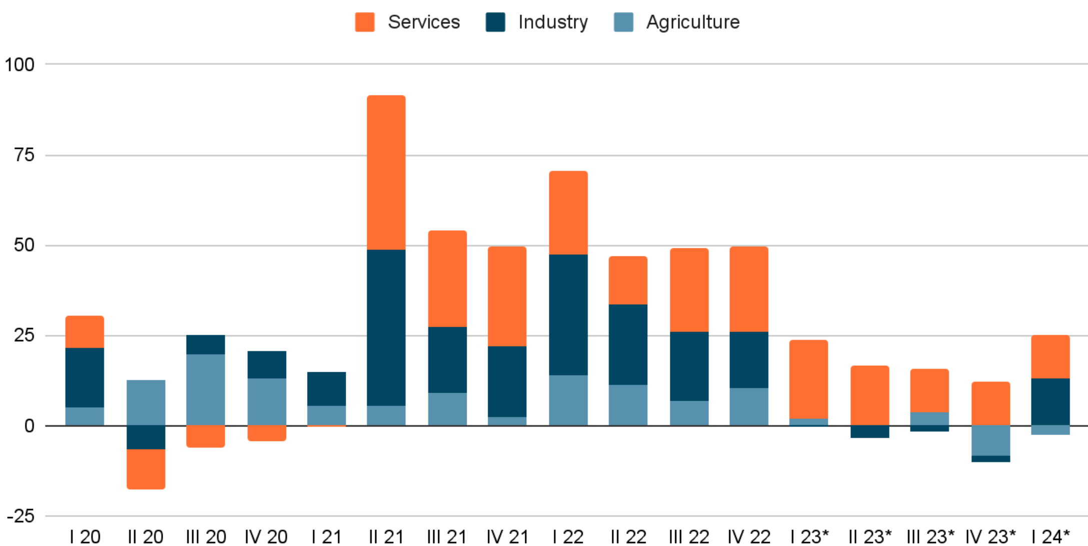

Figure 4: Real GDP growth quarterly change (%) by economic sectors (Source: National Statistics Office of Georgia)

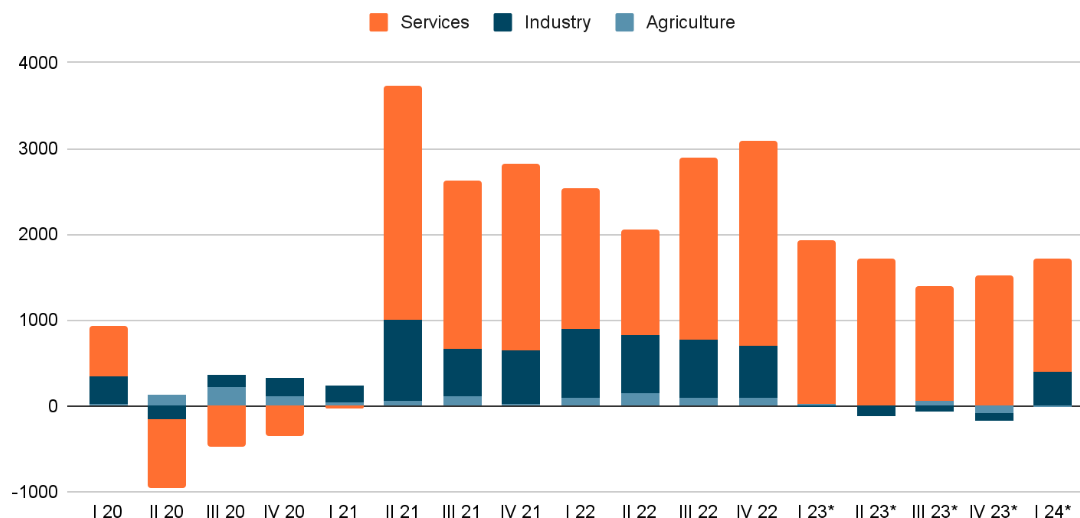

Figure 5: Real GDP growth quarterly change (at current prices, GEL million) by economic sectors (Source: National Statistics Office of Georgia)

3.2.2. Balance of payments

The Georgian economy has been marked by high levels of volatility. Due to its openness and small size, external factors have a direct impact on the balance of payments (BOP). The BOP's current accounts capture data on net exports, primary income (earnings from the provision of factors of production), and secondary income (redistribution of income through current transfers, such as non-governmental transfers and remittances, which are particularly significant for Georgia).

Over the years, Georgia's current account balance has remained in deficit (Figures 6 and 7), primarily due to a negative balance in the trade of goods and services. The country's size, scale, and high level of integration into the international market have resulted in the negative trade balance constituting a persistent issue, which Georgian economists have struggled to address. While demand for services has been increasing in recent years, the trade deficit in goods continues to deepen. On the other hand, remittances and private sector transfers (Secondary Income) have been key sources of inflow, helping to reduce the current account deficit to a manageable level.

In 2020, the impact of the COVID-19 pandemic on the Georgian economy was severe, and the current account deficit increased to a record high of USD 712.3 million in Q4 2020. Disruptions in global supply chains and reduced tourism revenues were significant contributors to such a spike in the current account deficit. High deficits persisted in 2021 due to reduced global trade and mobility, as well as ongoing COVID-19 restrictions and high infection rates.

A remarkable turnaround occurred in 2022, with Q3 recording a substantial surplus of USD 325.9 million, the largest surplus recorded in any economic quarter since 2000 (according to NBG data). This improvement can be attributed to a recovery in global demand, increased exports, and a rebound in the services sector, particularly tourism. However, the year ended with a deficit in Q4, once again demonstrating the ongoing volatility. 2023 followed a similar pattern, recording large deficits in the first two

quarters, an improved balance in Q3, and a deficit in Q4. Preliminary data for 2024 indicates a similar trend as both Q1 and Q2 have recorded negative balances for current accounts.

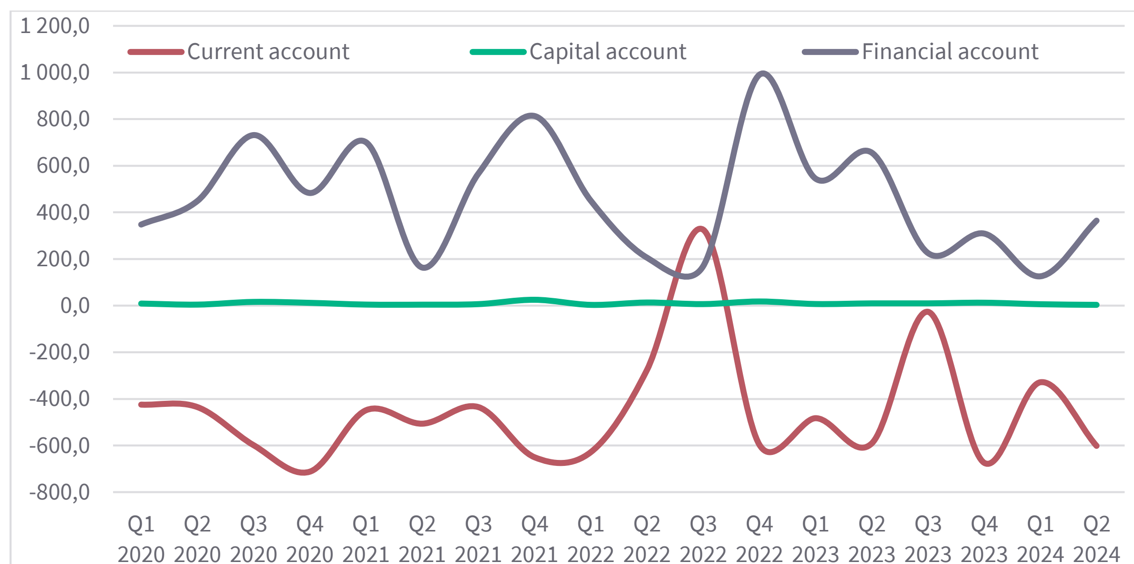

Figure 6: Balance of Payments – Current, Capital and Financial Accounts (Excluding Reserves and Related Items) 2020/Q1-2024/Q2, million USD, (Source: IMF)

As mentioned, the primary driver of Georgia's current account balance has been the trade in services, which exhibits clear seasonality. The third quarter (Q3) typically generates the highest inflows from service exports, largely due to the peak tourist season in Georgia. Notably, trade in services was one of the primary catalysts for the country's rapid economic recovery. However, it would be naive to assume that this recovery was solely powered by tourism inflows.

In September 2022, the first wave of mobilization in Russia led to a significant number of Russians leaving their country to avoid being drafted and sent to war. This coincided with Q3, which saw a substantial increase in demand for Georgia's service sector. The timing suggests that the influx of Russian nationals played a crucial role in boosting service exports during this period.

Another interesting observation is the role of service exports in Georgia's current account during the economic crisis from Q4 2020 to Q4 2021. During this period, service exports experienced a significant decline, while other components of the current account remained relatively stable. This decline highlights the vulnerability of Georgia's service sector to external shocks and underscores the importance of diversifying the economy to enhance resilience.

In addition to the challenges in the trade of goods, another area recording a negative balance has been primary income (profit repatriation from foreign direct investment (FDI) and interest on foreign debt). International investments negatively impact the current account of BOP due to the repatriation of profits from foreign-owned enterprises. While attracting FDI has contributed to the growth of the Georgian economy and the development of the labor market, the increasing outflow of income

due to foreign ownership and foreign borrowing exacerbates the negative primary income balance. Although this phenomenon is common among similar economies, it highlights the need to further improve the domestic investment climate, encourage the reinvestment of investment income within the country, and strategically manage foreign debt to reduce the burden of interest payments.

The BOP's financial account has been following an opposite trend to that of the current account, as it primarily offsets the deficit created recorded in the latter (Figure 6). The decomposition of the financial account can be seen in Figure 8, which provides insight into the types of investment. Financial derivatives and employee stock options remain unimportant, as there is no practice of utilizing these financial securities in the Georgian market. On the other hand, direct and portfolio investments, along with other types of investments, are the key drivers for the financial accounts.

Direct investment refers to a long-term interest and control by a resident of one economy (the direct investor) in an enterprise in another economy (the direct investment enterprise). In contrast, portfolio investment involves cross-border transactions in securities that do not grant significant control over the issuer, such as investments in fellow enterprises, debt, and reverse investment. Other investment serves as a residual category, encompassing all financial transactions not classified as direct or portfolio investments, including other equity, currency and deposits, loans, insurance, pensions, standardized guarantee schemes, trade credit and advances, other accounts receivable/payable, and special drawing rights (SDRs)[2].

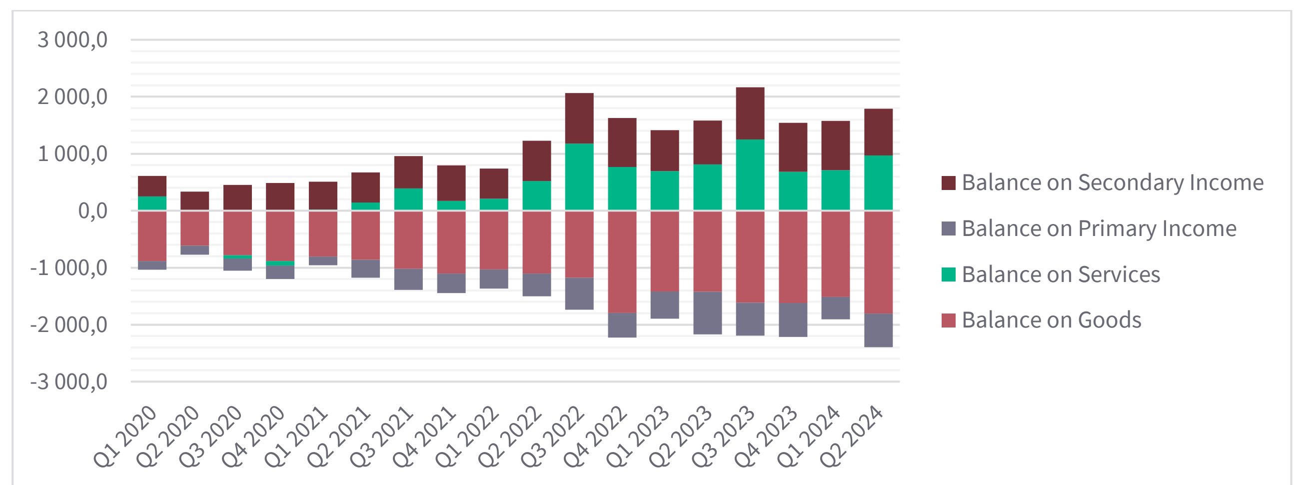

Figure 7: Balance of Payments – Current Accounts 2020/Q1-2024/Q2, by the flows, USD million, (Source: IMF)

According to the data mapped in Figure 8, the major type of investment outflows for Georgia's financial accounts comprises portfolio investments, while direct and other investments are the key sources of inflow for financial accounts. A significant spike in the outflow of portfolio investment was observed from Q2 to Q4 in 2022, while at the same time there was a significant increase in direct and other types of investments. This period coincided with an influx of visitors to Georgia, but the change is most likely due to the increased inflow of Russian-owned ventures and companies on the Georgian

[2] Further details on IMF methodology can be seen in the IMF's *Balance of Payments Manual* and *Balance of Payments and International Investment Position Manual*.

market, as it was one of the few ways used by Russian citizens to avoid international sanctions imposed on Russian banks. On the other hand, the outflow of the portfolio investments can be explained both by Russian citizens using the Georgian market to liquidate and transfer funds and by international investors being driven away by the regional developments.

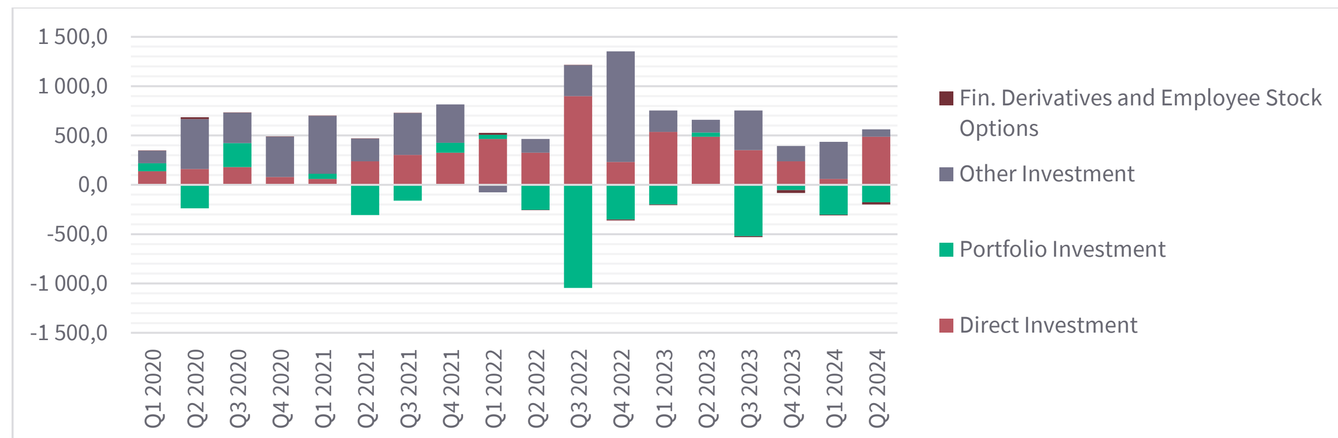

Figure 8: Balance of Payments – Financial Accounts 2020/Q1-2024/Q2, by the flows, USD million, (Source: IMF[3])

From the second part of 2023, the balance for financial accounts has stabilized; flows have been reduced to a similar level as in 2020–2021.

The International Investment Position (IIP) indicates whether a country is a net creditor or debtor. Georgia holds a net debtor position, meaning its liabilities exceed its assets. This has been caused by net FDI inflow, net inflow of other investments, and net foreign borrowing. Georgia has consistently been a debtor country, but the magnitude of its net international investment position has been gradually increasing over the years. This trend has continued in recent years without any drastic changes. Neither the COVID-19 pandemic nor the war in Ukraine has significantly altered Georgia's IIP. However, it is worth noting that there has been a slight increase in the growth rate of liabilities starting from late 2022.

Georgia's gross external debt has been on a consistent upward trend, reflecting the country's growing reliance on external borrowing (Figure 10). The total gross external debt rose from USD 17,855.09 million in Q1 2018 to USD 24,539.60 million by Q1 2024. This increase affected several sectors, including the general government, the central bank, deposit-taking corporations (except the central bank), as well as direct investment in intercompany lending. The growth was accelerated by increased government spending in 2020 and 2021. From 2022, public borrowing was reduced, but the debt of commercial banks started to climb. From Q1 2022 to Q1 2024, debt among private banks has grown by approximately 50%. Such growth in the short term can be explained by the increased demand for liquidity, which has been created by the inflow of people into Georgia.

[3] In the IMF Balance of Payments (BoP) methodology, financial account flows are recorded with a negative sign for net inflows (e.g., foreign investments into the country) and a positive sign for net outflows (e.g., domestic investments abroad). For clarity, the signs have been adjusted in this chart: net inflows are displayed as positive values, and net outflows are shown as negative values. This adjustment is intended to make the chart more intuitive for the reader.

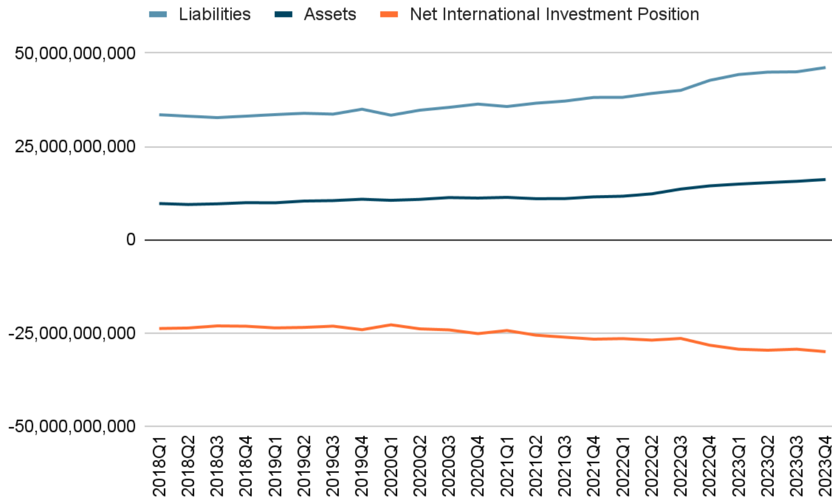

Figure 9: International Investment Position (IIP) 2019/Q1-2023/Q4, USD, (Source: IMF)

Other sectors, which include private enterprises and non-bank financial institutions, experienced fluctuations but generally trended upward, reaching USD 4,653.04 million by Q1 2024. This sector's debt dynamics can be linked to increased foreign participation in Georgia's economic activities and the growing need for external financing in the private sector. On the other hand, direct investment in intercompany lending, a component of FDI, exhibited more variability, peaking at USD 3,433.29 million in Q2 2023 before slightly declining to USD 2,998.71 million in Q1 2024. This fluctuation may reflect changes in multinational corporations' strategies, including profit repatriation and internal capital reallocations.

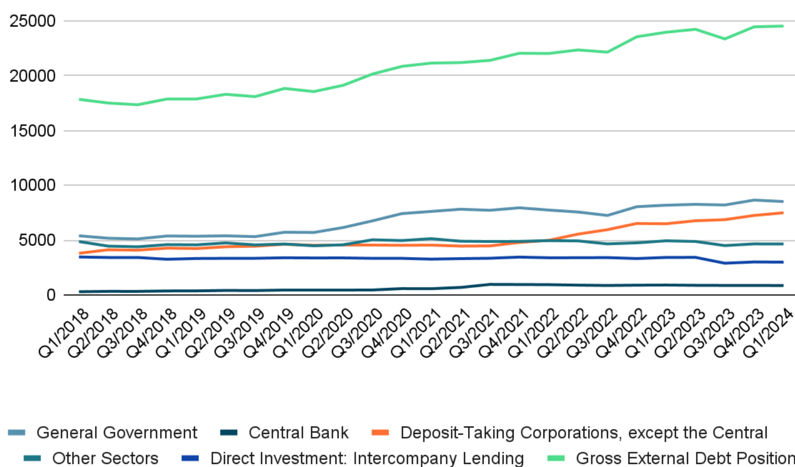

Figure 10: Gross External Debt, 2019/Q1-2023/Q4, USD million (Source: NBG)

3.2.3. Fiscal Situation

Georgia's general government expenditure and revenue dynamics highlight both fiscal challenges and opportunities for economic stability. Government revenue, primarily

driven by taxes, has remained consistent, ranging between 25% and 29% of GDP from the time of GFC (figure 11). Since 2011, 90% of revenue has been generated through taxes, while grants and other contributions cover the remaining 10%. In Georgia's context, social contributions have historically been a smaller share of general government revenue compared to countries with more extensive welfare systems. This is due to the relatively low levels of mandatory contributions and a narrower scope of public social insurance programs. Georgia's heavy reliance on tax revenue, such as VAT and income taxes, proved to be consistent over the years, but vulnerable to economic shocks. As a result, general government expenditures have grown at a faster pace, particularly during periods of economic shortfalls. For instance, during the COVID-19 pandemic in 2020, expenditures surged to over 34% of GDP as the government implemented fiscal measures to support public health, social protection, and economic recovery.

The expenditure-to-revenue gap has led to persistent fiscal deficits, requiring external borrowing to bridge the shortfall. While spending on infrastructure, healthcare, and education supports long-term economic growth, high expenditure levels strain fiscal sustainability if not matched by revenue enhancements. The trend of isolation, which the Georgian government has been following in the 2020s, is putting fiscal health under further strain. With increased isolation and a shaky political landscape, the debt is expected to get more expensive, further increasing the deficit. Addressing these shortcomings requires reforms to broaden the tax base, improve efficiency in public spending, and prioritize investments that yield high economic returns to ensure a more balanced and sustainable fiscal position.

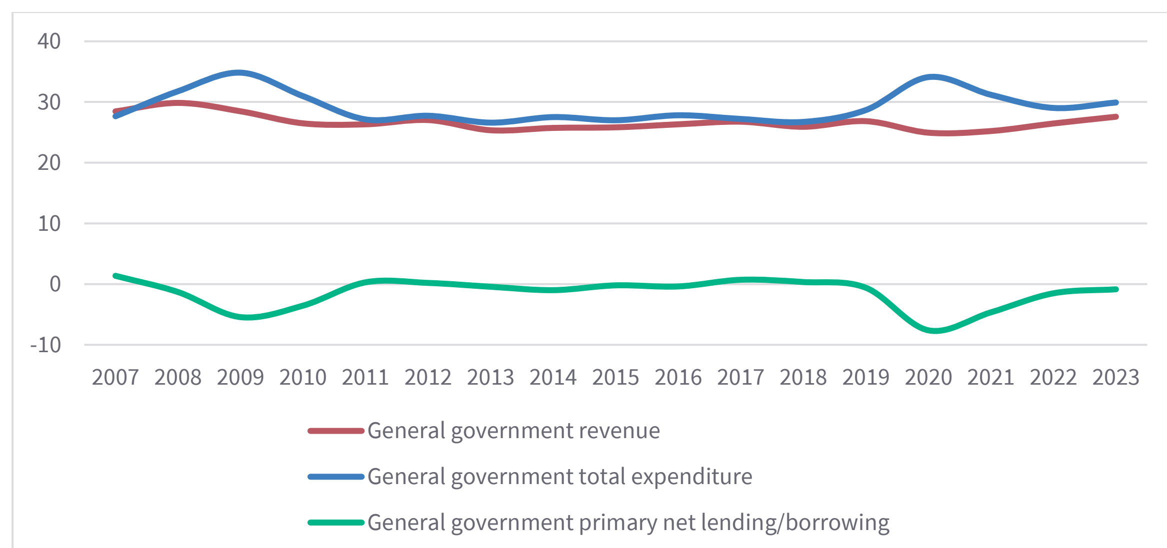

Figure 11: General government revenue, expenditure and primary net lending/borrowing, % of GDP (Source: IMF WEO Database)

3.2.4. External financial aid flows

External assistance has been crucial for Georgia's economic development, positively impacting both the BOP and the budget. This international aid can be divided into two main groups depending on the source: multilateral and bilateral.

Multilateral assistance comes from international financial and development institutions such as the IMF, the World Bank, the International Finance Corporation (IFC), the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB), and regional and multilateral organizations such as the EU, the United Nations (UN), and the Organization for Economic Co-operation and Development (OECD). This type of aid typically focuses on broad economic reforms, infrastructure projects, and sector-specific initiatives helping to stabilize and grow the economy.

Bilateral assistance, on the other hand, is provided directly by individual countries. Key bilateral partners for Georgia include the US, Germany, Japan, and various other European nations. This aid often supports specific projects or sectors, such as healthcare, education, and governance reforms, tailored to the needs and priorities of the Georgian government.

3.2.5. Monetary policy and inflation

The monetary policy is primarily led by the NBG as described in the previous parts of the chapter. One of the key indicators for monetary policy is broad money (M3) which reflects the total money supply in the economy. It serves as a key indicator for assessing the liquidity in the economy and the potential for inflationary pressures.

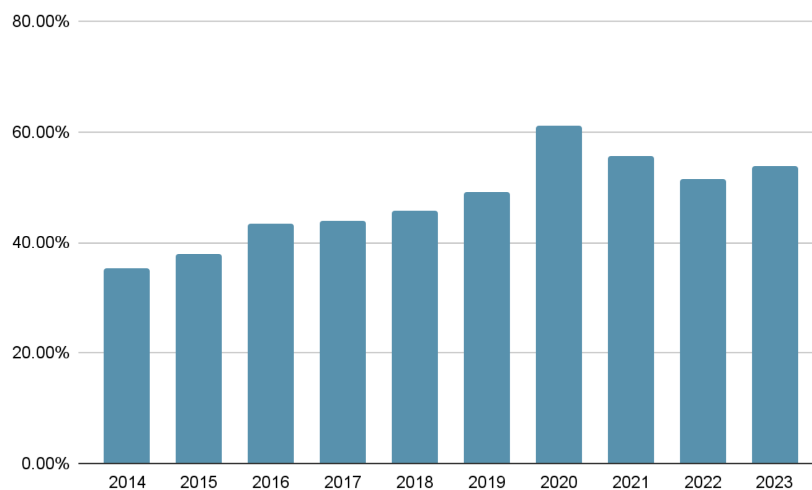

Figure 12: Share of Broad Money (M3) as % of GDP, 2014–2023 (Source: World Bank)

The share of broad money as a percentage of GDP reached its peak in 2020, which can be attributed to reduced spending by the general population and enterprises, higher interest rates, and GDP contraction. The level of broad money has been steadily increasing over the years. The reduction of interest rates is expected to further encourage spending, thereby increasing the level of broad money. Additionally, with increased business activities, the share of M3 as a percentage of GDP also rose in 2023, indicating that the influx of foreigners has further increased money demand. This situation presents a potential issue: the rapid outflow of foreigners could lead to decreased demand for money, potentially resulting in higher inflation rates and the need for the NBG to tighten monetary policy.

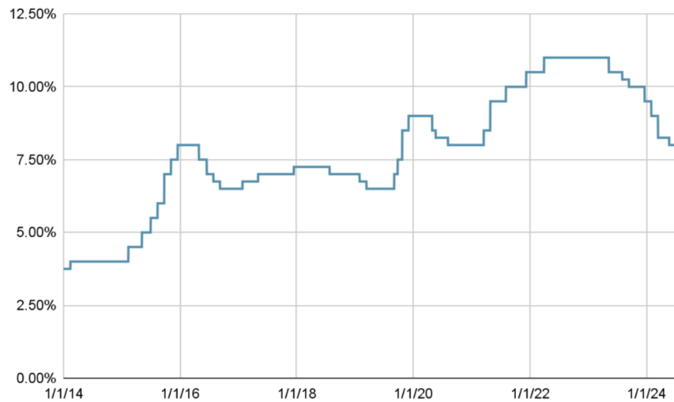

Figure 13: Monetary Policy Rate (%), 2014–2024 (Source: NBG)

The interest rate has been a key tool used by the NBG to manage monetary policy and keep the money supply at a manageable level. The interest rate is particularly important for Georgia, as external factors significantly influence inflation, and adjusting the monetary policy rate is a primary means of managing this impact. Starting in 2020, the NBG tightened the monetary policy rate in response to economic challenges, making borrowing more difficult. Recently, however, the policy rate was reduced to 8% (see Figure 13), which was still relatively high compared to advanced economies and even compared to the rates practiced before the COVID-19 outbreak. The tight monetary policy has been justified by the high inflation rates.

Inflation in Georgia is monitored closely, with the NBG setting an inflation target of 3%. Both monetary factors, such as money supply and interest rates, and non-monetary factors, such as global commodity prices and supply chain disruptions, impact inflation. The NBG's policies aim to control these pressures to maintain price stability. Inflation has been a persistent issue for the Georgian economy, and it drastically spiked because of the COVID-19 pandemic. This spike was caused by the increased strain on logistic chains and high uncertainties among consumers.

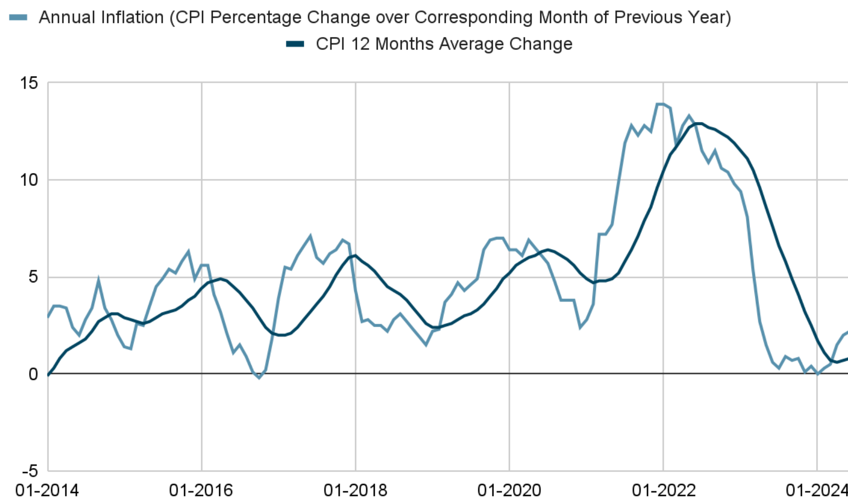

Figure 14: Annual Inflation, 2014–2024, in % (Source: NBG)

During 2022, the annual inflation rate reached double digits (Figure 14). It is important to note that inflation rates were high globally during this period, and Georgia was no exception. However, exchange rate fluctuations were an additional factor contributing to inflation.

Having a floating exchange rate and a small economy exposes Georgia to influences from changes in international financial markets. In particular, changes in demand for USD significantly impact GEL. Georgians have historically used USD for savings and large transactions, including purchasing vehicles, real estate, and bulk business purchases. Prices for these items are often denominated in USD, and payments are made in that currency. Despite the "larization" policy, which aims to encourage the use of the GEL for both savings and commerce and discourage the use of USD, the policy has not been entirely successful in stabilizing the exchange rate.

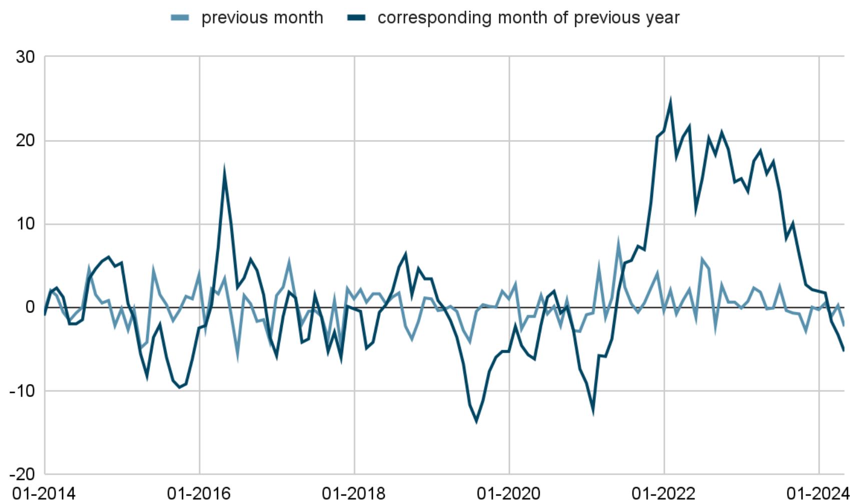

Figure 15: Real Exchange Rate[4] Indices of GE, 2014–2024, in % (Source: NBG)

The increased demand for GEL in 2023 had a positive effect on the real exchange rate year-over-year (Figure 15). This surge in demand was primarily driven by an influx of people, particularly from Ukraine and Russia, seeking refuge or relocating to Georgia. The internal demand for GEL was further bolstered by the depreciation of other regional currencies, making the GEL a more attractive and stable option.

For many, the GEL provided a safer alternative amid the economic uncertainties in their home countries. The influx of people not only increased the direct demand for the GEL but also contributed to the local economy through consumption and investment, further strengthening the currency. The geopolitical instability in the region, coupled with economic turmoil in neighboring countries, led to a preference for holding assets in GEL over other regional currencies, which were perceived as riskier.

This trend was beneficial for the Georgian economy, as a stronger GEL helped mitigate inflationary pressures by reducing the cost of imports, particularly of essential goods and commodities. However, it also posed challenges to export competitiveness, as a stronger currency could potentially make Georgian goods more expensive for foreign buyers. This issue particularly affects internally produced goods and services, though it is unlikely to significantly change the overall export picture in the near term, as re-exported goods are typically denominated in USD or other foreign currencies, minimizing the immediate impact.

In 2024, Georgia experienced a significant decline in real exchange rates, driven by several factors. Firstly, political instability and controversial decision-making by the governing parties undermined confidence in GEL. This uncertainty prompted both domestic and foreign investors to seek safer assets, contributing to currency depreciation. Additionally, the unusually strong performance of the GEL in the

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[4] Real Effective Exchange Rate presents evolution of the REER index based on the CPI. It is computed as a weighted geometric average of the real exchange rates to the major trade partners' currencies (Eurozone, Turkey, Azerbaijan, Russia, Ukraine, China, Armenia, USA, Bulgaria, and Poland). Read More at: https://nbg.gov.ge/fm/%E1%83%A1%E1%83%A2%E1%83%90%E1%83%A2%E1%83%98%E1%83%A1%E1%83%A2%E1%83%98%E1%83%99%E1%83%90/exchange_rates/eng/exchange-rates-statisticseng.pdf?v=mekpd

previous year created a challenging comparison base, exacerbating the perception of a sharp decline.

The October 2024 elections pose an additional risk to the GEL, as election years are often marked by increased exchange rate volatility. Political campaigns and policy uncertainties can lead to fluctuations in investor sentiment and capital flows, negatively impacting the stability of the currency. The combination of these factors creates a complex environment for the GEL, necessitating careful monitoring and potentially responsive measures from the NBG to stabilize the currency and maintain macroeconomic stability.

3.3. Primary Sources of Macroeconomic fragility and key macroeconomic risks

Georgia's economy faces several key vulnerabilities that threaten its macroeconomic stability. One significant concern is the country's rising levels of public and private debt. While still within manageable limits, the increasing debt burden poses long-term fiscal sustainability challenges, especially in the face of potential economic shocks. High private-sector debt, particularly within the banking sector, also raises concerns about financial stability if the economic environment worsens (see Chapter 4).

Institutional weaknesses and governance issues further exacerbate Georgia's economic fragility. These include inefficiencies within public institutions and SOEs as well as regulatory and policy uncertainties. Such issues can hinder economic efficiency, deter investment, and contribute to a lack of confidence among both domestic and foreign investors.

3.3.1. Macroeconomic Outlook

In 2024, the IMF and other international organizations such as the World Bank and the ADB, have provided a cautiously optimistic outlook for Georgia. Despite multiple shocks, including the COVID-19 pandemic and regional conflicts, Georgia's economy demonstrated resilience with a robust growth rate of 7.5% in 2023. However, growth is expected to moderate to around 5% in 2024, with consumption becoming a more significant driver of economic activity. Inflation, which fell to 0.4% by the end of 2023, is projected to rise to 4% in 2024, reflecting the normalization of external conditions and adjustments in monetary policy (ADB, 2024; EBRD, 2024; IMF, 2024a).

3.3.2. Domestic Weaknesses

Georgia's domestic economic weaknesses are marked by a high debt burden, both public and private, and challenges in generating sustainable fiscal revenues. The country is struggling to create high-quality jobs, with a substantial portion of the workforce engaged in low-productivity sectors such as agriculture. Access to finance, especially for small and medium-sized enterprises (SMEs), remains limited, exacerbating the mismatch of skills and hindering economic growth. Furthermore, governance issues, including the need for comprehensive SOE reforms, continue to pose significant challenges, impacting investor confidence and economic efficiency (IMF, 2024a; World Bank, 2024).

3.3.3. External Challenges Related to the War in Ukraine

The war in Ukraine has significantly impacted Georgia's economic landscape. The influx of migrants and associated financial inflows provided a temporary boost to the economy. However, these effects are expected to normalize, potentially widening the current account deficit. The regional instability and ongoing geopolitical tensions also threaten Georgia's trade and investment flows, particularly with key partners. As an economy heavily reliant on external markets, Georgia remains vulnerable to global economic shifts and disruptions in trade (EBRD, 2024).

Chapter 4. Financial sector stability in Georgia

4.1 Introduction

The financial sector of Georgia has developed alongside the country, facing the same challenges and erratic growth trajectory seen during the first decade of independence (1992–2004). In particular, lax regulation and a banking boom in the years immediately following the fall of the Soviet Union, coupled with political turmoil, triggered a major banking crisis in 1994 that only subsided due to a thorough restructuring of the system in 1997 (Amaghlobeli, Farrell, and Nielsen, 2003). Once this was completed, even the Russian financial crisis of 1998 had a relatively short-lived impact on the financial sector, while reforms in the real economy starting in 2003 began to shift Georgia away from its dependence on Russia and toward the West. Not surprisingly, these reforms resulted in growth and, in the case of the financial sector, a vast increase in the efficiency, size, and number of financial institutions.

During the GDC of 2007–2009, the banking sector saw major problems in terms of liquidity, mainly because the country was also facing an invasion from Russia at the same time and relied on funding from international donors (including the EBRD and the IFC, an arm of the World Bank Group). While the real economy was substantially impacted, the financial sector continued a period of consolidation and resumed growth, with the sector remaining heavily concentrated in banking: the IMF's financial stability assessment in 2020 noted that the proportion of the financial sector concentrated in banking had increased from 93% in 2015 to 94% in 2020 (IMF, 2021). The improvement in financial sector supervision during this period also helped the Georgian financial sector weather the storm from the rounds of sanctions imposed on Russia (and on the West by Russia) following Russia's first invasion of Ukraine and illegal annexation of Crimea. At the same time, buffers in place at the beginning of the COVID-19 pandemic also helped banks weather the storm, though at the cost of profitability (IMF, 2021).

As in neighboring Armenia, the second and full-scale Russian invasion of Ukraine precipitated a large influx of Russian money into demand deposits in Georgia, accompanied by a large exodus of Russian nationals. Many were fleeing sanctions on the Russian financial sector for the relative safety offered by Georgian banks. Demand deposits of all types increased by 40% from 2022 to 2023, but the size of the sector relative to GDP remained fairly stable (and had decreased since its highs in 2021, likely due to GDP contraction during the pandemic). During this period, the number of banks and their ownership structure also remained stable, suggesting that earlier reforms and measures to build a more resilient financial sector in the country may be paying off. However, the prospect of wider regional uncertainty (as with Nagorno-Karabakh and the war between Armenia and Azerbaijan) and global unrest (Russian escalation or success in its attempts to subjugate Ukraine) could once again impact the Georgian economy and its financial sector, and not for the better. Meanwhile, internal political turmoil surrounding the elections in mid-2024, plus a recently adopted amendment to the tax code (Gabritchidze, 2024), are the main challenges facing the Georgian financial sector.

4.2. The Banking Sector

As already noted, the banking sector (as in other countries still in transition) dominates the financial sector in Georgia, concentrating approximately 95% of the entire financial sector's assets as of 2022 (National Bank of Georgia, 2024). In terms of the sector's overall importance to the economy, by 2020 assets in the banking sector alone amounted to 115% of Georgia's GDP, although this decreased in the post-Covid environment (Figure 15). While the early 2020s have been associated with moderately stable performance in the sector, especially in commercial banking, further attention should be paid to the historical vulnerabilities along with potential threats and shortcomings associated with political discourse and public perception.

4.2.1. History of the Banking Sector

The development of Georgia's banking eco-system has followed a non-linear path. While its origins date back to Soviet times, it acquired its relevancy only after the country's independence had been regained. During the early 1990s, the number of private banks grew rapidly, reaching 179 by the end of 1993 (Amaghlobeli, Farrell, and Nielsen, 2003). However, the number of commercial banks continued to grow in the years to follow, as a result of high inflation, which reduced the minimum capital requirement to USD 500 (Kloc and Valliere, 1999). Many of the newly emerged banks primarily served the interests of a small number of private companies, providing them with low-interest loans (Kloc and Valliere, 1999). Once their objectives were fulfilled, these banks would just disappear. The misdeeds of these so-called "pocket banks" left a lasting leagacy of distrust toward the banking sector (along with other financial institutions) in Georgia. Such feelings can be detected in the low levels of trust that Georgians have in banks (Caucasus Research Resource Center, 2021).

4.2.2. Size of the Sector

Arrayed against the negative effects of sanctions, the Russian invasion of Ukraine has, as in neighboring Armenia, led to a large influx of Russian assets into Georgian banks. According to the NBG, as of May 2023, almost USD 1 billion (GEL 2.42 billion) was held in Georgian banks by Russian nationals (Menabde, 2023). As the war has dragged on and Russia has come no closer to attaining its goals, this level has increased, with the NBG reporting a total of GEL 3.5 billion (USD 1.32 billion) in deposits in Georgian banks by Russians as of February 2024 (Civil.ge, 2024d). As they comprise 7% of all deposits in the sector, the NBG has been careful to build a reserve buffer around these potentially "hot" deposits, setting liquidity requirements for these accounts at 80%. In February 2024, after Russian deposits in Georgian banks had stabilized, this was lowered to the standard level of 40% for non-resident deposits. However, the broader trend of dollarization in Georgian banks persists; by the end of 2023 50.8% of all deposits were held in foreign currencies, with the remainder in GEL. Despite the relative levelling-off of Russian deposits—which of course remain a short-term liability for banks—there remains the danger of either large outflows (should Russia make progress in subjugating Ukraine) or even more inflows (should Ukraine turn the tide). In either scenario, financial stability would be affected, and the NBG needs to keep an eye on banks' foreign currency deposits and their ability to weather short-term volatility. Additionally, the decision to ease the transition of offshore capital into Georgia by exempting it from profit tax and personal income tax carries the potential

to further increase the scale of foreign currency deposits, entailing added vulnerabilities and potential instability for the financial sector.

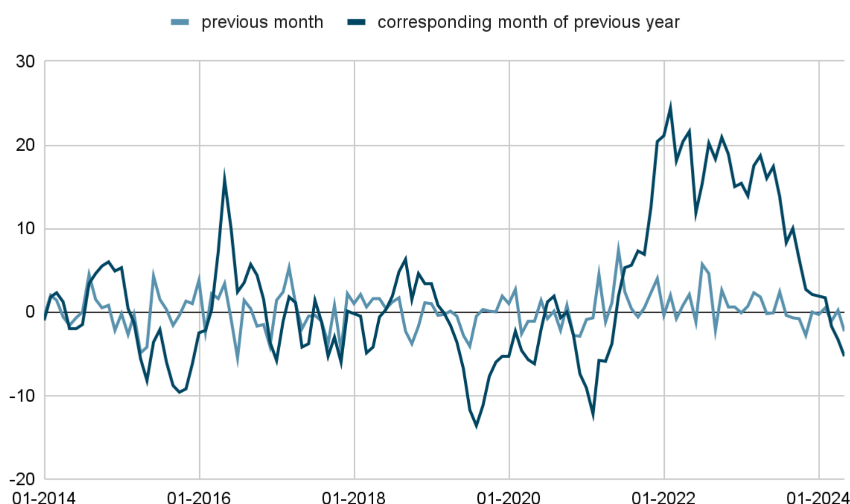

Figure 15. Size of the Banking Sector in Georgia as a % of GDP, 2007–2023 (source: National Bank of Georgia)

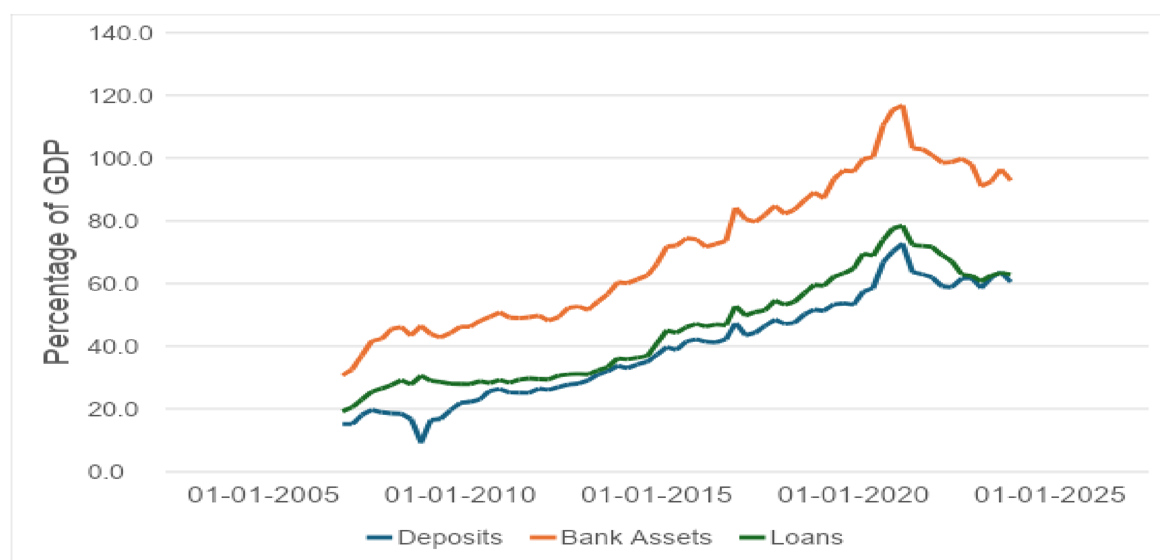

Figure 16: Size of the Banking Sector in Georgia as a % of GDP, 2007–2023 (source: National Bank of Georgia)

4.2.3. Concentration, Flagship Banks

As of the end of 2023, there were 15 commercial banks in operation, with a total of 146 branches and 759 service centers across the country. Of these banks, four stood out as the largest, with the Bank of Georgia (BoG) the undisputed leader. Holding 38.79% of assets and 41.98% of deposits, BoG is only rivalled by TBC Bank, which is the leader in terms of loan portfolio (39.40% of total loans versus 36.87% for BoG). Both BoG and TBC Bank list their shares on the London Stock Exchange, a mark of quality that is not lost on investors in the region. Nevertheless, the concentration of assets in only

two banks (accounting for over 70% of most bank metrics, including assets, loans, and deposits) makes the Georgian banking system somewhat more vulnerable. In one sense, the system is built on two "too-big-to-fail" banks, with 13 smaller ones cleaning up niche and more dispersed markets.

To give an example of this concentration, these two banks are followed by Liberty Bank, consistently third in most categories, but with a far smaller share of the Georgian market (averaging 5% of the sector in loans, liabilities, and other metrics). Finally, the Russian invasion of Ukraine also pushed out VTB Bank (Georgia), the fully Russian-owned subsidiary in Georgia, from the top 4 banks. In 2021, VTB Bank was running neck-and-neck with Liberty Bank for third place in the Georgian market, but has since fallen to twelfth as sanctions have begun to bite (KPMG, 2024). This is quite interesting where VTB Bank is concerned, since it decided to leave the Georgian market in June 2022 after it was prohibited from providing services to individuals and borrowers. Subsequently it sold most of its assets and liabilities to BasisBank (now the fourth largest bank in Georgia), but it still holds a portfolio of deposits and in particular income-generating loans. Even before the war VTB Bank was under scrutiny, and for example in 2021 it was fined GEL 70,000 by the NBG for breaches of laws on money laundering and financing terrorism (Agenda.ge, 2022).

4.2.4. Ownership Structure

Besides this Russian influx, a key attribute of the banking sector in Georgia is that foreign owners and investors participate in overwhelming majorities compared to domestic-only banks. Like Armenia, and in a welcome sign of best practices, Georgia has no state-owned banks, having privatized early. In addition the government allowed foreign ownership in the financial sector very early in the transition process (Clarke, Cull, and Shirley, 2005), leading to growing shares of foreign participation. According to NBG data 98% of assets held in commercial banks in 2022 were with institutions that had 50% or more foreign capital participation. This reliance on foreign capital has consistently been the case in Georgia, but it became even more pronounced in 2016, when after a series of consolidations in the industry resulting from the shock of 2015–16 the number of banks with less than 50% foreign participation dropped from 6.5% of the banking sector's assets to a mere 0.24%. While the case of VTB Bank (Georgia) has been discussed, even with its withdrawal from the Georgian market, 13 of the 15 commercial banks operating in the country have substantial foreign investment. Moreover, Georgian banks have begun to make forays into neighboring countries, with the Bank of Georgia—again, the largest bank in the country—signing a deal in early 2024 to take over Ameriabank, one of Armenia's largest commercial banks (Interfax, 2024). In this sense, Georgian banks have learned from their foreign investors and are now branching out on their own to become owners in foreign lands.

4.2.5. Savings, Deposits and Saving Behavior

Savings by Georgians have been steadily growing over the past decade, accelerating from 2016 –17 (Figure 17), the year when the gap in the volume between deposits in foreign currencies and in local currency widened. The reason behind this development can be found in the growing inflation of the national currency. As Aslanishvili and Omadze (2016) put it, the period from 2014 to 2016 was the third and harshest monetary crisis for Georgia. In 2016, the NBG pushed out a policy designed to discourage the

use of foreign currency (de-dollarization). However, the short-term success of the "larization" policy has been questionable, as well after 2016 the GEL was still depreciating, and the gap between savings in local and foreign currency remained large. It was only by 2023 that the gap had closed somewhat with the rapid growth of deposits in GEL, associated with the inflow of Russian money.

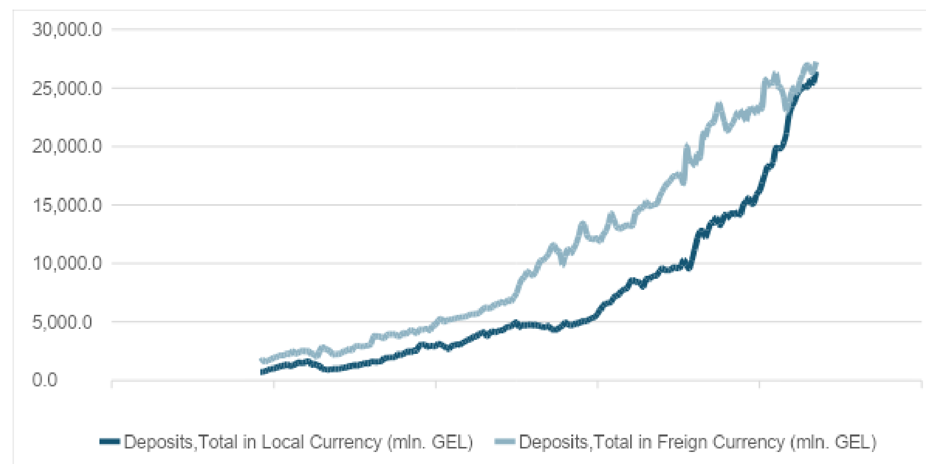

Figure 17: Volume of Currency Deposits of Legal Entities and Households in Commercial Banks (GEL million, NBG)

4.2.6. Credit Dynamics

In terms of credit dynamics, the banking sector in Georgia has been moving in lockstep in terms of its lending behavior: loans make up the largest portion of assets in the banking sector, accounting for approximately 68% of all banking assets at the end of 2023. This lending has been primarily directed to households, which accounted for 54% of all loans in 2023, followed by trade loans (a mere 10% of the total). The largest group of loans in the banking sector as a whole is that of "loans secured by real estate" (i.e., mortgages), making up 34% of loans in 2023; for the sake of comparison, the outstanding amount of mortgage loans is equal to 73% of all loans given to industry in the same year. Overall, loans have been growing steadily, with year-on-year growth of 14.9% from 2022 to 2023, continuing a trend of 5% growth from 2021 to 2022. From the end of the GFC (2010) to 2023, the aggregate loan value grew by a staggering 755%, with household lending growing by 252% from 2015 to 2023.

4.2.7. Non-Performing Loans and Other Sources of Vulnerability

Georgian banks have also seen an increase in their profitability. The return on assets in the sector increased to 3.41% in 2023 (from 3.16% in 2022), while return on equity has remained around the level of 24%—since the end of the COVID-19 pandemic, hitting historical highs in terms of the net profits in all banks in the sector (hitting GEL 2.1 billion in 2022) (KPMG, 2024). Perhaps more encouragingly from the point of view of financial stability, banks have also been able to keep a lid on problematic lending in the sector. According to the IMF, the Georgian banking sector has also done an excellent job in keeping non-performing loans (NPLs) low; as Figure 18 shows, NPLs peaked during the GFC at slightly over 6% of all loans, and have been consistently between 2 and 3% since (and have been falling since COVID-19 in tandem with the increase in bank profitability). The only risk manifesting itself here is the issue of foreign currency

loans, as NPLs in foreign currencies have consistently been higher than those denominated in GEL; geopolitical tensions surrounding the war in Ukraine can make such loans far more expensive, as was seen during the economic shock in 2015-16 (and again during COVID-19).

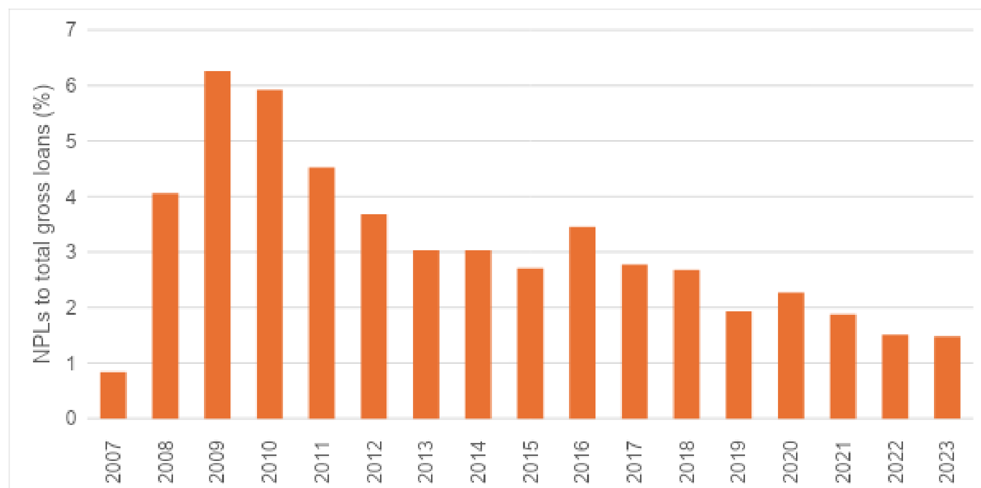

Figure 18: Non-performing Loans as % of Total Gross Loans, 2007–2023 (Source: International Monetary Fund)

A final point about the banking sector relates to broader macroeconomic concerns and monetary policy in particular. The post-COVID-19 recovery and the increase in inflation, coupled with the shock of the Russian invasion of Ukraine, forced the NBG to raise its policy rate to its highest point since the GFC, reaching a level of 11% in 2022 and early 2023. The NBG has pulled back from these highs, with the April 2024 rate at 8.25%; the reality is that the banking sector has done fairly well in stabilizing through some very difficult times, and now that credit conditions are easing, it should be performing even better.

4.2.8. Exposure to Russia

The inflow of Russians has had a marginally positive impact on Georgia's economic indicators. However, as has been a pattern in the Georgian economy for decades, the positive performance of economic indicators is not necessarily reflected in the standard of living (Salomé, 2024). Meanwhile, every crisis directly affects the average Georgian household. Consequently, short-term gains from the Russian influx are not expected to translate into sustainable long-term gains for the economy, except for perhaps becoming additional leverage in the hands of Russian stockholders.

4.3. Non-banking financial institutions

As with other countries examined under this project, Georgia's non-bank financial institutions, including pension funds, insurance companies, microfinance institutions, credit unions, and investment funds, remain a small part of the overall financial sector. According to NBG data, the non-bank financial sector accounted for a mere 9.38% of banking sector assets in 2022, and only 8.57% of all assets in the Georgian financial sector (excluding financial auxiliaries such as stock exchanges and other securities, which will be treated below). If we use the NBG's definition of microfinance

organizations, loan issuing entities, currency exchange units, and credit units as non-bank institutions, this proportion shrinks even more to 3.16% of all assets (down from a high of over 8% in 2016).

Going beyond the NBG's definition, the second largest pool of finance in Georgia comes from pension schemes, which accounted for approximately 4% of all assets in the financial sector in 2022. Pension assets began to rise rapidly in 2018 due to an ambitious pension reform which transferred 6% of a worker's salary into individual savings (with the worker paying 2%, and the employer and the state each paying 2%); from 2018 to 2022, the amount of pension assets increased by GEL 170 million to approximately GEL 3.6 billion, an increase of 1,692%. As the pension reform continues to mature—and in tandem with the fact that the government has placed a priority on increasing assets in the pension funds—this figure will likely continue to increase in coming years.

4.4. Capital Markets

Unlike the banking sector and the stratospheric rise of pension assets, the Georgian Stock Exchange (GSE) has seen little increase in market capitalization since the Russian invasion of Ukraine, with the only change in the GSE occurring in August 2023 (Figure 19). The major increase that occurred then was the result of one deal, the placement of USD 150 million in 5-year bonds issued by Georgia Capital (an investment firm listed on the London Stock Exchange) to refinance Eurobond debt; this issuance had buy-in from international investors such as the EBRD due to its "sustainability" novelty, linked to Georgia Capital's net-zero plans (ISET, 2024). However, this one-off increase in capitalization should not be mistaken for an increase in the importance of the GSE in the Georgian financial sector, as for the most part the GSE remains a little-utilized source of funds for Georgian businesses. According to the financial media Commersant.ge, the total number of deals concluded on the GSE in the whole of 2023 was a mere 29 (up from 19 in 2022!), with the only deals other than the Georgia Capital issuance involving either Liberty Bank or Bank of Georgia (Commersant.ge, 2023).

Figure 19: Total Capitalization in the Georgian Stock Market, GEL million (Source: Georgian Stock Exchange)

As the USAID report on the capital market in Georgia notes, "At present, the market suffers from deficiencies in both the issuance of financial instruments on the supply side and the participation of investors from the demand side" (ISET 2024, p. 3.). Despite the government's goal to achieve market capitalization at 6.5% of GDP (before 2023, it was falling annually, standing at approximately 4% of GDP), turnover ratios remain low and have been falling since 2018, while the total number of listed companies at end-2023 was only eight. In an attempt to revitalize the market, the Georgian government enacted new and forward-looking legislation on the securitization of transactions, which came into effect in April 2024. These legislative moves have been positively received by investors; however, it is too early to assess their short-term impact, and Georgia cannot rely on one large deal per year to drive capital market growth. Thus, as with the other countries explored in this report, the threat to financial stability from capital markets is low, primarily due to their underutilization and their need to develop. In fact, as in Armenia, the threat that comes from capital markets does not lie in their potential to harm the financial sector but the very fact that they are underutilized; a more robust capital market could allow for diversification away from banking and provide resilience and alternative sources of capital for Georgian businesses.

4.5 Financial regulation

The NBG is the sole financial regulator in the country, overseeing banks, non-bank institutions, and capital markets in their entirety. While the model of a single regulatory authority has fallen out of favor internationally (with many countries now preferring to delegate financial stability and regulation to separate bodies), this approach remains prevalent across the Caucasus and, at least in Georgia, has seen some success. Indeed, in this role, especially concerning the banking sector, the NBG has adhered to international standards and best practices and has improved over time; as noted by the

IMF in 2021, "the NBG has strengthened the legal and regulatory framework for the financial sector by implementing Basel III standards and prudential tools, including for responsible lending and dollarization-related risks" (IMF 2021, p. 21). An early mover in this regard, already by 2014 the NBG had "*introduced an advanced risk-based supervisory regime while maintaining a conservative approach aimed at detecting vulnerabilities at an early stage and allocating supervisory resources in the most efficient and effective manner*" (International Monetary Fund 2014 pp. 9–10). In recognition of the foreign participation in the banking sector, the NBG is also conservative in its treatment of foreign exchange risks, imposing higher risk weights (150%) on foreign exchange lending—and thus making banks that engage in this lending hold larger buffers of reserves. Additionally, the NBG also adopted the International Financial Reporting Standards (IFRS) at the beginning of 2023, basing its *Regulation on Identifying Risk Categories of Financial Instruments and Expected Credit Losses* on IFRS 9 and bringing the country closer to EU standards.

Much like other central banks internationally, NBG also produces an annual financial stability report, covering the main risks that they see for stability within the sector and focusing on the macroprudential tools and forecasts of the Bank. The NBG also developed a financial stability department in 2017, making it responsible for macroprudential policy and integrating the work of financial stability with other divisions of the Bank. As part of this work, the NBG has created a risk assessment framework "that combines micro- and macroprudential supervision in one process," making it a constituent part of the supervisory process (Martin et. al, 2018, p. 8.). The magazine *Global Finance* scores central banks globally on their abilities, and NBG has come in consistently as an "A-," just off the top grade of "A," due mainly to the commitment of the NBG to maintaining both macroeconomic and financial stability (Domat et. al, 2022). The only points that the IMF noted in terms of improvements were communication with banks on supervisory actions, and conducting deeper assessments of bank corporate governance (IMF 2021).

Summary: Main Sources of Financial Fragility and Risks

Georgia's financial sector, overwhelmingly dominated by banks, has faced shock after shock in the past 15 years, although it has weathered the storm admirably. While the banking sector faces a problem of concentration—with two banks dominating assets, deposits, and loans—the regulatory framework and general conservative approach of the NBG have ensured an effective macroprudential environment. Indeed, the problems that the financial sector may face all relate to concentration: not only in terms of the size of banks, but also the concentration of assets in the banking sector rather than diversification across banks, non-bank institutions, and capital markets. The government of Georgia has set goals for developing its capital markets, but this requires more than just government planning and needs broader development of the real economy. Similarly, the concentration of deposits in foreign currencies—and the concentration of Russian money in Georgia—also pose threats to future financial stability.

As with other countries explored under this project, the geopolitical situation and the progress of Russia in its invasion of Ukraine will also color the risk premium that Georgia's financial sector institutions will face. Russian success will undoubtedly act as a drag on the financial sector's performance, either in terms of increasing risk or

precipitating capital outflows (as Russians withdraw their deposits). However, as noted above, Georgia's banking sector in particular has a keen awareness of risk management, and many of the necessary safeguards for financial stability have been put in place by the NBG. Despite its difficult position sharing a border with Russia and in a neighborhood of conflict, Georgia's financial sector has in many ways outperformed. And with an easing environment, it appears that it might continue to do so.

Chapter 5. External economic relations

Modern Georgia has been shaped by the aspiration to become a full-fledged member of the international community. Its small size, openness, and wide array of economic ties reflect the country's willingness to engage in economic relations, regardless of political agenda. While maintaining a close economic dependency on Russia is one example of Georgia's governments prioritizing short-term economic gains over potential threats and the long-term health of the economy, its geographical position along with its political openness toward working with "everybody" has enabled Georgia to serve as a vital trading bridge between Europe and Asia. Moreover, the country's trade and investment landscape has been shaped by various agreements and memberships, fostering deeper economic integration with partners worldwide.

5.1 The role of external trade in the Georgian economy

Georgia has been highly dependent on international trade. When describing this dependency, a few key criteria should be mentioned. First and foremost, the size of the trade turnover has been approximately similar to the nation's entire GDP. It would therefore be rather hard to imagine the Georgian economy surviving in its current state without active participation in international markets. On the other hand, Georgia is a small country with limited resources and manufacturing capacity, frequently relying on international partners to source goods and commodities. For example, Georgia's energy sector is highly dependent on imports (discussed in Chapter 6). Additionally, basic commodities such as wheat are also largely imported. These dependencies in the economy create the need for Georgia to remain actively engaged with its trade partners, even if those partners do not always adhere to principles of fair play. Russia, for example, has frequently attempted to exploit its economic ties with Georgia, using them as leverage to influence domestic policymaking. Nonetheless, Georgia continues to actively engage in economic activities with its northern neighbor, despite the risks involved.

Georgia has preferential trade agreements with all countries of the Commonwealth of Independent States (CIS), Turkey, the EU, countries of the European Free Trade Association (EFTA) and with the People's Republic of China and Hong Kong (Revenue Service, 2020). Furthermore, Georgia benefits from the Generalized System of Preference (GSP) in its trade with the US, Japan and Canada. This system enables developed economies to offer non-reciprocal agreements to developing countries by reducing tariffs or through duty-free entry on pre-determined products. Furthermore, Georgia has been a member of the WTO since 2000. Its membership serves as the foundation upon which trade relationships with the rest of the world have been framed.

The key milestone for Georgia's European integration is the DCFTA agreement with the EU, effective since 2014[5]. The DCFTA has opened the EU market to Georgian products and services, while also aligning Georgia's regulations and standards with those of the EU. Notably, before DCFTA's adoption, Georgia was already benefiting from the GSP+ agreement with the EU. GSP+ was introduced in 2006, leading to

[5] Additional information along with the annual action plan can be seen at https://dcfta.gov.ge/en/

enhanced trade with the EU. Because of this, when the DCFTA was later adopted its impact on trade was marginal (Langbein & Guruli, 2021).

The Georgian government has been heavily reliant on external inflows to the economy. Alongside trade, FDI has had a significant importance for Georgia's economic development. Consequently, along with its set of trade agreements, Georgia has several bilateral investment agreements with partner countries to ease the process of investment. These agreements provide legal guarantees to investors, including protection against expropriation and the right to repatriate profits, which are critical to ensuring potential investors' security.

5.1.1. Trade openness

The overall international trade value (exports and imports combined) has always been close to Georgia's GDP. For a small economy, it is not uncommon to have trade turnover exceeding the country's GDP. In other words, Georgia fits the pattern rather well. Besides, trade plays a multifaceted role in the economy of Georgia. A significant part of it is based on the re-exporting of imported goods. For example, there are imports of used vehicles into Georgia, which are then re-exported.

The economy's openness has been steadily increasing. The trade share in GDP started from just above 80% in 2007, exceeded 100% in 2017, and peaked at around 117% in 2019. The fluctuations, particularly in 2018–2020, could be explained by external shocks caused by the COVID-19 pandemic and global economic slowdown coupled with regional political tensions. Despite these challenges, Georgia's dependency on international trade remains high, reflecting its limited domestic production capacity and heavy reliance on imports for essential goods and commodities, including energy and basic foodstuffs.

While Georgia's high trade openness offers numerous opportunities, it also exposes the country to significant risks, such as vulnerability to external shocks and global economic volatility. This vulnerability is compounded by the country's dependency on imports of essential goods that could be exploited during times of geopolitical tensions.

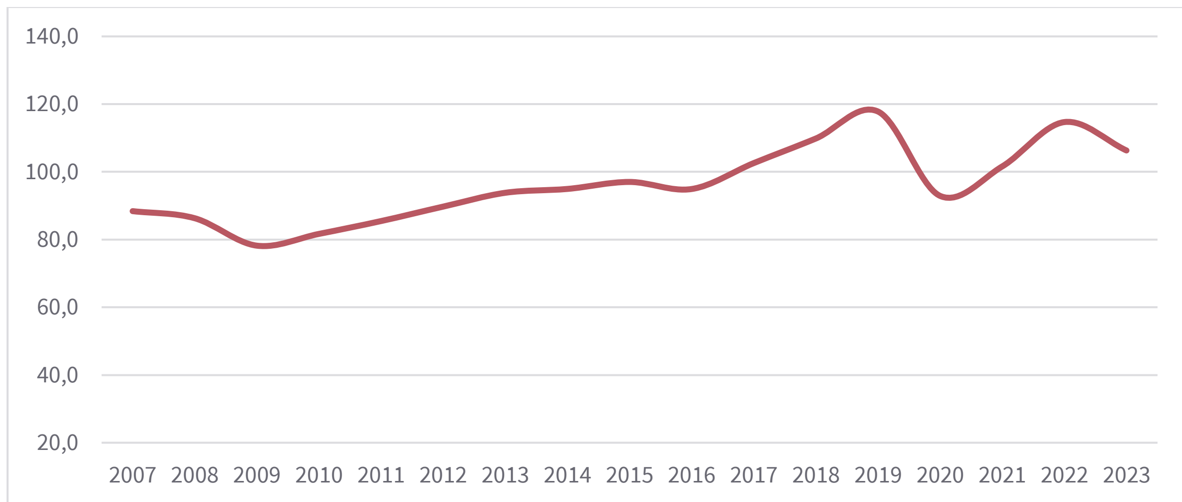

Figure 20: Trade in goods and services as a share of GDP, in %, 2007–2023 (Source: World Bank – World Development Indicators)

Moreover, the influx of imported goods puts considerable pressure on domestic industries, potentially challenging the growth and expansion of local businesses as they struggle to compete with cheaper or more diverse foreign products. For example, Georgian farmers have struggled to compete with cheaper produce from nearby countries. Russian wheat, in particular, has flooded Georgian markets with low prices, making local production less appealing and leaving Georgia almost entirely dependent on wheat imports (GBC, 2023). Meanwhile, the imports of cheaper goods from Turkey are further expected to negatively impact the competitiveness of domestic products according to the majority of Georgian economists (PMC Research, 2023).

This high volume of international trade also introduces substantial exchange rate risks. The constant flow of different currencies (notably, most of the trade by Georgian companies is invoiced in USD and EUR) in and out of the country leads to increased volatility of the GEL, making it challenging for businesses to plan long-term and for consumers to maintain stable purchasing power. This has also contributed to rising inflation, especially for goods like petrol. Local prices often remain high even when global prices drop, as importing companies maintain them at the level of their initial purchase. However, if international prices rise, they quickly increase local prices in anticipation of future purchases. Overall, the high trade-to-GDP ratio puts an additional strain on the Georgian economy, and requires careful economic management and diversification strategies to mitigate the inherent risks.

The structure of Georgian trade in goods has been relatively stable over the years, despite the increase in its overall volume (see Figures 21 and 22). Despite this stability, certain sectors have experienced faster growth than others. Notably, both exports and imports of machinery and transport equipment have surged since 2019. Although the re-export market for machinery and transport equipment is significant, it is not the sole driver of the rise in imports. The annual imports of these goods have been approximately twice as large as their exports.

This upward trend is mirrored in other sectors as well, although their growth has been more gradual and without major spikes. In imports, beyond machinery and transport equipment, significant growth has been seen in manufactured goods, mineral fuels and

lubricants, and chemicals. As for exports, from 2012 to 2023 the main growth was in food and live animals, as well as beverages and tobacco. However, the export value of raw materials (excluding fuels) and manufactured goods declined between 2019 and 2023.

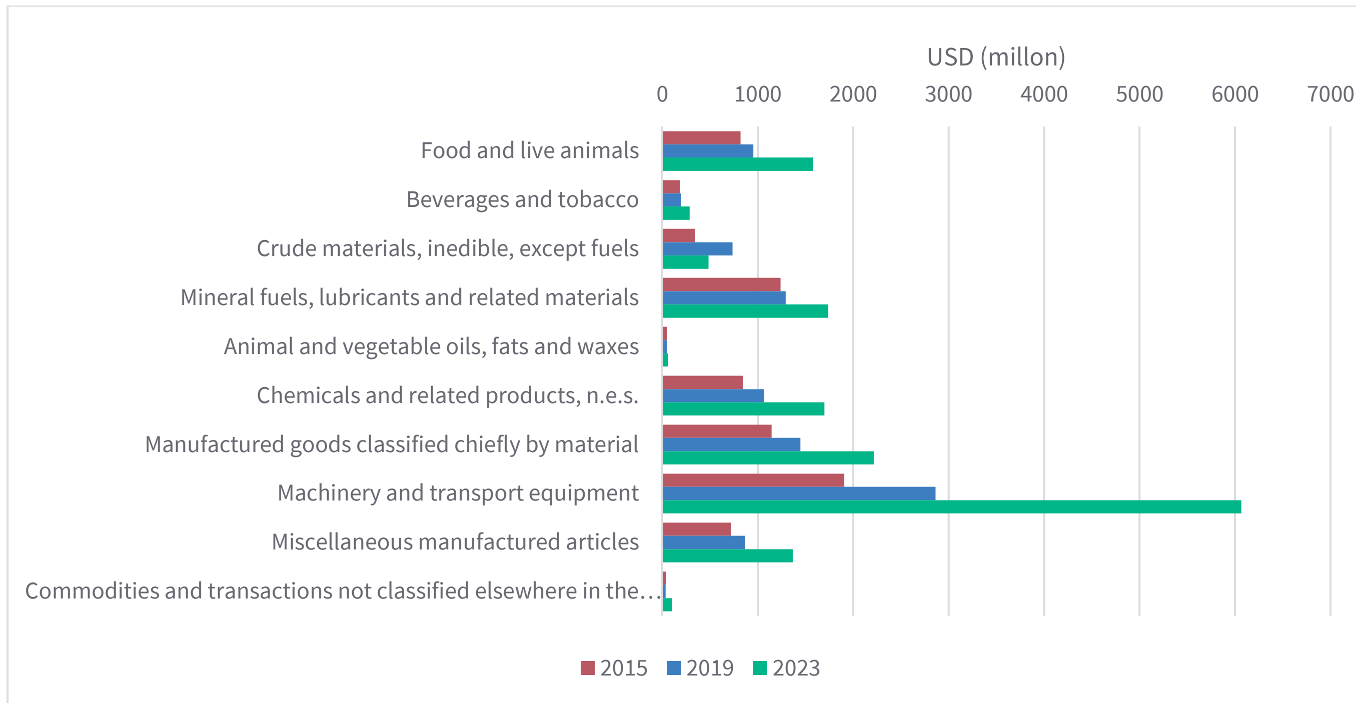

Figure 21: Import of goods (USD million) in 2013, 2019, 2023 (Source: UN Comtrade)

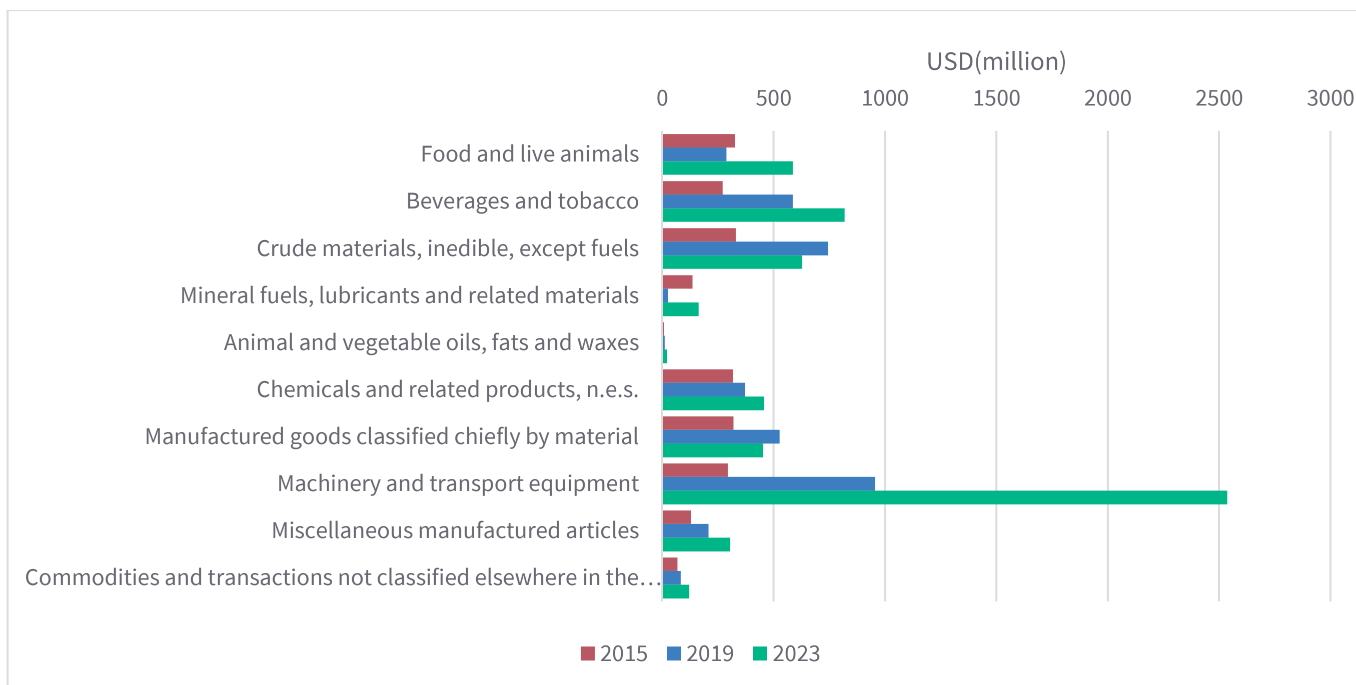

Figure 22: Export of goods in 2013, 2019, and 2023, USD million (Source: UN Comtrade)

5.1.2. The share of services in exports and imports

While the Georgian economy is heavily reliant on imports of goods, imported services account for a rather small part of the total trade. However, according to the data (Figure 23), imports of services have remained relatively stable over the years. There have been a few marginal peaks and drops during this period, but services' share of imports has remained at around 15% to 22% of the total. Meanwhile, services' have constituted a major part of Georgian exports. From 2007 (35%) there was growth in services' share of exports, and even the war in 2008 and consecutive economic crises did not significantly affect this share. In 2015, services became the main contributor to total Georgian exports (50.5%). They remained at this level until 2020, when services' share of exports dropped to a historic low of 26.7% (due to the COVID-19 related restrictions on travel and tourism, Georgia's most important service export sectors). The pandemic dramatically decreased international tourist arrivals, affecting hotels, restaurants, tour operators, and other related services.

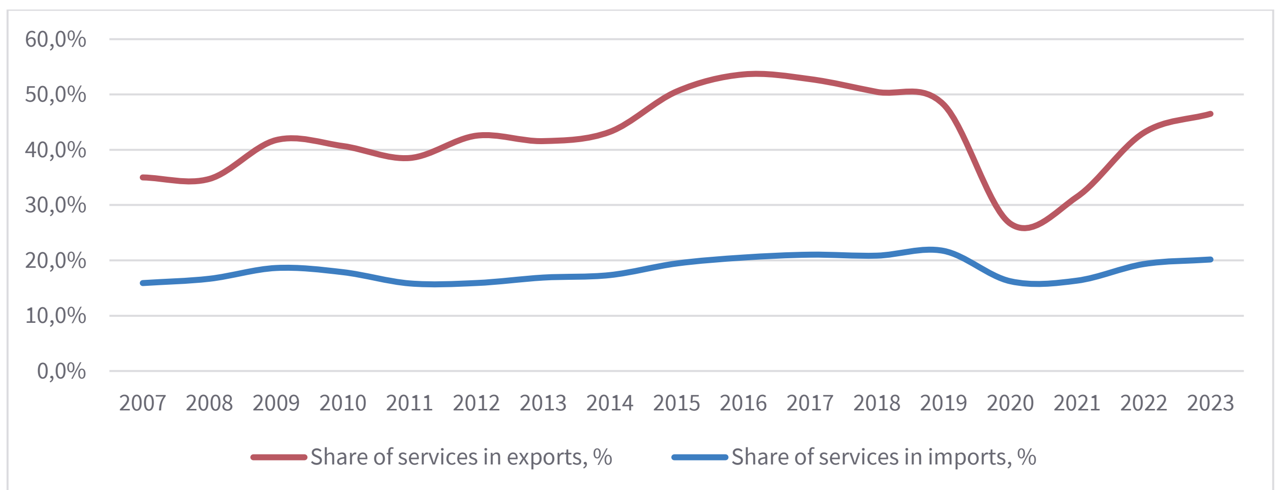

Figure 23: Share of services in imports and exports in Georgia 2007– 2023, in %
(Source: World Bank – World Development Indicators)

Services exports have been recovering steadily since 2021. However, their share has not yet reached the pre-pandemic levels. The pace of recovery began to plateau between 2022 and 2023, but it is still following an upward trend.

5.1.3. Trade balance

Georgia is currently recording a negative trade balance. Over the years, the Government of Georgia has been vocal about reducing this imbalance by promoting Georgian exports and domestic production. As mentioned earlier, high levels of dependency on international imports pose significant risks for the economy. The government has been marginally successful in reducing the negative trade balance. As Figure 23 shows, there has been some fluctuation in the scale of the negative trade balance as a share of GDP. The negative trade balance tends to deteriorate when the Georgian economy faces challenges, and shrinks when economic conditions improve.

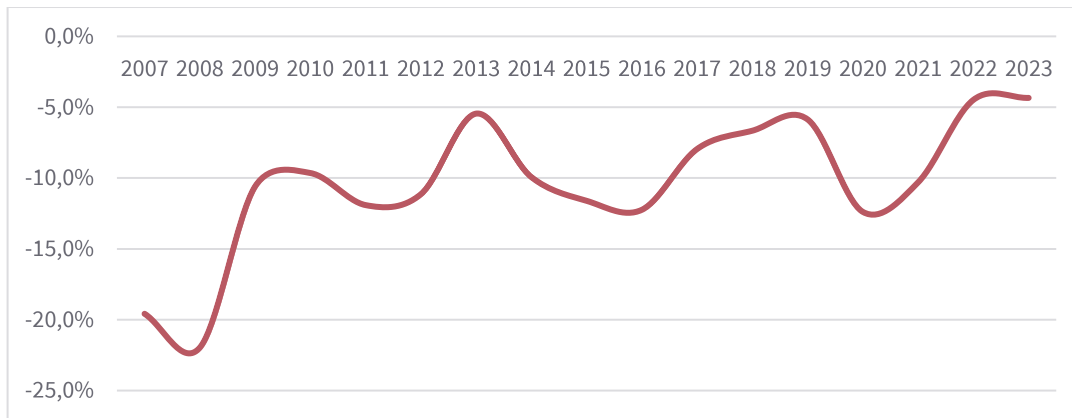

Figure 24: Trade balance as share (%) of GDP in 2007-2023 (Source: World Bank – World Development Indicators)

Figure 24 indicates that the trade deficit as a share of GDP was highest around 2009 (close to 20%), due to the war in 2008 coupled with the GFC. Following this, there were periods of partial recovery, with the trade balance improving somewhat but remaining negative. Peaks and troughs, as shown in Figure 23, highlight the ongoing challenges in balancing trade. Despite efforts to boost exports and domestic production, the negative trade balance persisted, fluctuating between -10% and -20% of GDP from 2010 to 2023. The post-pandemic recovery brought the negative trade balance down to its lowest point. The inflow of foreign citizens and the restructuring of the trade routes have positively impacted the Georgian economy.

Further exploration of trade balance data provides better insight into the factors influencing the fluctuations described here. The trade balance for goods and services has experienced different patterns of change, as various types of shocks have affected each differently.

5.1.4. Balance in trade in goods

External economic shocks, such as fluctuations in global commodity prices, regional political tensions, and changes in trade policies, have had significant impacts on the trade balance. Exports of goods are heavily dependent on raw materials (copper ores, ferro alloys) and agricultural products (hazelnuts, wine, citrus fruits) (Eradze, 2021). Due to the lack of sufficient production capacity, Georgia exports raw materials without processing them, which results in lost opportunities to create additional value added.

The negative balance in trade in goods amounted to around 20% of GDP in 2020–2023. Notably, neither the COVID-19 pandemic nor the war in Ukraine has had a significant impact on the trade balance. However, before 2015, the trade balance for goods was more volatile, marked by sharp fluctuations that reflected a less stable trade environment. This shift indicates that, in recent years, Georgia’s trade in goods has become more predictable. Despite this relative stability, the persistently high trade deficit highlights a structural challenge that may hinder long-term economic growth, emphasizing the need for policies aimed at enhancing export competitiveness and reducing the reliance on imports.

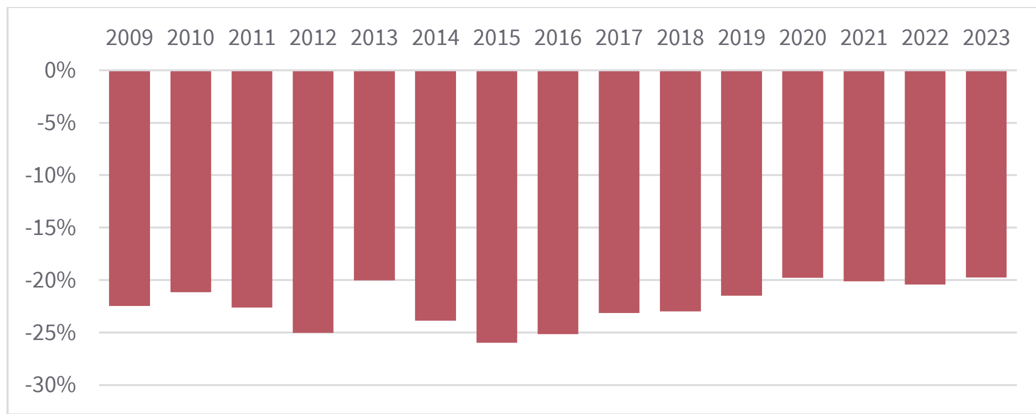

Figure 25: Balance in trade of goods, in % of GDP in 2009–2023 (Source: World Bank – World Development Indicators)

5.1.5. Trade Balance of services

Georgia's balance in trade in services is positive. In 2023, it amounted to 11% of GDP, which was slightly less than the pre-pandemic level. The 2020 economic shocks negatively impacted service exports, because tourism was the major contributor, hence a drop in services' trade balance to 1% of GDP in 2020. Service trade is vulnerable to external shocks that might discourage international visitors. The growth of information and communication technology (ICT) and financial services in the share of service trade offers more sustainability and less vulnerability to external shocks. However, their share still remains smaller than that of tourism.

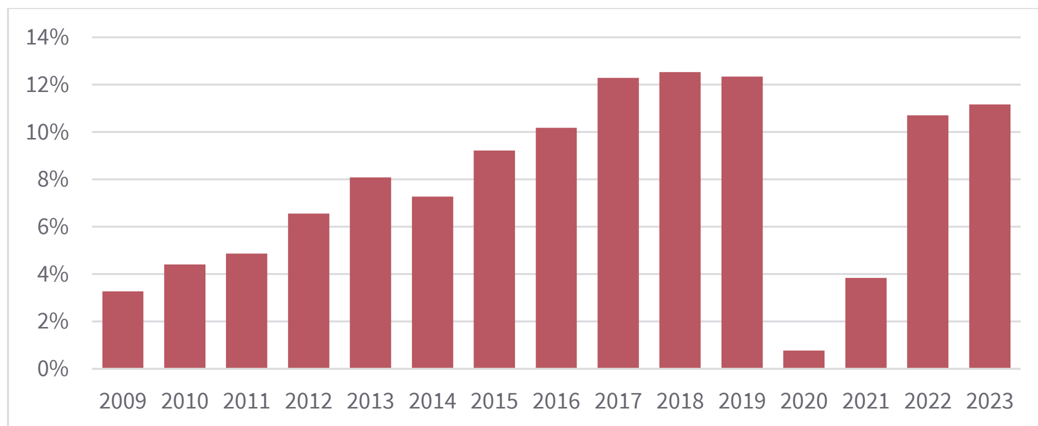

Figure 26: Balance in trade in services, in % of GDP in 2009–2023 (Source: World Bank – World Development Indicators)

5.1.6. Foreign direct investment

Foreign direct investment (FDI) has been a crucial component of Georgia's economic strategy, significantly contributing to its growth and development over the years. Figure 27 shows the net FDI inflows as a percentage of GDP from 2007 to 2023. During this period, FDI inflows have fluctuated, reflecting changes in the global economic environment, regional stability, and the domestic investment climate.

Before 2007, Georgia experienced substantial FDI inflows driven by major reforms to improve the business environment. The government's efforts to reduce corruption, streamline regulations, and enhance infrastructure made Georgia an attractive destination for foreign investors. These investments were instrumental in modernizing various sectors, including real estate, energy, banking, and telecommunications. However, the war in 2008 reduced international investors' interests in Georgia. Hence the inflow of FDI dropped from 19% of GDP to 6% in 2009.

FDI inflows have never returned to the pre-war highs (as a percentage of GDP). In 2014–2018, they remained within the range of 9%–10% of GDP. Inflows began decreasing in 2019, first due to increasing tensions in regional politics, later coupled with the COVID-19 pandemic. Since 2020, FDI inflows' share of GDP has been growing again, albeit at a slow pace.

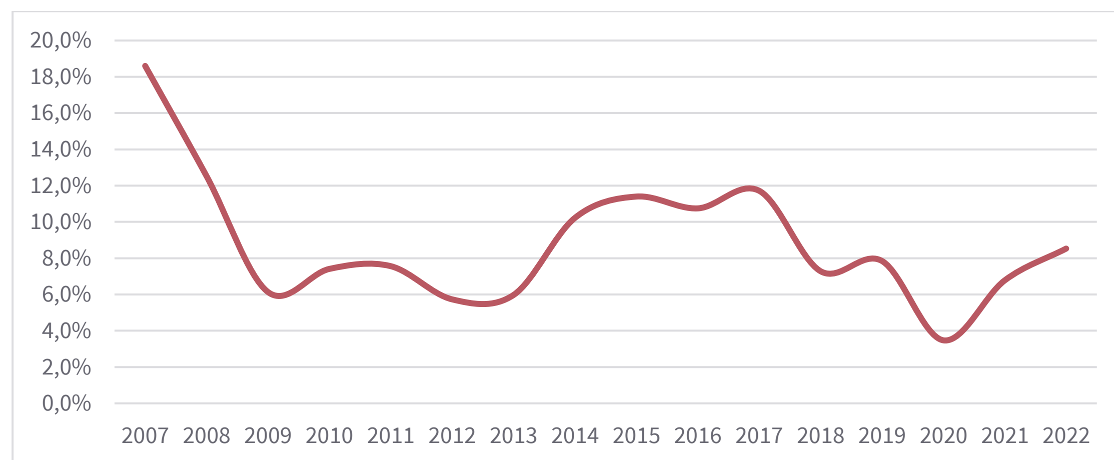

Figure 27: FDI net inflows (%) of GDP in 2007–2022 (Source: World Bank – World Development Indicators)

5.1.7. Remittances

Georgia is recording significant outward migration, leading to a large inflow of remittances. They play a crucial role in the Georgian economy (Dilanchiev et al., 2021), providing a significant and stable source of income for many Georgian households. They help alleviate poverty, improve living standards, and provide access to essential needs such as healthcare, education, and housing. For many families, remittances enable them to maintain a decent quality of life amidst the economic challenges. However, beyond the impact that remittances are having on households, they are contributing to the BOP, offsetting trade deficits, and helping to stabilize the national currency.

While the benefits of remittances are easy to see, there are also associated risks, especially when their role becomes too large. Currently, the size of incoming remittances exceeds 15% of GDP. A heavy reliance on remittances can become an issue if migration policies are changed, or when the countries where remittances are coming from suffer an economic crisis. However, it should be noted that none of the economic shocks—such as the war in Georgia and GFC in 2008, the COVID-19 pandemic, or the war in Ukraine—have had a significant impact on the role of remittances in the country's economy.

The share of remittances in GDP increased from 8% in 2008 to around 15% in 2022 (Figure 27). In 2023, it dropped to 14% due to the reduced flows of remittances from Russia.

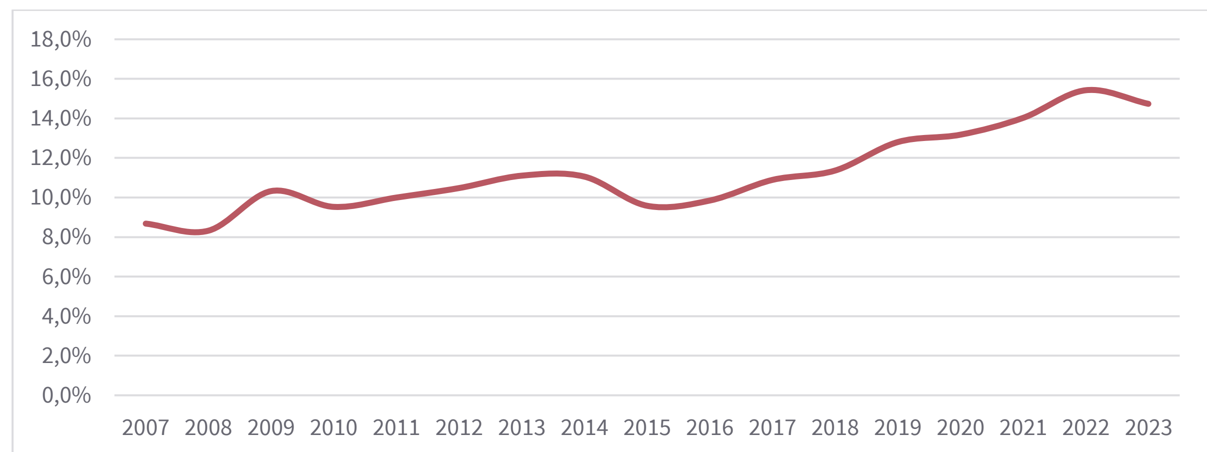

Figure 28: Remittances received as a share of GDP in 2007–2023, in % (Source: World Bank – World Development Indicators)

5.2. Fragility in trade in goods

Georgia's trade in goods demonstrates notable fragility due to a combination of structural economic factors, external dependencies, and geopolitical dynamics. Despite efforts to reduce the negative trade balance, there have been no tangible results. Furthermore, structural fragilities can be found in Georgia's trade partners as well as its trade portfolio. Each of these fragilities is explored further in the following sub-sections.

5.2.1. Geographic structure of trade

Geopolitics has played an important role in shaping the geographical distribution of Georgian trade partners. Based on the data in Figures 29 and 30, one could argue that the geographical structure of Georgian exports has changed more than that of imports. Figure 28 shows a rapid increase in exports to Russia from 2013, and again in 2017. These two spikes show a rise from near zero between 2009 and 2012 to around 15% in 2017. Similarly, exports to China increased from virtually non-existent levels in 2013 to 15% in 2020. These changes have led to a decrease in the share of exports to the EU and Turkey.

This trend is particularly interesting because Georgia has already experienced Russia using trade dependency as a tool of policy influence. In 2006, Russia imposed a ban on importing Georgian wine (Economic Policy Research Center, 2023a), followed by a ban on flights (Agenda.ge, 2019). On the other hand, in August 2023, Georgia banned the reexports of EU and US cars to Russia and Belarus to comply with Western sanctions against Russia (Transparency International Georgia, 2024).

The continuous reliance on the Russian market, along with the Georgian government's recent "anti-Western" rhetoric and the adoption of the law on "foreign agents," indicate

that Georgia is diverging from its Western partners not only politically but also economically.

How the trade structure evolves is to be seen. Georgia's trade relationships in the future will most likely depend on changing geopolitical and economic conditions in the region, which will probably impact the country's export and import patterns (De Waal, 2021).

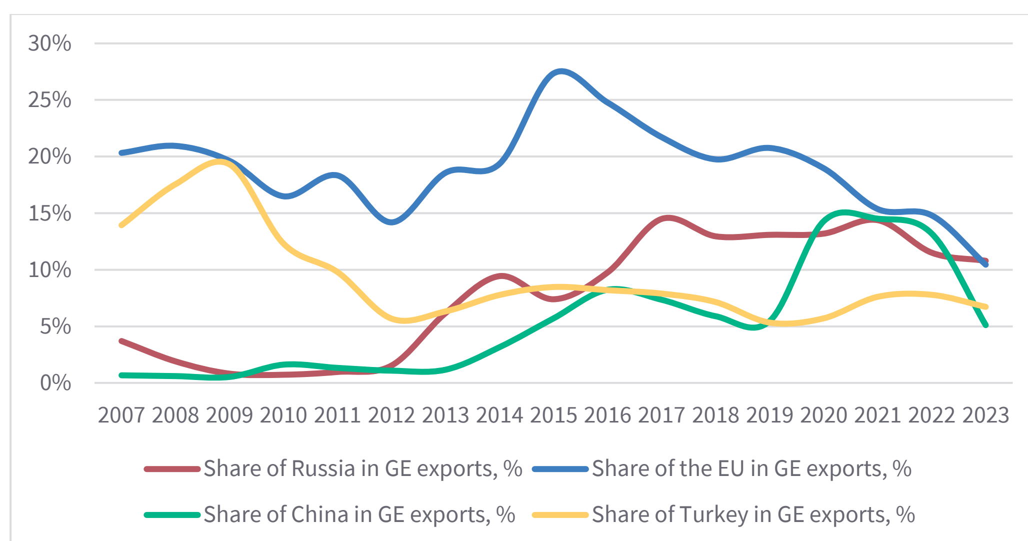

Figure 29: Georgia's exports to major trade partners as a share of Georgia's total exports in 2007–2023, in % (Source: UN Comtrade)

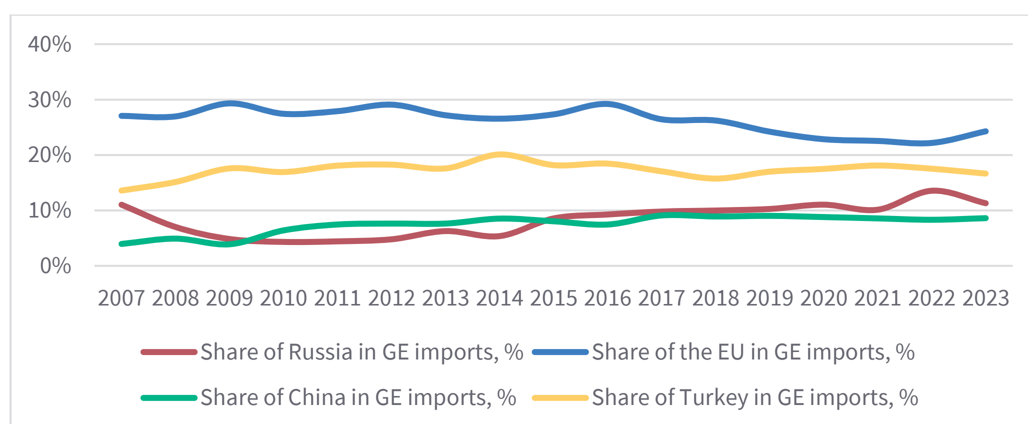

Figure 30: Georgia's imports from major trade partners as a share of Georgia's total imports in 2007–2023, in (%) (Source: UN Comtrade)

5.2.2. Trade by end-use

Georgia's trade structure, as reflected in the data on exports (Figure 31) and imports (Figure 32), illustrates its deep integration with global value chains. The dominance of intermediate goods in both exports and imports, consistently accounting for 40–60% of trade, underscores Georgia's role as both a supplier and consumer of semi-finished products. This suggests the country's significant involvement in processing or value-adding activities within regional and global production networks. While the export structure has shown more dynamism over time, particularly in the fluctuating shares of

mixed end-use and household consumption goods, the import structure has remained relatively stable. This stability in imports, coupled with a higher share of capital goods compared to exports, indicates Georgia's ongoing dependence on foreign technology and equipment for economic development. According to the 2021 OECD data, 68% of exported goods from the agriculture, forestry, and fishing sector are destined for household consumption, while 31% are used as intermediate goods. However, the size of this sector is rather small, and it contributes only around 5% of total exports. Meanwhile, all mining and quarrying (100%) is exported as intermediate goods, representing approximately 20% of total exports. Export of manufacturing is divided between household (36%), intermediate (37%), and mixed end-use (22%). Meanwhile, imported goods have slightly different structures. Although a majority of Georgian imports come from manufactured goods, their end-use is mixed: capital goods (13%), intermediate goods (34%), household goods (24%), mixed end-use (19%), and miscellaneous (10%). Furthermore, the overall scale of intermediate goods in Georgia's imports has increased due to imported mining and quarrying goods, which are entirely (100%) classified into intermediate goods and represent approximately 11% of Georgian imports.

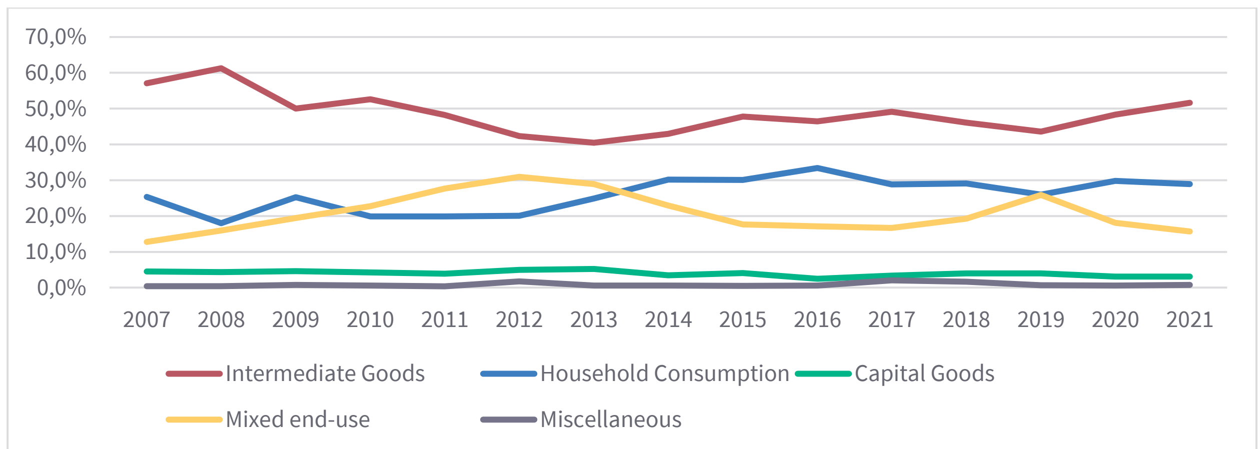

Figure 31: Export of goods as share of total exports by end-use in 2007– 2023, in % (Source: OECD stats)

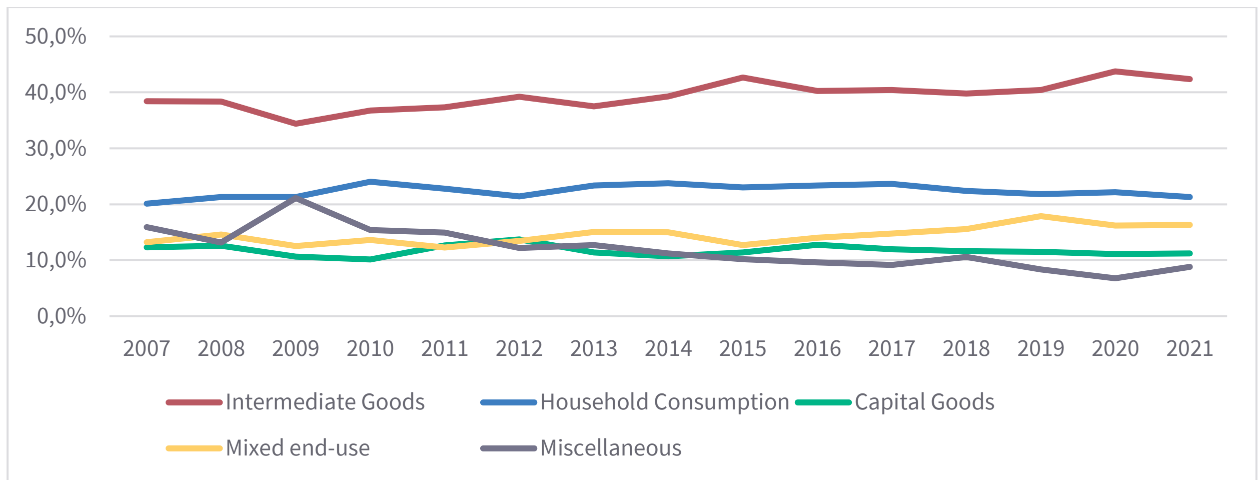

Figure 32: Import of goods as share (%) of total imports by end-use in 2007–2023 (Source: OECD stats)

5.2.3. Trade similarity index

The Export Similarity Index provides a valuable perspective on economies based on their export portfolios and geographic distribution. Using these criteria, the similarity of exports between countries is computed, offering insights into which nations Georgia competes with in terms of international trade. As Figure 33 shows, Georgia has the most similarities with Peru, Chile, Panama, and Ecuador, both in terms of the geography of trade and the portfolio of traded goods. Interestingly, there is neither a geographical nor a historical link between Georgia and these countries.

Another group of countries with a similar trade disposition includes Tajikistan, Uzbekistan, and Mongolia. In this group, the interlink is stronger on the geographical side rather than the portfolio of traded goods. This suggests that while these countries may share some geographical similarities with Georgia, their export portfolios differ more significantly compared to the first group of countries. Understanding these similarities helps Georgia identify its competitors and potential collaborators in international markets, offering strategic insights for enhancing its trade policies and economic partnerships.

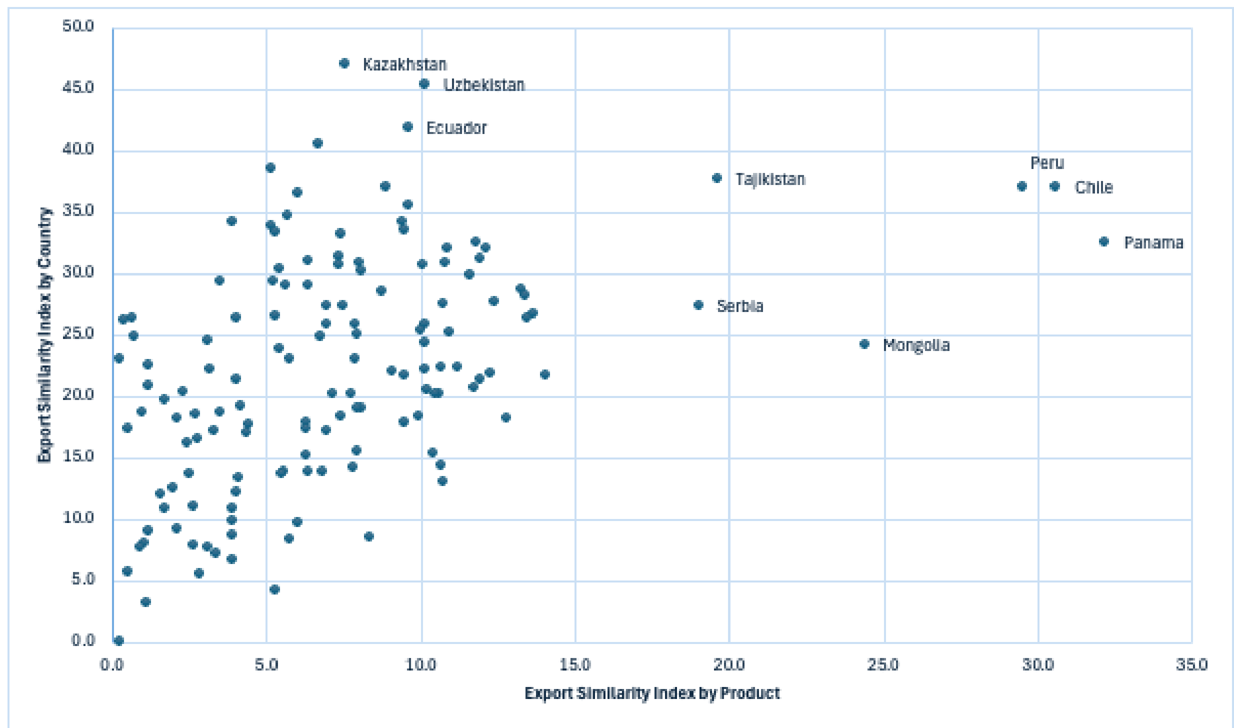

Figure 33: Export Similarity Index 2022 (Source: World Integrated Trade Solutions – WITS, World Bank)

5.2.4. The role of raw materials in the country's trade

The role of raw materials in Georgia's trade has been important, as demonstrated in Figures 34 and 35). Over the years, exports of raw materials have shown considerable fluctuation. In 2009, raw materials constituted 43% of total exports, peaking at 47% in 2010. However, their share then declined, reaching 18% in 2023. Notably, from 2022 to 2023 the share of raw materials halved from 36% to 18%. While the reduced dependency on raw materials exports is a positive development, such substantial changes require further investigation.

On the other hand, imports of raw materials have remained relatively stable, consistently accounting for approximately 22% to 24% of total imports, with slight increases observed in the 2020s. In 2023, their level increased to 30% of total imports. This stability indicates a sustained demand for raw materials from Georgia's domestic industries and consumption.

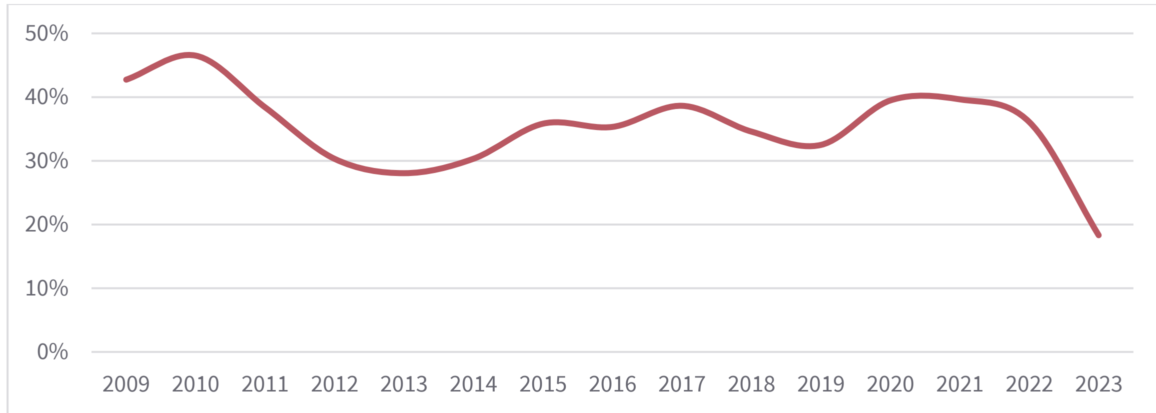

Figure 34: Exports of raw materials as the share of total exports in 2007–2023, in % (Source: UN Comtrade)

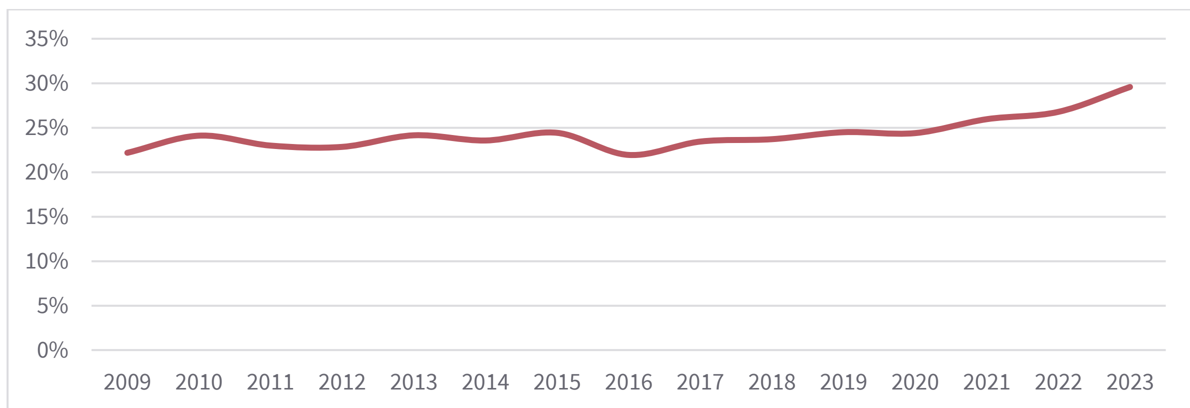

Figure 35: Imports of raw materials as the share of total imports in 2007–2023, in % (Source: UN Comtrade)

5.2.5. Characteristics of re-exports

As described earlier, a significant portion of Georgia's exports consists of re-exports. In recent years, however, attention to the structure of Georgian re-exports has been driven not just by their importance to the Georgian economy, but also by concerns that they could serve as a potential loophole for Russia to circumvent economic sanctions imposed by the US and the EU.

The data presented in Figure 36 highlights a notable increase in re-exports to Kyrgyzstan, Kazakhstan, Armenia, and Azerbaijan. In the context of geopolitical tensions, Georgia's role in re-exporting goods to neighboring countries has raised eyebrows. It could be interpreted as a willingness to help Russia in avoiding sanctions through loopholes. Notably, Georgia is not the only country with increased trade with Kyrgyzstan and Kazakhstan.

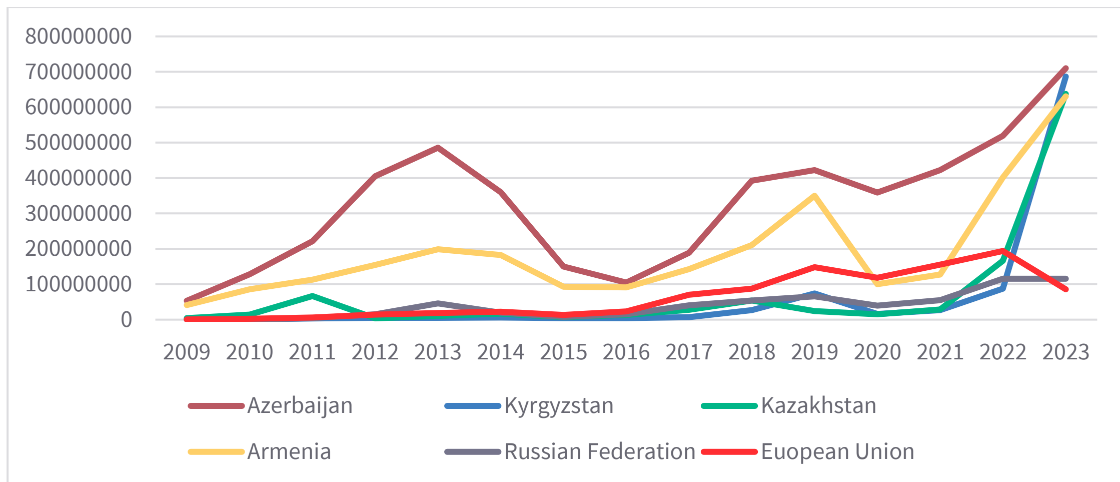

Figure 36: Re-export of goods in 2007–2023, (USD) (Source: UN Comtrade)

5.2.6. Logistic bottlenecks

As Georgia strives to serve as a corridor and transit hub connecting Europe and Asia, the logistics sector has become immensely important. In recent years, the sector has seen growth, and projections for the future indicate that it will continue to expand (Public and Management Consulting Group, 2024). However, the overall logistics environment still lags behind advanced economies (Figure 37). According to the Logistic Performance Index (LPI) benchmark developed by the World Bank, Georgia has been making progress in recent years (Figure 38).

One of the critical areas where the logistics environment lags is infrastructure. The lack of a deep-sea port on the shore of the Black Sea is one of the most significant shortcomings in logistical infrastructure, which has also become a major political issue both domestically and internationally. Currently, a Chinese-led consortium is set to build a deep-sea port in Anaklia (Radio Free Europe/ Radio Liberty, 2024). Other issues are: high tariffs for containers at the Black Sea ports, relatively longer dwell times in Georgian ports, and a lack of regional coordination between the “corridor countries” (Public and Management Consulting Group, 2024).

However, many of these conditions have been improving over the years, except for the tracking and tracing scores (Figure 38). The lack of data on road transport in Georgia is a challenge that has not yet been addressed, and one that hinders the entire logistics environment.

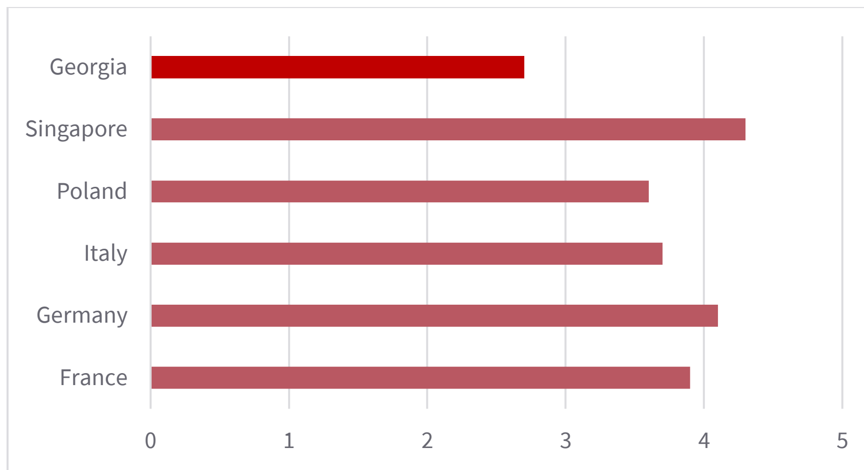

Figure 37: Georgia's Logistic Performance Index (LPI) compared to the world's best performers in 2023 (Source: World Bank)

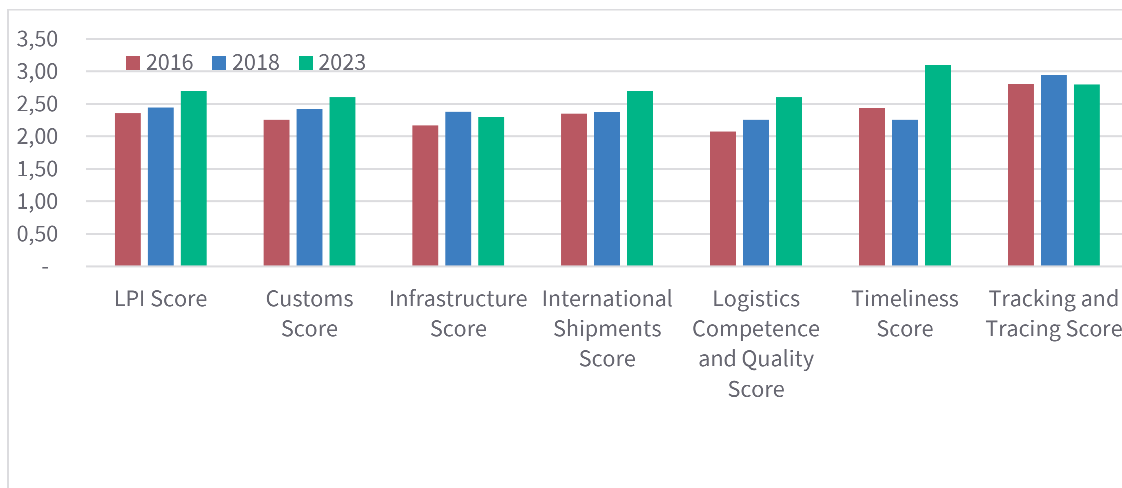

Figure 38: Georgia's Logistic Performance Index (LPI) decomposed, 2016, 2018, 2023 (Source: World Bank)

5.2.7. The concentration of exports and imports (Herfindahl-Hirschman Index)

Georgia's trade concentration has remained relatively low, as illustrated by *Figure 39*. The *Herfindahl-Hirschman Index (HHI)*, which measures trade concentration on a scale from 0 to 1, indicates the extent to which a country's trade is concentrated in a few markets. A country with highly concentrated trade, focused on just a few export or import partners, will have an index value close to 1, reflecting a higher risk of dependency. In contrast, Georgia's HHI has consistently remained around *0.05*, signifying a highly diversified trade portfolio with low levels of concentration. This level of diversification is favorable compared to other economies of similar size, suggesting that Georgia's trade is spread across many markets, reducing its vulnerability to external shocks or disruptions in specific trading relationships. This resilience is a positive indicator of long-term economic stability and growth potential.

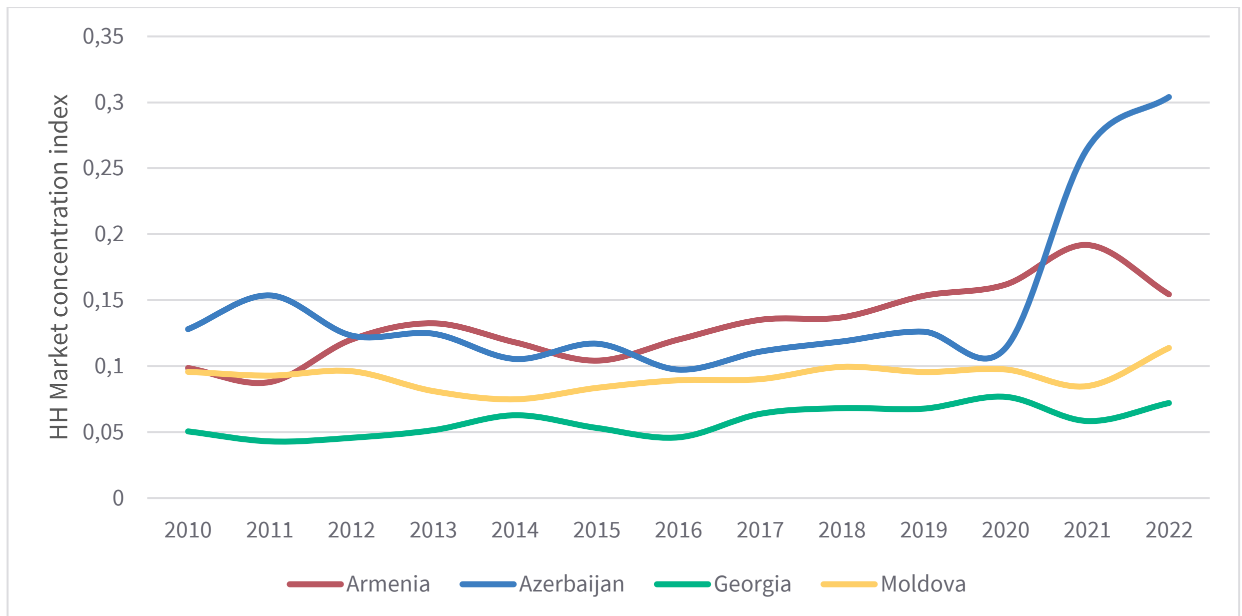

Figure 39: Hirschman Herfindahl (HH) index for Georgia and similar economies from 2012 to 2022 (World Integrated Trade Solutions – WITS)

5.3. Fragility in trade in services

Service exports remain crucial for the Georgian economy as they help to offset the persistent trade deficit in goods. The service sector, particularly tourism, travel, and ICT services, has been a significant contributor to Georgia's GDP. However, there is evident fragility in the trade of services, primarily due to regional geopolitical tensions and external economic shocks.

Geographically, Georgia's service exports are highly dependent on a few key markets, including the EU, Russia, and neighboring countries in the South Caucasus region. This concentration makes the sector vulnerable to political and economic changes in these regions. For instance, the tourism sector, a major part of service exports, saw a sharp decline in revenues as Russia declared a ban on direct flights. In addition to geopolitical risks, the COVID-19 pandemic severely impacted the service sector, particularly tourism and hospitality, leading to substantial revenue losses.

5.3.1. Composition of exports by services

One of the primary challenges of service exports in Georgia is their heavy reliance on the travel and transport industries. Consequently, any potential disruptions to mobility can have a severe impact on the Georgian economy. Figure 40 demonstrates the share of three major service exports. According to data up to 2019, more than 90% of service exports were dominated by transport and travel. In 2020, the share of travel halved due to the COVID-19 pandemic and associated restrictions.

Additionally, 2020 marked a significant push toward digitalization services, which has been reflected in Georgia's service export portfolio. From 2020 onwards, the ICT sector began to capture a larger share of total service exports. This shift indicates a growing

diversification within the service sector, reducing the heavy dependence on the travel and transport industries.

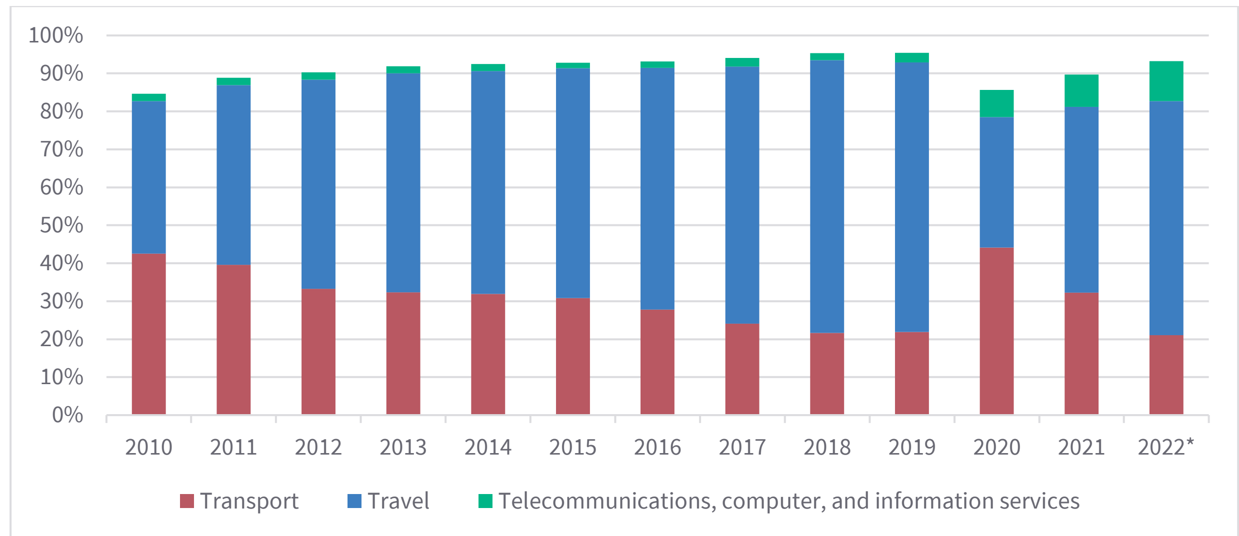

Figure 40: Export of services share in total service exports 2010–2022, in % (Source: UN Comtrade)

5.3.2. The role of tourism in exports

As described previously, the role of the tourism sector has been significant for service exports. Figure 41 provides information on international tourism receipts as a part of total service exports. The data demonstrates the negative impact the COVID-19 outbreak and reduced travel had on the inflow of international tourists. The contribution of international tourism fell to below 10% in 2020, compared to 39% in 2019.

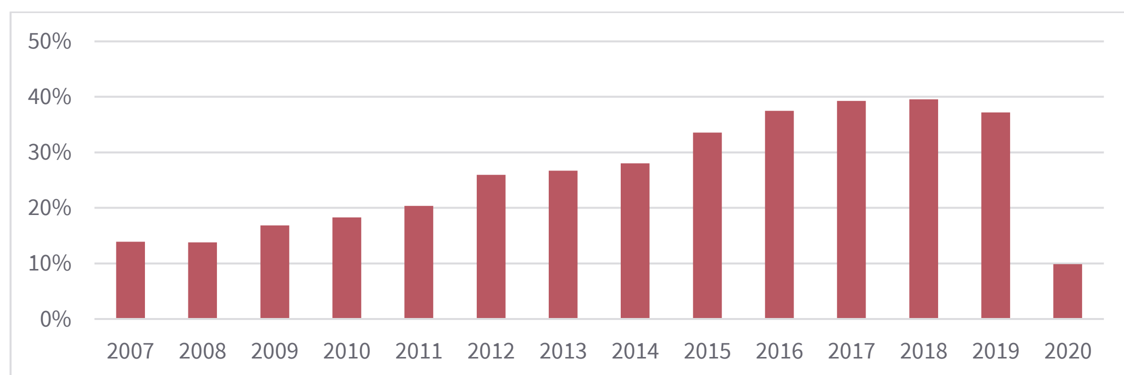

Figure 41: International tourism, receipts share (%) of total service export 2007–2020 (Source: World Bank - World Development Indicators)

5.3.3. The role of ICT exports

ICT exports are less vulnerable to economic turbulence. They are therefore a more sustainable source of foreign exchange inflows for Georgia. Consequently, the trend of increasing ICT exports captured in Figure 42 is a positive outcome of the increased digitalization. While the tourism and travel industries remain the major service items

exported by Georgia, sectoral diversification is creating positive expectations for the future. Continuous growth in ICT exports can offset the deficit in the trade of goods.

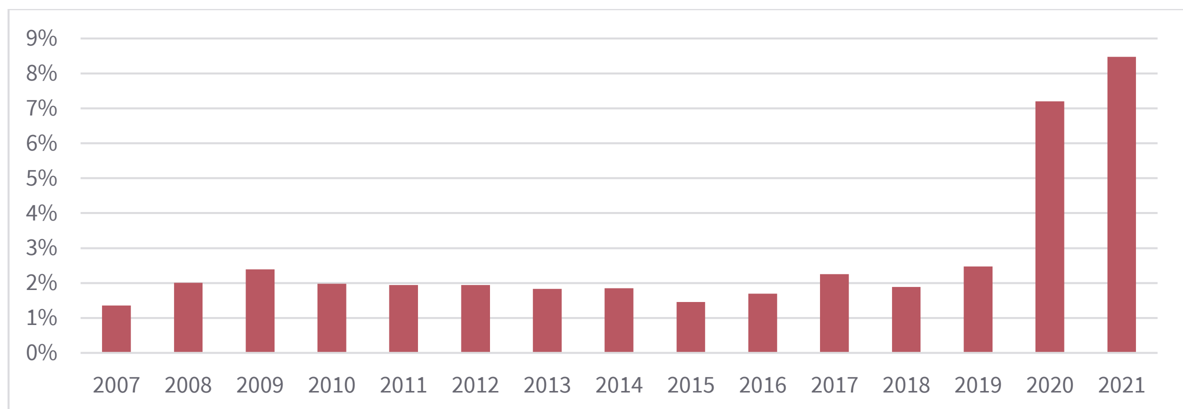

Figure 42: ICT service export share of total service exports (BoP), in % 2007–2020 (Source: World Bank – World Development Indicators)

5.4. Fragility in foreign investment

Difficulties in attracting foreign investment to Georgia can be linked to a range of factors that impact investor confidence and economic stability. One major concern is the geopolitical risk associated with the region, particularly the tensions with Russia and the unresolved status of the separatist regions of Abkhazia and South Ossetia. These issues are creating an unpredictable environment for foreign investors, leading to increased risk perception. Additionally, Georgia's economic vulnerability is exacerbated by its heavy reliance on external debt and aid, which can limit the government's fiscal flexibility and cause economic instability (International Monetary Fund, 2023). The combination of these factors is harming the investment climate in Georgia, and leading to volatility in foreign investments.

5.4.1. Trends in FDI inflows and outflow

FDI inflows have depended on Georgia's investment climate. As discussed previously, the attractiveness of the Georgian economy during the early and mid-2000s was drastically reduced due to the security risks created by the Russian invasion in 2008. Since then, net inflows of FDI have not returned to pre-war highs (Figure 43). The COVID-19 pandemic became another reason for a reduction in FDI inflows in 2020. However, this was a global phenomenon and not a local issue. Throughout 2020, the IMF (2020) expected a reduction of global FDI by 40%.

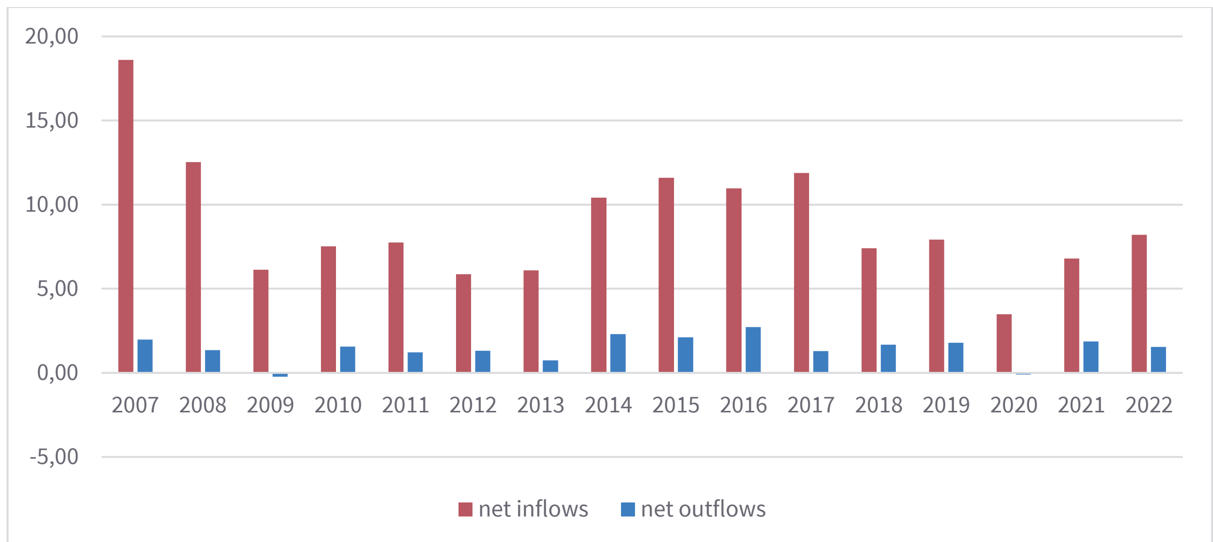

Figure 43: Net inflows and outflows of FDI as a share of GDP 2007–2022, in % (Source: UNCTAD)

5.2.4. FDI stock compared to peer countries

Georgia attracts more international investment than Azerbaijan, Armenia, and Moldova (see Figure 44). This higher level of investment is primarily due to its more open and free market, as well as its historically more stable political environment. However, recent developments might challenge this trend. On the one hand, Moldova, along with Ukraine, is moving closer to EU membership, which could enhance its attractiveness to international investors. On the other, the Georgian government's questionable decision-making has stalled its EU integration process, potentially diminishing its appeal. Geopolitical and economic shifts in the region are reshaping the investment landscape, and how these changes unfold will be crucial for future investment flows.

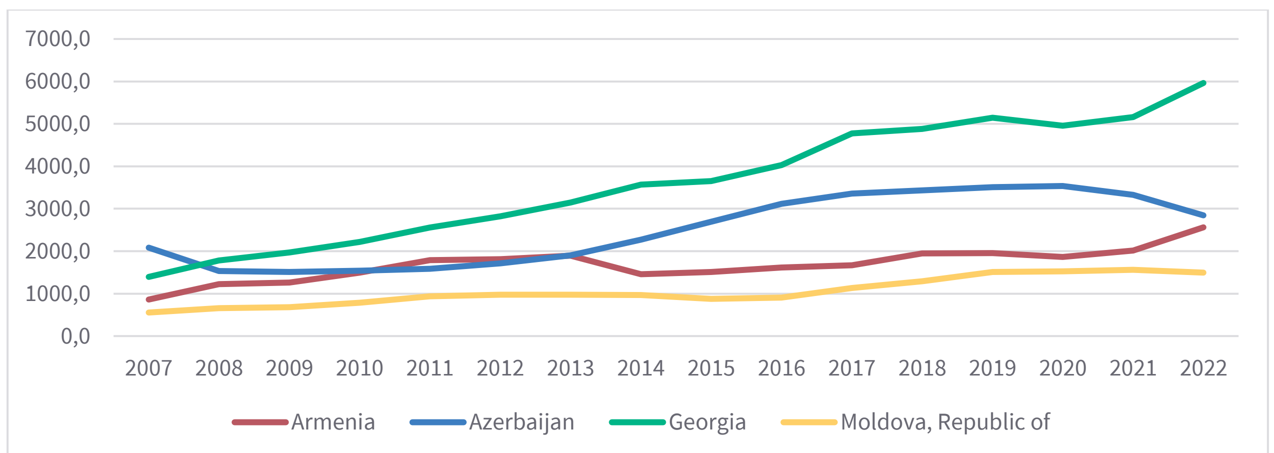

Figure 44: FDI stock per capita compared to peer countries 2007–2022 (Source: UNCTAD)

5.4.3. Geographic structure of inward FDI

The largest stock of FDI comes from the EU (Figure 45), hence the uncertain integration prospects will most likely reduce the size of the investment. Loss of investment interest from the EU and UK will be very hard to compensate for, because neither China nor other Eastern economies make major investments in Georgia.

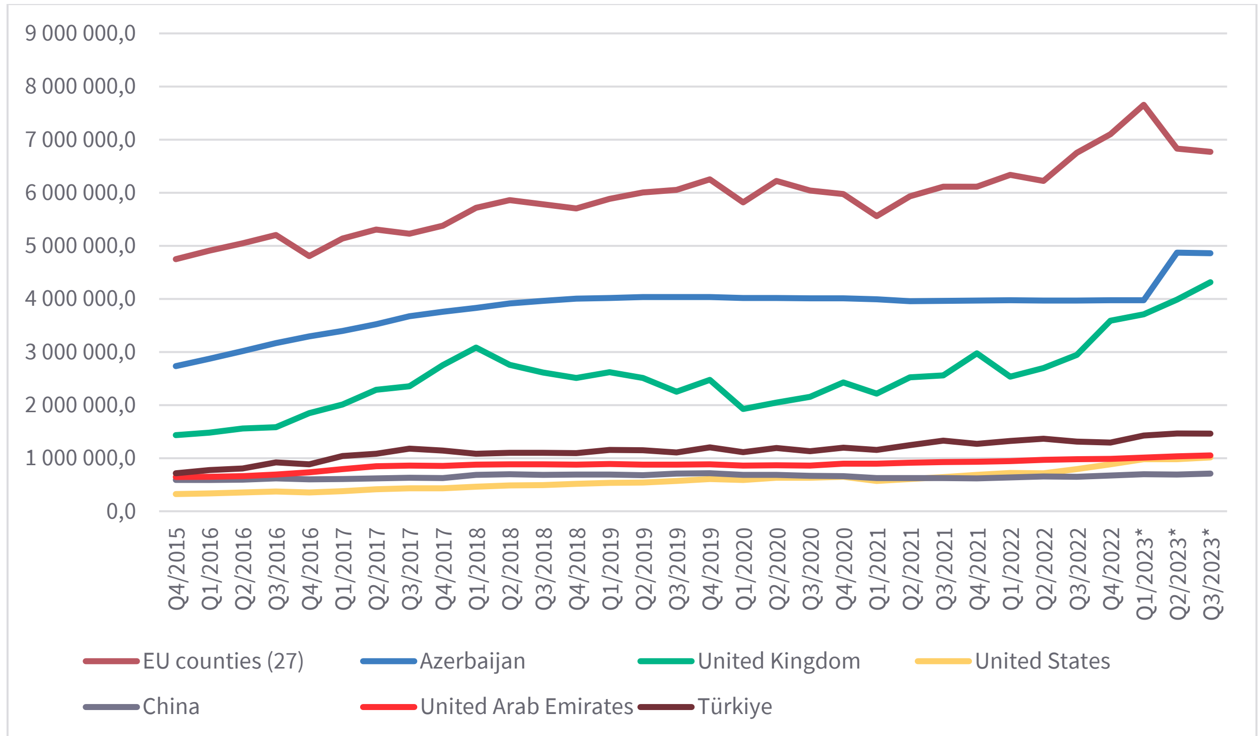

Figure 45: FDI stock by biggest investors 2015/Q4 – 2023/Q3 (Source: UNCTAD)

5.4.4. Composition of inward FDI

While the transportation and storage sectors used to attract the most investment (approximately 30% of the total), in the 2020s the share of investment in the financial sector increased. In Q2 2023 the financial and insurance sectors mobilized the most investment (Figure 46). Change in investor interests from infrastructural projects to the financial sector can be seen as positive. However, one should keep in mind that investors' attitudes are very fragile and the trend might reverse rapidly.

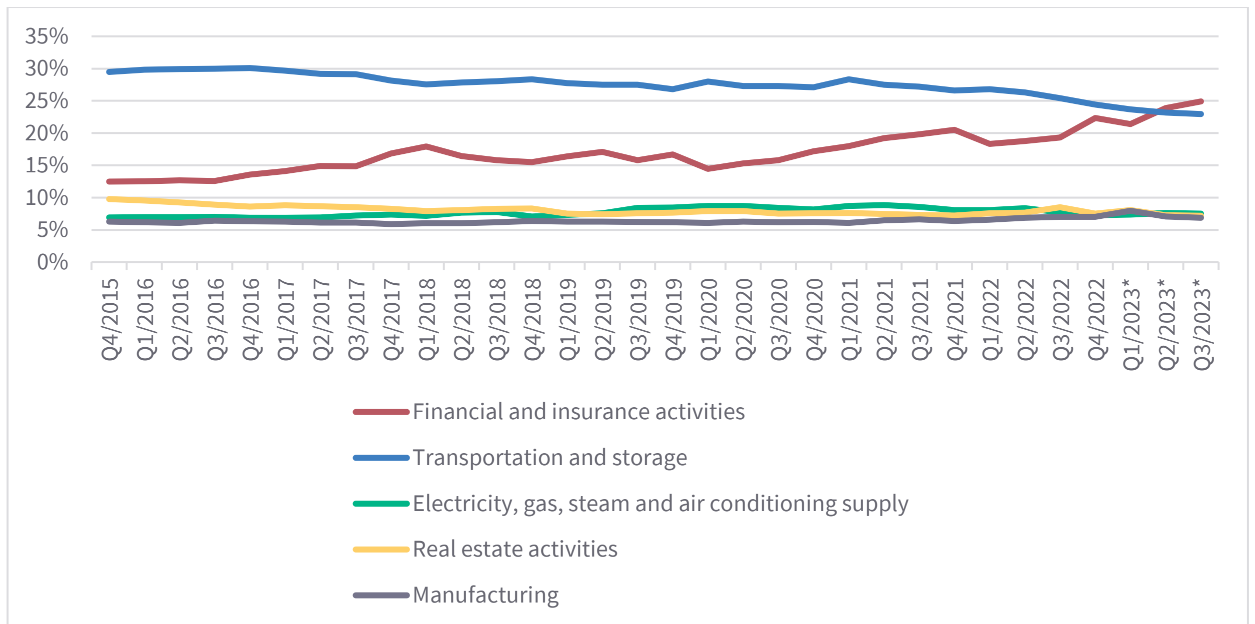

Figure 46: Composition of inward FDI by economic sectors 2015/Q4 – 2023/Q3 (Source: UNCTAD)

5.4.5. Outward FDI

While the Georgian economy is heavily reliant on inward FDI, there is little outgoing investment (Figure 47). On the policy level, there are no regulations supporting or hindering Georgian investors' investment activities outside of the country. However, due to the lack of available capital, it is not very common. Few financial institutions invest outside of Georgia, and they mostly limit their investment portfolio to the region and Central Asia.

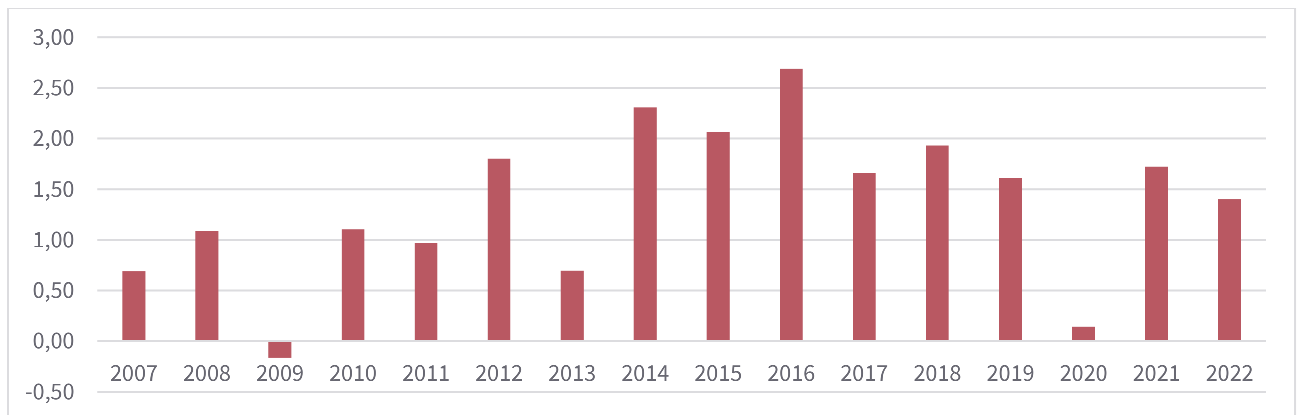

Figure 47: Outward FDI flows as share (%) of GDP 2007–2022 (Source: UNCTAD)

5.4.6. Portfolio investment

The Georgian financial market is not developed. Hence, the attraction of portfolio investments is sluggish. In recent years Georgian companies have started to utilize alternative financing instruments, such as short- and medium-term bonds. Adaptation of such financial instruments for attraction of external capital is still in its early stages,

but can already be seen in Figure 48. The high level of fluctuation further demonstrates the markets' limited capacities.

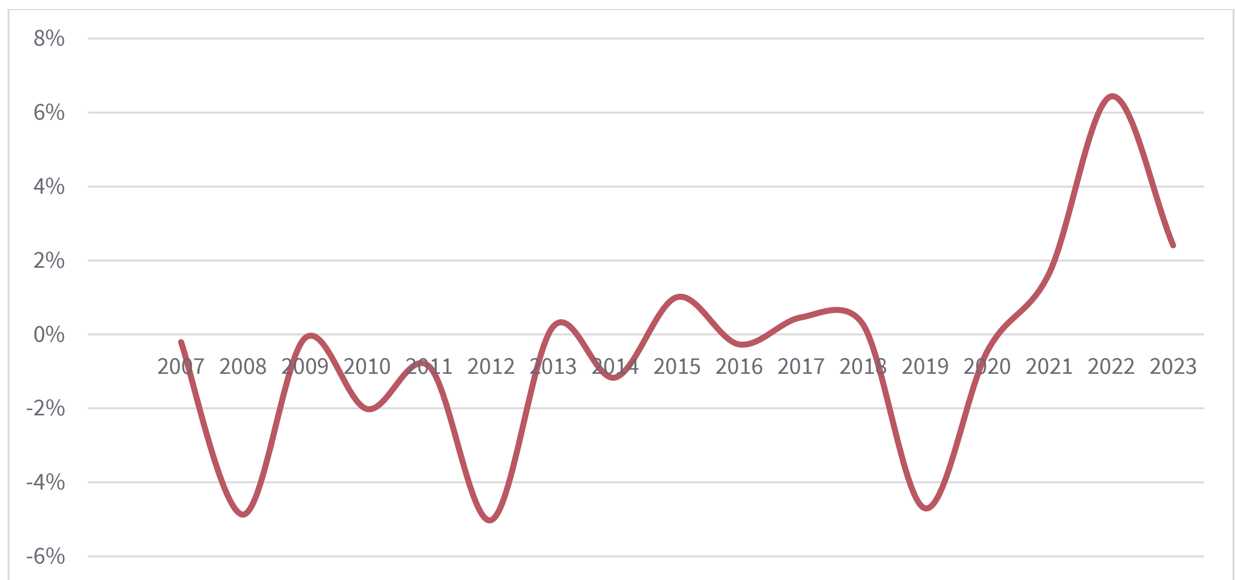

Figure 48: Net portfolio investment as share (%) of GDP 2007–2023 (Source: World Bank)

5.5. Fragility related to personal mobility

Georgia's labor market is characterized by significant outward migration and reliance on remittances. Remittances play a crucial role in Georgia's economy, consistently accounting for around 10–12% of GDP. However, the reliance on remittances exposes Georgia to external shocks, as demonstrated during the COVID-19 pandemic when their flows briefly declined before rebounding. The impact of migration on domestic labor supply is another aspect of the problem. This brain drain effect is partially offset by the transfer of skills and knowledge when migrants return, but the overall impact on labor market dynamics remains a concern.

5.6.1. Labor emigration

Emigration from Georgia has been an ongoing challenge. Since the early 1990s, large numbers of Georgians have been leaving the country, looking for better economic conditions. The emigration rate increased in 2022–2023, a development that can be explained by the increased domestic political tension coupled with the regional conflict.

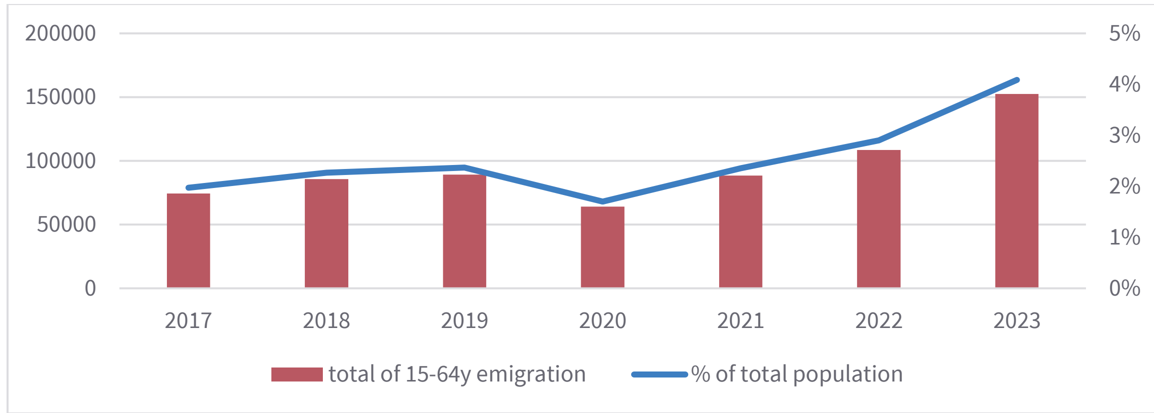

Figure 49: Number of 15-64 years-old Georgian emigrants, thousands (left axis) and as a share total population, in % (right axis) 2017–2023 (Source: ILO)

5.5.2. Labor immigration

The increased outflow of the working-age population is compensated for by an increased inflow of immigrants (Figure 50). This recent surge in immigration is primarily fueled by regional conflicts, particularly the war in Ukraine, which has led to a significant number of Ukrainians and Russians seeking refuge or relocation in Georgia (Figure 51). This influx presents both opportunities and challenges for the Georgian labor market and the economy as a whole.

The arrival of skilled professionals from Ukraine and Russia has the potential to partially offset the brain drain experienced due to Georgian emigration. Many of these newcomers bring valuable expertise in ICT, finance, and other high-demand sectors, which could contribute to knowledge transfer and innovation in the Georgian economy. Furthermore, this influx has stimulated certain sectors of the economy, particularly in urban areas, through increased demand for housing, services, and consumer goods.

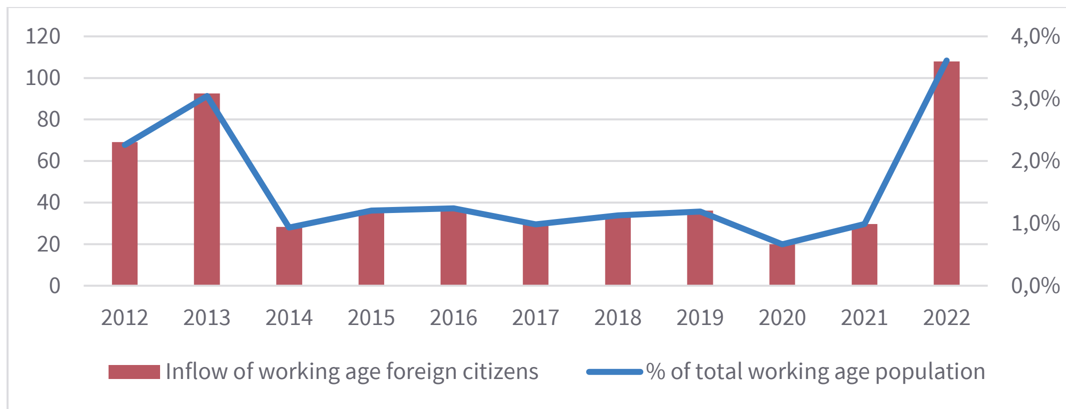

Figure 50: Total of working-age immigrants coming to Georgia, thousands (left axis) and as a share of the total working population of Georgia, in % (right axis) 2017–2022 (Source: ILO)

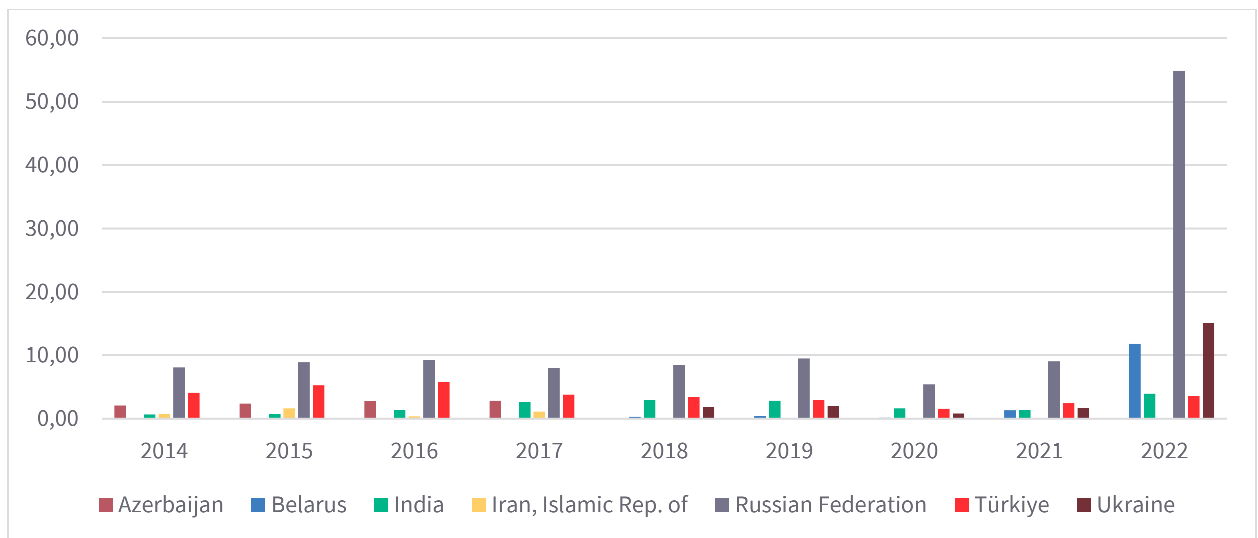

Figure 51: Geography of inward migrants, thousands, 2014–2022 (Source: ILO)

5.5.3. Geography and scale of remittances

Between 2008 and 2022 there was a significant increase in both the absolute value of remittances and as a percentage of GDP. Figure 52 shows that remittance inflows grew from around USD 1 billion in 2008 to over USD 3.5 billion by 2022, with a corresponding increase in their share of GDP from about 10% to nearly 16%.

The geography of remittances, illustrated in Figure 53, reveals the changing dynamics of Georgia's economic ties. Historically, Russia was a major source of remittances, but its share declined from over 50% in 2008 to around 30% in 2024. On the other hand, the EU emerged as an increasingly important source, with its share rising from about 30% to over 40% during the same period. The US and Israel have maintained relatively stable, but smaller, shares of around 10% each, but both remain important sources of remittances for Georgia.

Data from 2022 is interesting as it shows a huge spike in the inflow of remittances from Russia. However, this inflow was not connected to Georgia's increased immigration to

Russia, but rather the inflow of Russians to Georgia. Money transfers to Georgia served as a tool to avoid the banking sanctions imposed on Russia.

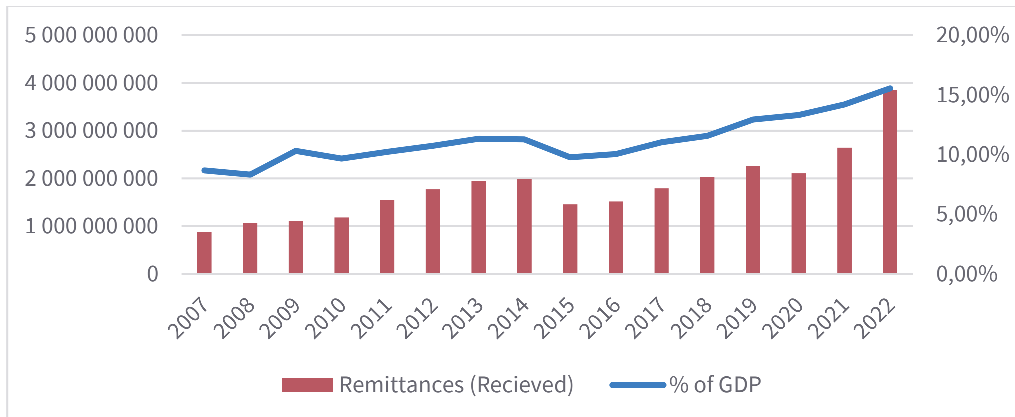

Figure 52: Total remittances, in USD (right axis) and as a share of GDP, in % (left axis) 2008–2022 (Source: World Bank and National Bank of Georgia)

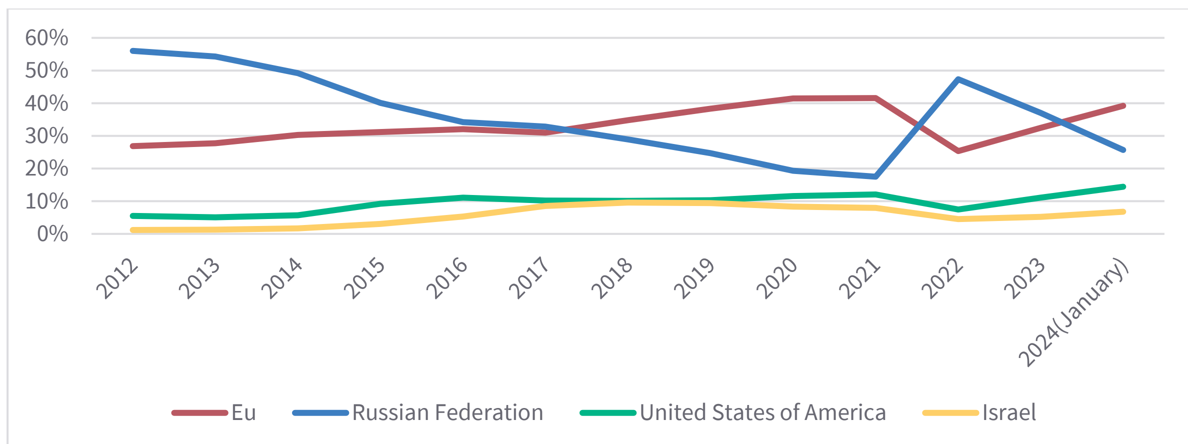

Figure 53: Geography of remittances as a share of total remittances, in %, 2008–2024 (Jan) (Source: World Bank and National Bank of Georgia)

5.6. Summary

The Georgian economy is highly vulnerable to external developments, and the Russian invasion of Ukraine has unsurprisingly impacted a wide array of Georgia's economic indicators. According to the IMF (2024b), the medium-term effects of the war are expected to have a positive impact on the Georgian economy. However, a large-scale displacement of people also presents potential risks. A resolution to the current conflict could result in the outflow of those who relocated to Georgia after the outbreak of the war, and therefore lead to a reduction in the consumer base. To maintain a healthy economy throughout the upcoming waves of uncertainty, Georgia should leverage the short- and medium-term gains to further diversify its economic structure, and increase investments in sustainable development.

Chapter 6. Energy: sources, dependences, and outlook [**** target for Sunday]

Access to energy resources at an affordable price is essential for the provision of basic human needs, sustainable development, and the overall stability and growth of a nation (World Economic Forum, 2020). Energy security is therefore an integral part of economic security, as it is challenging to maintain one without the other. To understand the existing structure of the energy sector in Georgia, this chapter pays close attention to the energy balance, its dependency on international markets, and the structure of the internal consumption and energy infrastructure.

After Georgia regained independence, the existing energy infrastructure and, consequently, the energy balance—much like the rest of the economy—came under immense strain. The transition to a market economy plunged Georgia into a long-term energy crisis and stagnation, which affected both the household and industrial sectors. The shortage of energy production, combined with Georgia's dependence on energy imports, worsened its transition process. The supply of natural gas and electricity remained limited, leading to restrictions and, in some cases, forced outages. Furthermore, the supply was mostly dependent on neighboring countries, as Georgia had insufficient time to restructure the energy suppliers (Chomakhidze, 2016).

Following nearly a decade of turmoil, including a destructive civil war in the early 1990s that left the country and its infrastructure including its energy system, in ruins, the situation began to gradually improve in the aftermath of the Rose Revolution in 2003. A radical and swift reform and reconstruction process then followed, supported by substantial financial aid from international donors, leading to accelerated economic growth. However, in 2006, Georgians experienced a harsh reminder of their vulnerability to sudden interruptions in energy availability. On January 22, 2006, two explosions on the Mozdok-Tbilisi natural gas pipeline in North Ossetia, classified as sabotage, interrupted the gas supply from Russia to Georgia during a cold winter (Radio Free Europe/ Radio Liberty, 2006). Shortly after this, another act of sabotage damaged the high-voltage power line delivering electricity from western Georgia to the eastern part of the country, causing a blackout in most of Eastern Georgia (Petriashvili, 2006), including the capital Tbilisi. These events, coupled with the 2008 Russo-Georgian war, made Georgian policymakers increasingly wary of the possibility of energy being used as a weapon in geopolitical conflicts. Consequently, they defined energy security as a national security issue, emphasizing the need to protect the country from such vulnerabilities (Pignatti, 2023). As a result, Georgia reduced its energy dependency on Russian imports in the years that followed. In recent years, however, Georgia has shifted its approach, and energy imports from Russia have been increasing once again. This growth spans all the energy subsectors (Economic Policy Research Center, 2023b). At the same time, the danger of dependency on energy imports again becoming leverage for influencing national policymaking has not disappeared. On the contrary, with the Russian invasion of Ukraine, threat levels in the region have further increased. Consequently, the Georgian economy is exposed to potential political pressures, and instability leaves it vulnerable in times of heightened risk.

6.1. The country’s energy background

6.1.1. Total energy supply

Georgia, being a small country with limited domestic energy resources, relies heavily on energy imports. In 2022, the country’s energy supply consisted of a diverse mix, dominated by natural gas, which accounted for 51% of the total (Figure 54). Such reliance on natural gas highlights the importance of securing consistent and affordable imports to meet Georgia’s energy needs. However, recent data indicates that the share of Russian gas in the country’s total natural gas imports has been growing (Economic Policy Research Center, 2023b).

Oil is the second-largest resource, contributing 25% to the total energy supply, which underscores Georgia’s dependency on fossil fuels. Hydropower, a renewable energy source, accounts for 16% of the energy mix, reflecting the country’s underutilization of its abundant water resources. Biofuels and waste, as well as coal, each contribute 4%, while wind, solar, and other renewables represent a mere 1% of the total energy supply. This composition reveals a significant reliance on non-renewable energy sources, and the necessity for further investment in renewable energy infrastructure. Addressing this imbalance is crucial for enhancing Georgia’s energy security, reducing environmental harm, and fostering sustainable economic growth.

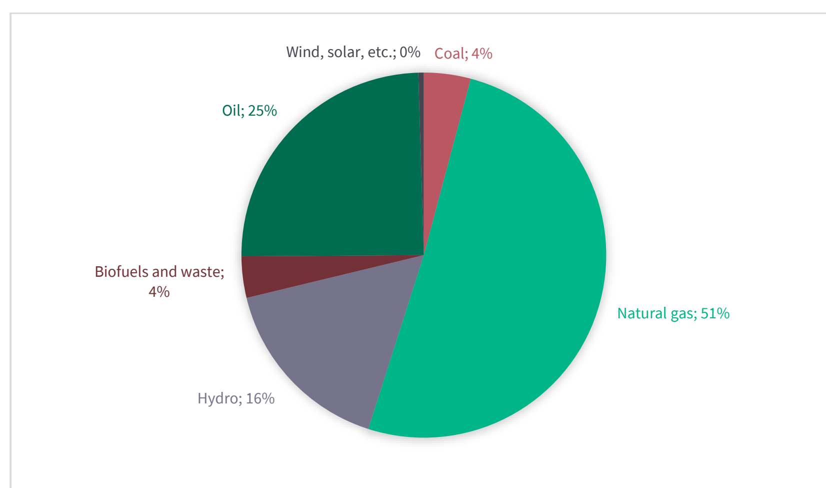

Figure 54: The shares of energy sources in Georgia’s total energy supply in 2022, in %. (International Energy Agency)

Since 2007, the structure of the energy supply has seen little change. Oil and natural gas have continued to dominate the country’s energy balance. As illustrated in Figure 55, the primary sources of energy supply have remained the same. Oil has made up 25% to 30% of the total energy mix, while the share of natural gas increased from 40% in 2007 to 50% in 2022. Notably, the share of oil has slightly declined over the years, not due to a reduction in quantity, but because the total energy supply has outpaced its growth rate. On the other hand, the rapid decrease in the share of biofuels and waste is a result of its reduction from 16,499 TJ in 2007 to 8,713 TJ in 2022.

The deficiencies of Georgia’s energy structure extend beyond the vulnerabilities in its energy supply to also encompass its energy efficiency. Georgia’s energy intensity

remains relatively high compared to EU benchmarks (see Figure 56). Inefficiency in energy use can be attributed to energy subsidies, which—as Pignatti (2023) argues—often encourage wasteful consumption. One notable example is the provision of free electricity in mountainous regions, which has made these areas attractive for crypto mining. While subsidies are intended to assist the most vulnerable groups, evidence shows that they can be abused by people who are not the intended beneficiaries. In some cases, this can do further harm to vulnerable groups. The outages in Svaneti, caused by increased demand due to crypto mining, illustrate this issue. While most of the population struggled with unstable electricity, a small number of miners were capitalizing on government policy (Shonia, 2022).

Georgia's high energy intensity is especially interesting as it is a service-based economy. As a rule, service economies are less energy-intensive (European Commission, 2019). This suggests that manufacturing is not the primary driver behind the country's high energy intensity. The reasons may lie instead in household consumption and inefficiencies in infrastructure.

Several measures can be applied to reduce energy intensity. First, demand for gas should be reduced as natural gas is both expensive and has a large share in the energy mix. Alternatively, more effort should be made to further develop electricity generation and its applications. On the one hand, this could help reduce energy costs; on the other, it may benefit from infrastructure that is relatively easy to adapt and expand. Such an approach would reduce the energy intensity further, especially if the electricity were to be generated from renewable sources. Georgia's energy infrastructure is also responsible for high energy intensity. Investment in bringing this infrastructure up to date would reduce energy losses and, as a result, lower the energy intensity.

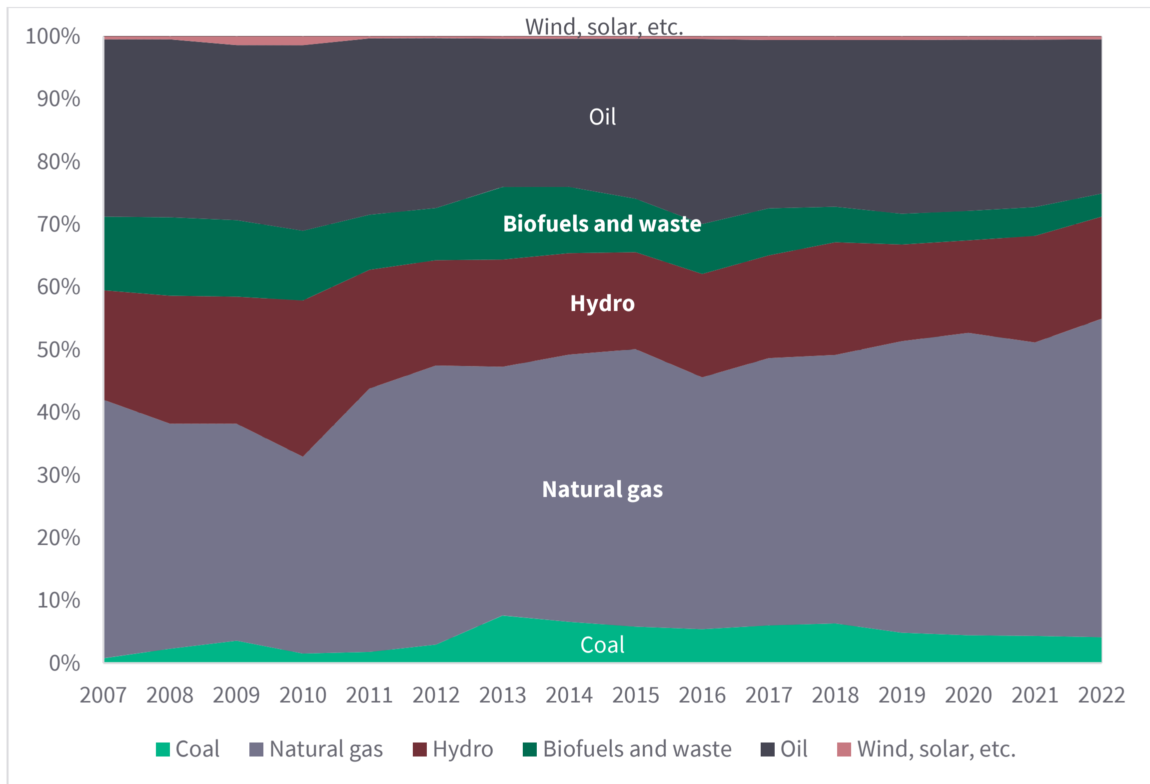

Figure 55: The shares of energy sources in Georgia's total energy supply in 2007-2022, in %. (International Energy Agency)

In the 2020s, Georgia's energy intensity has been decreasing, creating expectations for further improvement. Regional comparison (Figure 56) shows that Armenia and Azerbaijan have higher energy intensity than Georgia, while Turkey's energy intensity is lower.

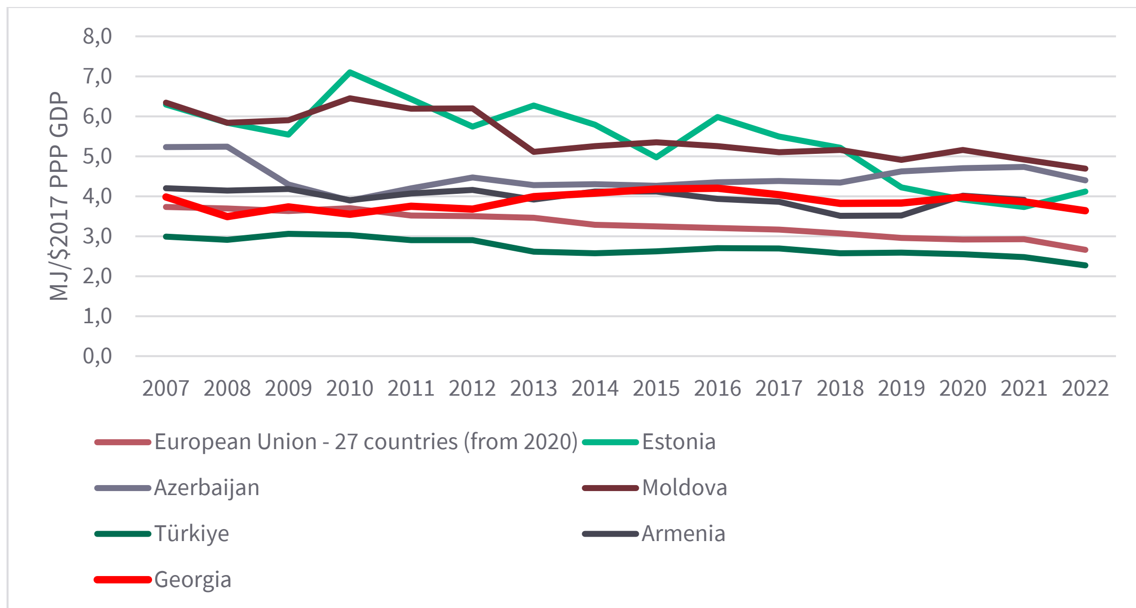

Figure 56: Georgia's energy intensity (MJ/USD 2017 PPP GDP) compared to energy intensity in the EU27 and other benchmark countries, 2007–2022. (World Bank – World Development Indicators)

6.1.2. Energy distribution infrastructure

Georgia's energy infrastructure is well integrated with its neighbors. Part of the infrastructure was inherited from Soviet times, while the remainder was developed under international projects and bilateral partnerships. Georgia is connected to all its neighbors (Armenia, Azerbaijan, Russia, and Turkey) by gas pipelines. Gas imports come from Azerbaijan and Russia, and are partially transited to Armenia and Turkey. Georgia also imports oil products from Azerbaijan, Russia, and Turkmenistan and transits crude oil from Azerbaijan and Kazakhstan to Turkey.

The primary pipeline for importing gas from Azerbaijan's SOCAR (State Oil Company of Azerbaijan Republic) is the Karadaghi-Tbilisi interconnection, with a diameter of 700 mm and a 46 km section within Georgia. Additional gas imports from Azerbaijan are facilitated by the South Caucasus Pipeline (SCP), which runs parallel to the Baku-Tbilisi-Ceyhan oil pipeline, spanning 692 km (442 km in Azerbaijan and 250 km in Georgia) with a diameter of 1,067 mm and a capacity of 8 billion cubic meters (bcm).

The expansion of the Shah Deniz gas field and the completion of the SCP Expansion (SCPX), the Trans-Anatolian Natural Gas Pipeline (TANAP), and the Trans-Adriatic Pipeline (TAP) in 2019 increased gas flow to Türkiye and Europe to 16 bcm. To boost the system's transmission capacity to 24 bcm, Georgia constructed a parallel gas pipeline and additional compressor plants, each with 61 MW capacity, which was commissioned in 2018. Underground gas storage is vital for Georgia's energy security, helping balance seasonal supply and demand and providing a buffer against supply interruptions. A 2016 feasibility study by Geostock found it technically feasible to build such a facility in the depleted Samgori Southern Arch oilfield, but funding was redirected to Georgia's COVID-19 emergency fund, putting the project on hold.

The North-South Gas Pipeline (NSGP) system supplies Russian gas to Georgia and transits it to Armenia. Georgia's section, built between 1988 and 1994, is 133 km long with a 1,200 mm diameter, and operates at a pressure of 55 bars. The pipeline's usage has declined, with 1.94 bcm of gas transported to Armenia and 0.17 bcm to Georgia in 2019.

Georgia's internal gas market is served by the East-West and North-South Main Gas Pipeline systems, which include the Kazbegi, Kakheti, Southern, Ajara, and Poti branches. The gas pipeline system connects with Russia at the Georgia-Russia border, with Azerbaijan through the South Caucasus Pipeline, and with Armenia near the Georgian-Armenian border. The integrated system includes 19,000 km of distribution pipelines, gas distribution stations, metering units, and two currently inactive compressor stations.

6.2. Energy consumption, domestic energy production, and energy import

6.2.1. Energy consumption

Energy consumption in Georgia has been steadily increasing over the years, except for 2020. During the pandemic year, consumer behavior changed significantly, leading to a temporary reduction in energy consumption. This anomaly should be considered an outlier rather than part of the overall trend. Increased consumption and demand have further challenged Georgia's energy security. Having limited domestic production to cover the increased demand, Georgia must increase its imports, making it further dependent on external energy suppliers.

Georgia's electricity production mostly covers its domestic needs, but due to increased demand, there is a growing need to import electricity from neighboring countries. In the early 2020s, most of the imported electricity came from Russia. The share of Russian imports in the total energy mix fluctuates, but most of the imported energy is transferred to Abkhazia (Economic Policy Research Center, 2023b). Although Georgia could import electricity from Azerbaijan or Turkey, it chose Russia due to more favorable pricing (World Experience of Georgia, 2022). However, electricity imports from Russia could easily be substituted with alternative sources if necessary.

Demand for natural gas in Georgia has also increased in recent years, driven by greater access to this energy source. The Georgian government has invested significantly in connecting the entire population to the gas network. However, unlike electricity, gas is fully imported, meaning that increased consumption directly correlates with increased dependency on external suppliers. Most of the gas was imported from Azerbaijan, but with increased demand, the capacity of the pipeline was capped, leading to a rise in imports from Russia. Gas imported from Russia now carries fewer risks compared to 2006, as the pipeline is also used to deliver gas to Armenia. Any closure would thus pose a greater threat to Armenian energy security than to Georgia's. Furthermore, most of the gas imported from Russia is used by industry, so the impact on households would be limited (World Experience of Georgia, 2022).

Being a service-oriented economy with limited manufacturing, transportation is the largest oil-consuming sector. Oil products are produced in limited quantities

domestically, making the country heavily reliant on international imports. Russia is a significant supplier of oil products to Georgia, accounting for around 13% of total imports. The war in Ukraine has had little to no effect on oil imports from Russia. From 2021 to 2022, the volume of oil imports from Russia doubled, mainly due to increased demand. In 2021, Russian imports constituted 10.1% of Georgia's total oil imports, and this rose to 13.5% in 2022. However, from 2022 to 2023, both the volume and share of Russian imports slightly decreased to 13.3%.

Georgia's domestic energy consumption has shown continuous growth since 2010. The upward trend applies to all energy sources. Notably, natural gas consumption recorded a significant rise, from 597.77 kilotons of oil equivalent (ktoe) in 2010 to 2,170.90 ktoe in 2022, reflecting an increasing reliance on this energy source. Oil products also experienced growth, with consumption rising from 941.61 ktoe in 2010 to 1,406.30 ktoe in 2022. Electricity consumption increased as well, from 615.56 ktoe in 2010 to 1,150.90 ktoe in 2022. On the other hand, consumption of biofuels and waste dropped from 352.73 ktoe in 2010 to 208.10 ktoe in 2022, indicating a shift away from these traditional energy sources. Other renewable sources like wind and solar have remained minimal in the energy mix.

The overall trend suggests a growing dependence on natural gas and electricity, with a gradual decline in the use of biofuels and waste. The structure of energy consumption was rather stable from 2010 until 2022 (Figure 57). With improvements in gas networks, its share in total consumption is growing, crowding out traditional means of heating (for example waste).

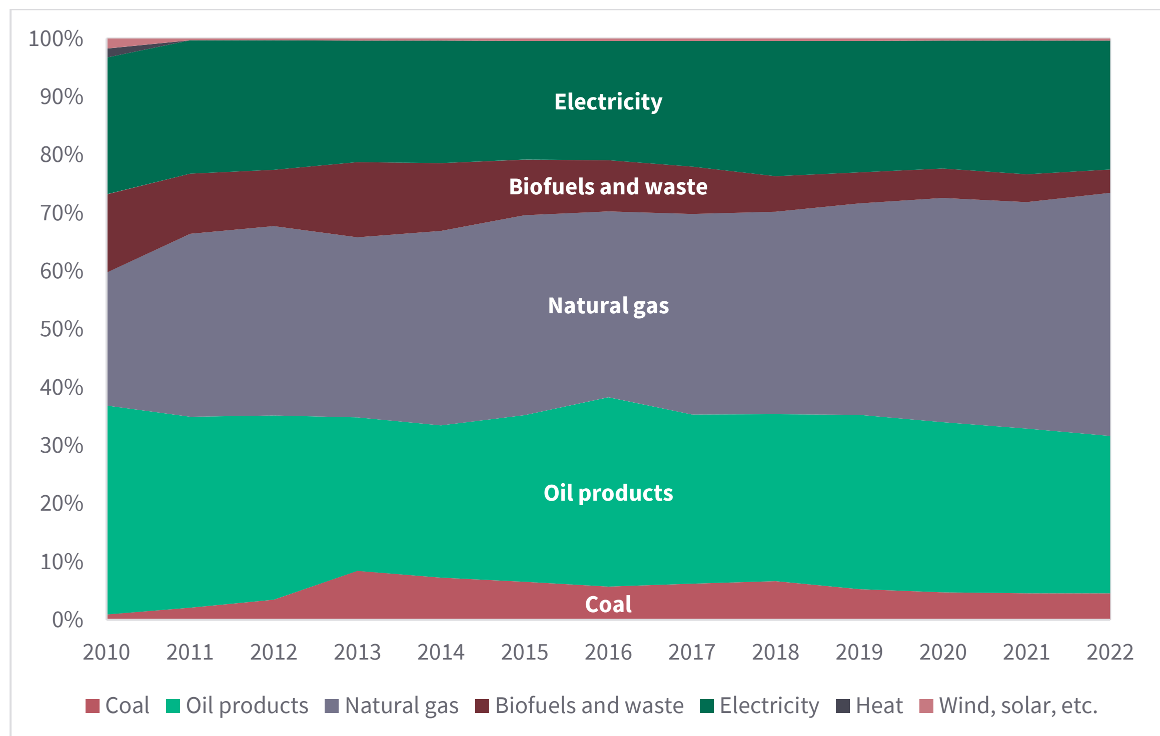

Figure 57: Final energy consumption by source, 2010-2022, in % of the total (International Energy Agency)

The residential and transport sectors are the largest consumers of energy, while industrial consumption remains below 20% (Figure 58). Both the industry and transport sectors saw a decrease in energy consumption in 2020 due to the COVID-19 pandemic, but returned to their pre-pandemic growth rates in the following year. The lockdowns and economic restrictions had no observable impact on household energy consumption, which remained stable throughout the analyzed period.

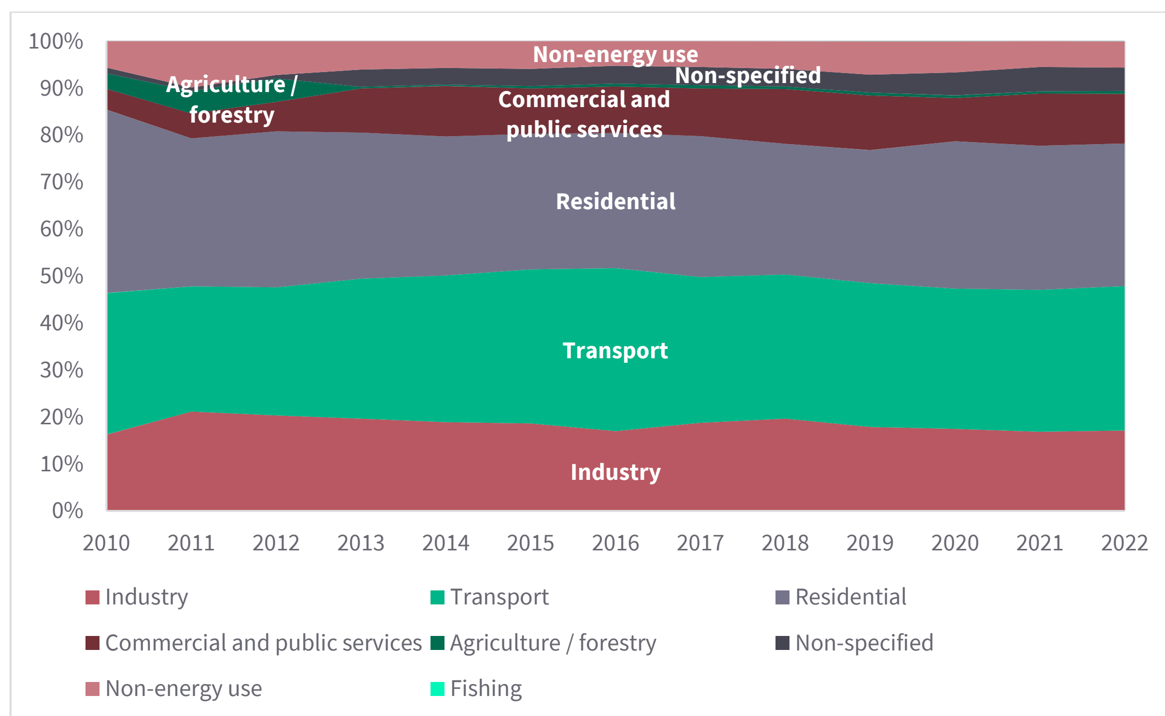

Figure 58: Total final energy consumption by sector, 2010–2022, in % of the total (International Energy Agency)[6]

6.2.2. Domestic energy production

Georgia does not have much in the way of its own energy resources. Most of Georgia's energy production comes from hydropower plants. The country also produces a small amount of crude oil. Since 2013, overall domestic energy production has declined slightly, mostly because of reduced output in coal, biofuels and waste. The decline in coal production has been offset by a partial substitution with natural gas. However, the primary cause of the decline in coal output lies in the poor state of the coal industry itself. The sector suffers from inefficient, aging infrastructure, frequent accidents, and a critical lack of investment needed to make it nationally and internationally competitive (Pignatti, 2023). Additionally, striving for sustainable energy has made the coal industry less attractive to both local and international investors. On the other hand, the decrease in biofuel production is largely due to the implementation of stricter policies aimed at reducing illegal logging and promoting sustainable management of

[6] Georgia published its first official energy balance report in 2014 (for the year 2013). Prior to this, the International Energy Agency's (IEA) data relied on alternative sources. As a result, the noticeable restructuring evident in the energy consumption chart, particularly the shift from agriculture and forestry to non-specified categories, can be attributed to changes in reporting practices rather than actual changes in energy consumption patterns.

Georgia's forests. Furthermore, the expansion of the gas network, which now serves a growing number of Georgian households, has also reduced reliance on biofuels.

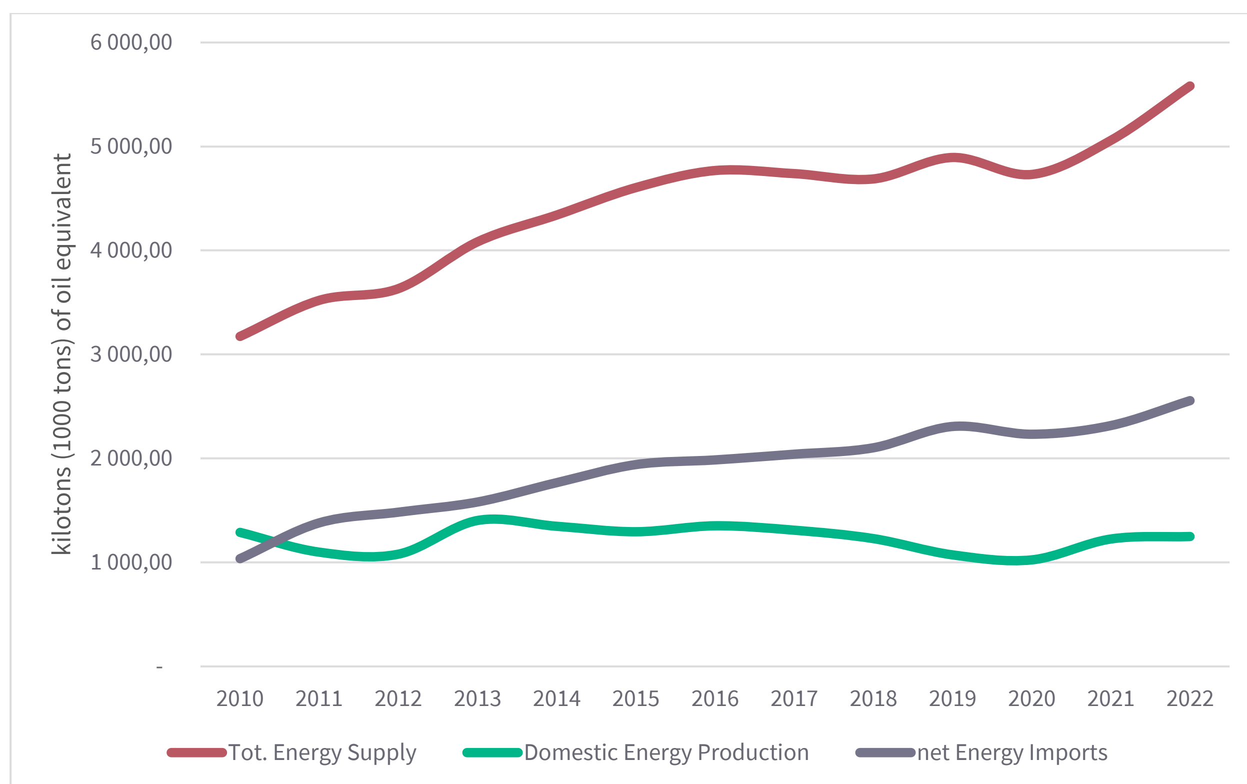

Figure 59: Total energy supply, domestic energy production, and net energy import, 2013–2022, in ktoe (International Energy Agency)

The inability of domestic production to meet the rising energy demand in Georgia has led to a growing reliance on energy imports. As shown in Figure 59, the trends in energy imports closely mirror the overall pattern of total energy supply, while domestic production has remained largely stagnant. Consequently, unless distinct measures are taken to further develop and utilize existing energy production infrastructure, Georgia's dependency on the international markets will further grow.

Most of the electricity produced in Georgia comes from hydropower plants (see Figure 60). Georgia's hydropower resources have great potential, with 2,286 proposed projects capable of generating 30 TWh/year at a construction cost of less than 0.35 USD/kWh. Hydropower could help regulate water flow during periods of extreme runoff and address various other needs, making it a vital tool in climate change mitigation and adaptation efforts. Furthermore, it offers a clean and sustainable alternative to other energy production methods.

The main challenges in developing Georgia's hydropower potential include a lack of valid environmental impact assessments and widespread public distrust in foreign companies and the government. These issues are deeply interconnected, as inadequate environmental assessments fuel public skepticism, leading to resistance against hydropower projects. Addressing these challenges is crucial for Georgia to advance its hydropower capabilities effectively. Transparent and comprehensive environmental

studies and active community engagement will be essential in overcoming these hurdles and ensuring sustainable development.

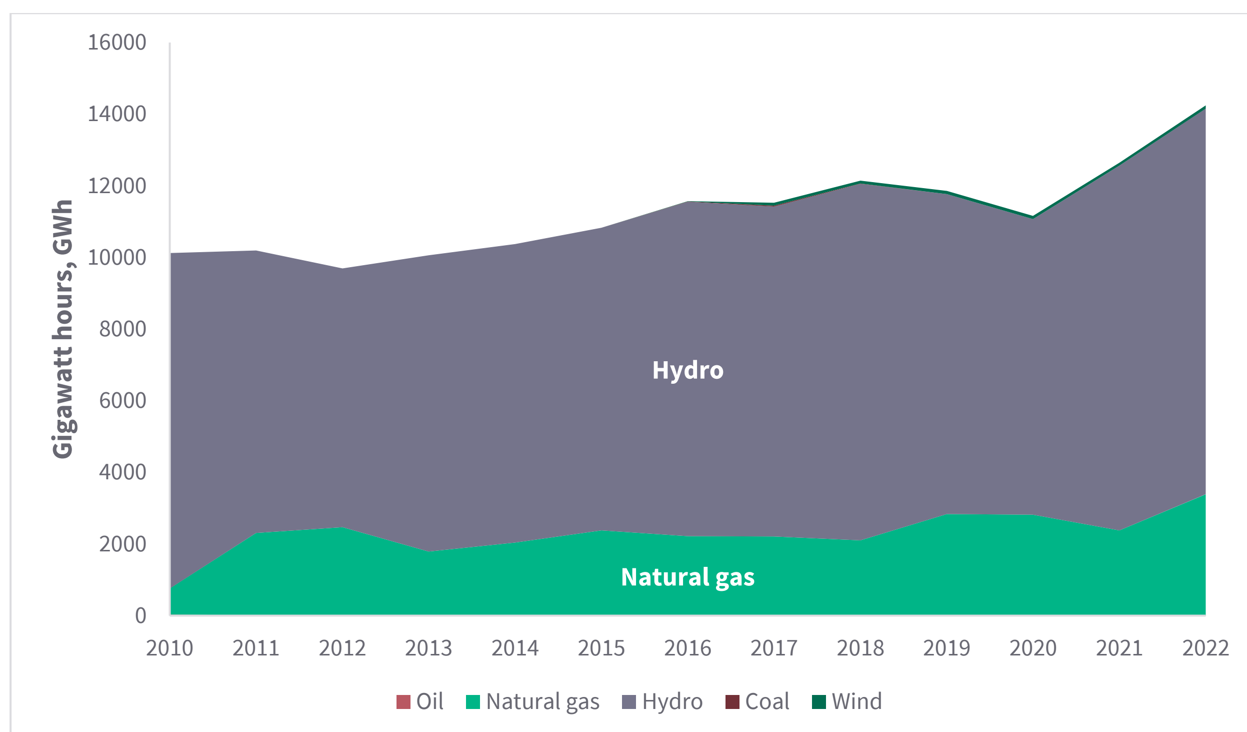

Figure 60: Domestic electricity generation by energy source, 2010–2022, in gigawatt hours, GWh (International Energy Agency)

6.2.3. Energy Imports

As discussed in earlier sections, Georgia's energy balance depends heavily on imports, particularly for gas and oil (Figure 62). While electricity imports remain relatively low, mainly during winter months, a portion of the country's electricity is generated through gas-fired thermal plants and supplemented by imports (World Experience of Georgia, 2022). This reliance on imported energy poses mid- and long-term challenges to Georgia's energy security. Although there are currently no immediate threats—since existing agreements with partner countries are secure—any potential disruption could be managed through alternative solutions. However, this dependency highlights the need for a more resilient and diversified energy strategy to ensure long-term stability.

The largest energy source imported into Georgia is natural gas. Unlike oil products, which only in 2022 returned to pre-pandemic levels, growth of natural gas imports has been consistent, even during the COVID-19 pandemic (Figure 61). This surge in natural gas imports highlights Georgia's growing dependence on this energy source and, by extension, on the countries from which it imports gas. Despite the ongoing war in Ukraine, Russia continues to be a significant gas supplier to Georgia. In fact, in 2023 gas imports from Russia to Georgia increased by 16.5%. However, Azerbaijan remains the primary supplier of natural gas to Georgia (Civil.ge, 2024b).

The share of imports in Georgia's energy supply has at times surpassed 80% (Figure 62). For economies with limited energy production, such high dependency is not surprising. In Figure 62, Georgia is compared to the EU and other countries of the

region in their dependency on energy imports. Energy dependency is calculated by considering the scale of energy exports. Georgia's energy dependency is smaller than the share of imports in the total balance, as Georgia re-exports part of the imported energy.

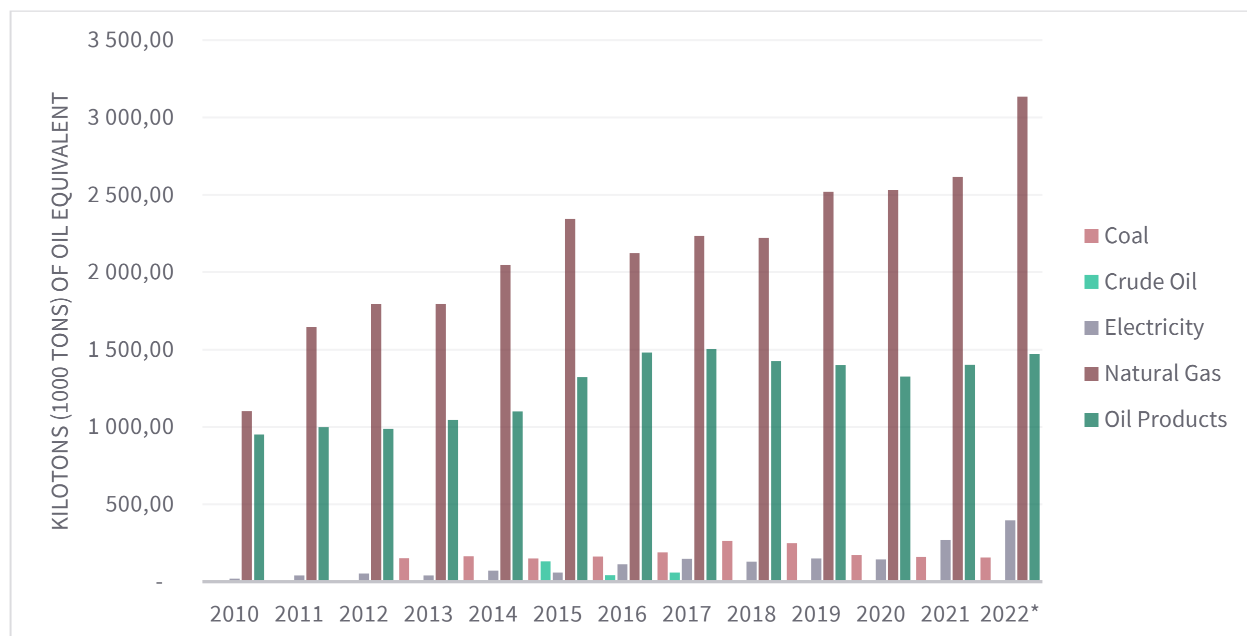

Figure 61: Net energy imports by energy source (coal, natural gas, crude oil, natural gas, electricity, oil products), 2010–2022, in ktoe (International Energy Agency)

Georgia's dependency on energy imports is above the EU average (Figure 62), which is understandable given the differences in domestic energy production and infrastructure development. EU countries benefit from higher levels of domestic energy production and more advanced domestic infrastructure, which reduces their need for imports, although they remain dependent on external energy sources. In contrast, Georgia's reliance on imported energy, particularly natural gas and oil products, highlights the vulnerability of its energy system.

The import dependency shown in Figure 62 considers the scale of not only imports, but also exports. According to the data, Georgia's dependency on imported energy is growing. In 2022 it reached 77%, while in 2013 it was around 66%.

To understand energy dependency better, the geographical distribution of the countries from which Georgia imports energy should be considered. According to Figure 62, its major import partners are Azerbaijan, Russia, Romania, Bulgaria, and Turkmenistan. Since 2015, Azerbaijan has been the largest energy exporter to Georgia. In 2022, Georgia experienced significant disruption in its energy imports, with the share of fuel imported from Russia rising sharply from around 20% to 42%. Notably, the overall year-on-year increase in energy imports, approximately USD 659 million, was largely driven by this surge in imports from Russia, which accounted for USD 569 million of the total increase between 2021 and 2022. The increased imports of fuel from Russia in 2022 were particularly notable, as they occurred despite the EU and US introducing sanctions against the Russian energy sector.

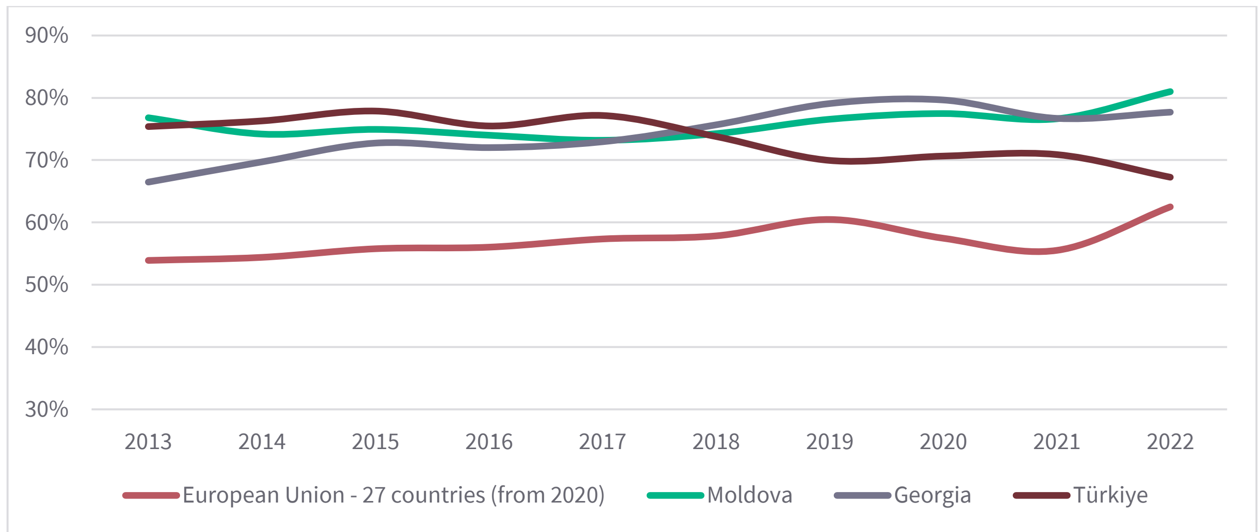

Figure 62: Energy import dependency, 2013–2022, in % (Eurostat)[7]

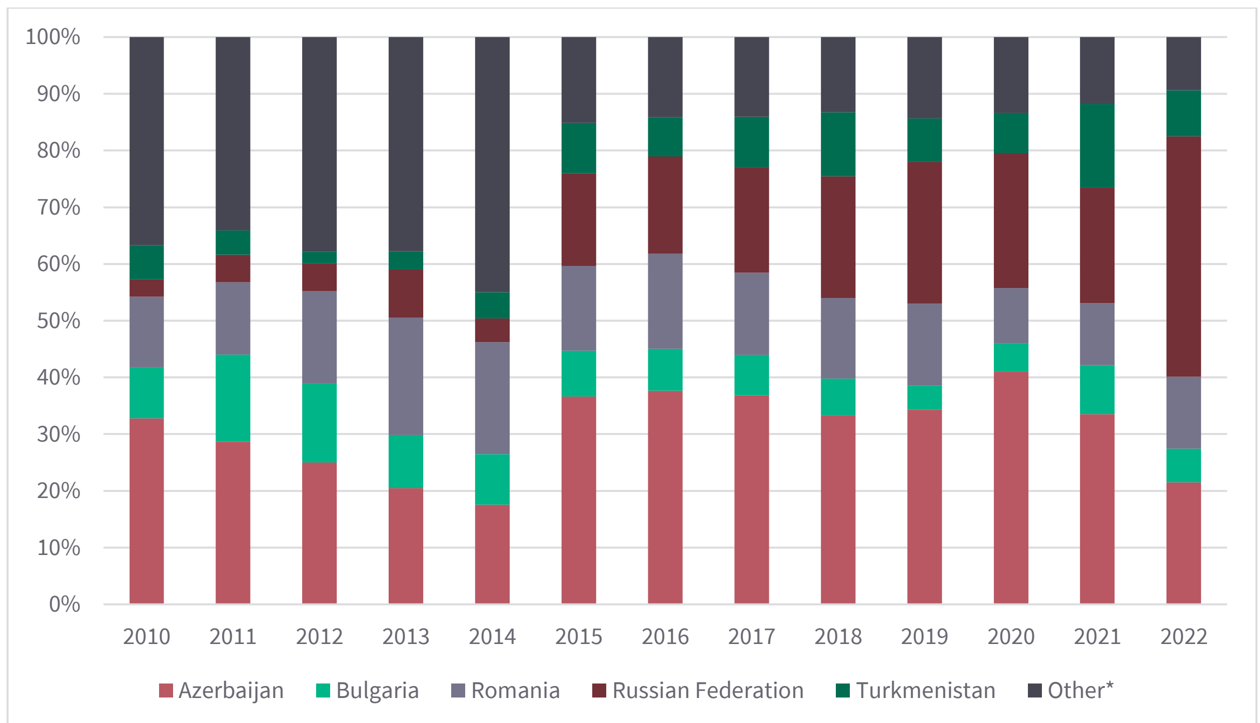

Figure 63: Energy import by partner country 2010–2021, in % of the total (World Integrated Trade Solutions – WITS)[8]

[7] Energy imports dependency (Figure 63) shows the share of a country's total energy needs met by imports. The rate shows the proportion of energy that an economy must import. It is defined as net energy imports divided by gross available energy, expressed as a percentage.
[8] In the selected timeline (2010–2014) large chucks of energy imports are marked as "Unspecified," hence the number of other imports is drastically reduced once the "Unspecified" imports are reduced to 0.

6.3. Renewable energy: development and potential

In 1994, Georgia joined the United Nations Framework Convention on Climate Change (UNFCCC). In 2017, the country's government approved the Paris Agreement. Georgia updated its national climate goals in April 2021 through its revised Nationally Determined Contributions (NDC), by setting more ambitious objectives. According to the revised NDC, Georgia plans to unconditionally reduce its greenhouse gas (GHG) emissions by 35% below the 1990 level by 2030, or by 50% if international support is available (Ministry of Environmental Protection and Agriculture, 2021). In other words, the Georgian government has shown openness and willingness to contribute to global climate objectives.

Georgia is currently one of the leading countries in the use of renewable energy sources for electricity generation, as shown in Figure 66. Despite the growing energy demand, the share of renewable and low-carbon footprint sources in Georgia's power generation remains over 70%, although there has been a slight reduction recently. Increased demand has negatively impacted electricity production, as renewable sources struggle to meet the growing demand, leading to an increased reliance on gas as an alternative source of power generation. Consequently, the share of renewables in total final consumption has also declined (see Figure 66), which has been reflected in higher carbon emissions (see Figure 64). However, despite the rise in carbon emissions, Georgia remains below the world average. In a regional context, Georgia's carbon emissions are on a par with Armenia's and outperform Moldova's.

This decline in the share of renewable energy reflects the challenges of meeting increasing energy needs while maintaining a high reliance on renewables. However, as discussed earlier, there is significant potential to improve this situation by enhancing infrastructure and further developing hydropower resources. Investing in these areas could sustain and increase the share of renewable energy in Georgia's energy mix, reinforcing the country's commitment to sustainable and low-carbon energy generation.

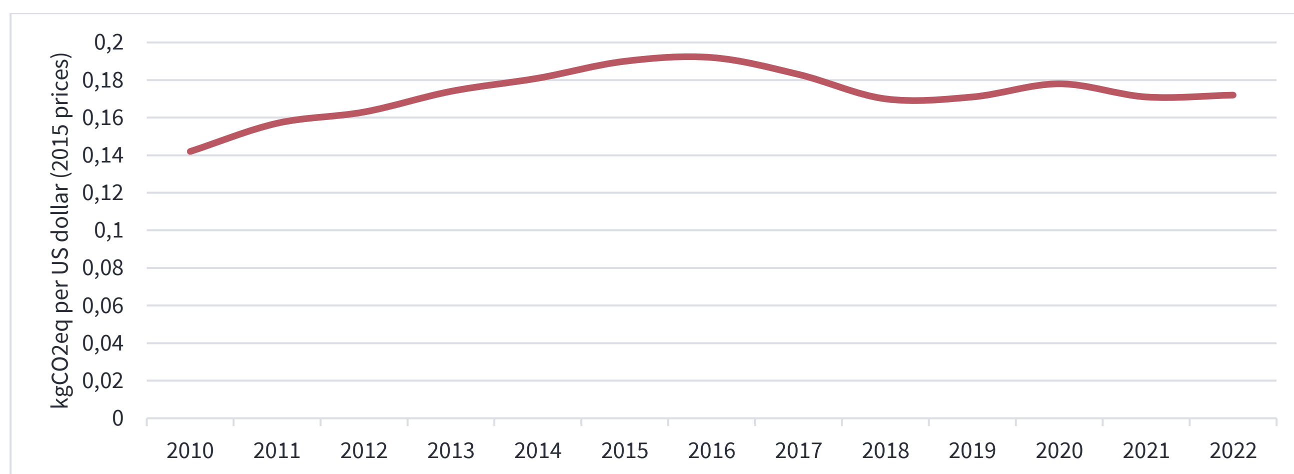

Figure 64: CO2 emissions per unit of GDP (PPP of 2015), 2010–2022, (International Energy Agency)

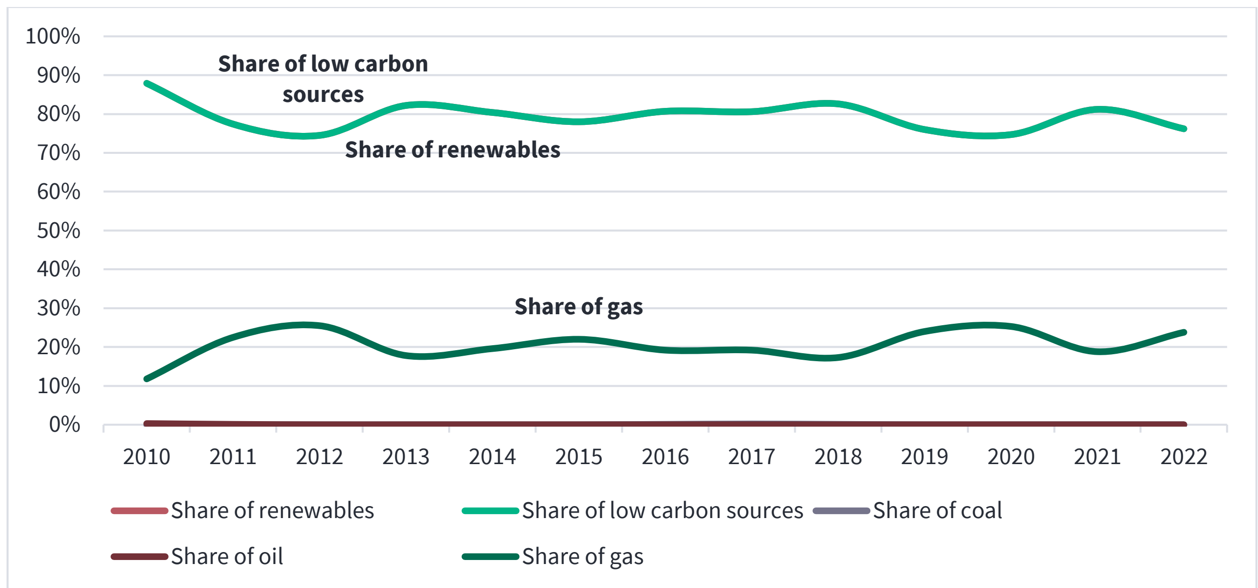

Figure 65: Share of renewables, low-carbon sources, and fossil fuels in power generation, 2010–2022, in % (International Energy Agency)

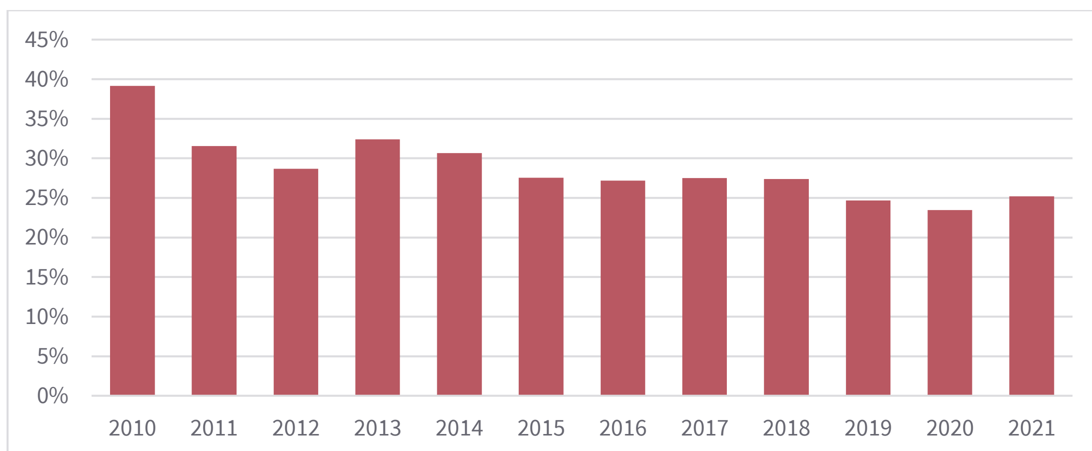

Figure 66: Renewable share in final energy consumption, 2010–2021, in % of the total (International Energy Agency)

6.4. Energy policies and outlook

The primary objective of Georgia's energy policy is to improve energy security by providing a continuous and affordable supply of sufficient, high-quality, and diverse forms of energy as stated on the webpage of the MESD. To achieve this objective, a set of policies was identified by the Parliament of Georgia (2015a):

- Diversification of energy supply sources, optimal utilization of Georgia's energy resources, and the creation of reserves;
- Utilization of Georgia's renewable energy resources;
- Gradual alignment of Georgia's legislation with EU legislation;
- Development of Georgia's energy market and improvement of energy trading mechanisms;

- Enhancing Georgia's role as a transit country in the region;
- Positioning Georgia as a regional hub for clean energy production and trade;
- Development and implementation of a unified approach to energy efficiency;
- Incorporation of environmental components in the implementation of energy projects;
- Improvement of service quality and protection of consumer interests.

A strategy document to maintain the coherence of Georgia's energy policy has been adopted in 2024 (MESD, 2024). According to this document, Georgia's energy policy is managed by several key institutions, each with distinct roles. The MESD is responsible for developing and implementing energy policies, including setting strategic priorities and ensuring energy security. The Georgian National Energy and Water Supply Regulatory Commission (GNERC) regulates the electricity and gas sectors, issuing licenses, setting tariffs, and protecting consumer rights. The Georgian Energy Development Fund promotes renewable energy projects, while the Georgian State Electrosystem operates the national electricity transmission grid. Additionally, the Georgian Oil and Gas Corporation (GOGC) manages gas imports and infrastructure, and the Georgian Gas Transportation Company ensures the safe operation of the gas pipeline network. Finally, the State Agency for Oil and Gas oversees the exploration and production of oil and gas resources, ensuring adherence to state policies and attracting investments.

6.4.1. Policies regulating energy prices, subsidies, and preferential treatments

In Georgia, most consumer tariffs for electricity and gas are fully regulated, allowing the population to benefit from tiered electricity tariffs. However, the Georgian government has made steps toward deregulating the electricity market, and potentially allowing the market to dictate the pricing—at least to a certain degree. Starting in July 2024, large consumers were enabled to trade on the Georgian Energy Exchange. However, trade remains voluntary and open mostly to large-scale consumers. According to MESD, the current year will be used for monitoring purposes (Agenda.ge, 2024). As of 2024, approximately 60% of total electricity consumption, covering the general population and some businesses, is subject to regulated tariffs. The remaining consumers, primarily large businesses, purchase electricity on the wholesale market, which operates independently of GNERC's regulation (Galt and Taggart, 2024).

Tariffs are currently designed with the idea of promoting energy conservation and reducing social burdens. In other words, tariffs are progressive, to discourage over-consumption. Reduced tariffs have been applied to predetermined vulnerable groups. For consumers in high mountainous settlements, the government compensates 50% of monthly charges for electricity, as long as the consumed electricity does not exceed 100 kWh (Parliament of Georgia, 2015b). Furthermore, government subsidies reduced tariffs of up to 200kWh consumption per month for families with a rating score of less than 150,000 in the Unified Database of Socially Vulnerable Households.

Commercial tariffs for natural gas follow a similar structure, providing commercial consumers with natural gas under publicly offered conditions and prices. There is no separate control over state-owned energy companies engaged in trade and supply or

network-related activities. Households and thermal power plants (collectively referred to as the "social sector") receive gas at rates regulated by the GNERC. These rates are further supported by preferential pricing established through a memorandum of understanding between the Government of Georgia and SOCAR, with subsidies provided by the GOGC. In contrast, gas prices for the commercial sector, including industry and small enterprises, are deregulated. Supply companies are required to publish gas quantities and prices for deregulated consumers on their official websites (Energy Community, 2023)

6.4.2. Policies and strategies for reducing dependency on fossil fuels and development of renewable energy sources

Georgia has made attempts to prioritize the development of renewable energy to reduce its reliance on fossil fuels and potentially offset its energy dependency on the international markets. In 2020 (Parliament of Georgia, 2019), Georgia adopted the renewable energy promotion law, which sets the legislative frameworks that encourage investment in renewable energy, particularly focusing on hydropower, wind, and solar. This law incentivizes private investment by offering tax breaks and favorable Power Purchase Agreements. In line with Georgia's commitments under the Energy Community Treaty, Georgia developed the National Renewable Energy Action Plan (NREAP), which sets out the country's goals for renewable energy development. It outlines specific targets for hydropower, wind, and solar energy production, with a long-term goal of increasing the share of renewables in the national energy mix (NREAP, 2019).

6.4.3. Agreements related to reducing the country's dependency on energy imports

Georgia has signed several international agreements aimed at reducing its dependency on energy imports and promoting the production of renewable energy locally. In 2017, Georgia became a member of the Energy Community, and by doing so committed to aligning its energy policies with the EU's energy market regulations. Georgia is part of the Black Sea Transmission Network Project, an initiative supported by the EBRD and the World Bank, which involves building a high-voltage transmission line connecting Georgia with Turkey and facilitating the export of Georgian-generated electricity to the EU market. Such an initiative aligns with Georgia's need to integrate with the European energy market and reduce dependency on a narrow group of energy partners. Furthermore, the AA with the EU has been one of the overarching documents guiding reforms in the energy sector, particularly in renewable energy development.

Chapter 7. Sources of Vulnerability and Risk Factors in Georgia's Economic Sectors

The Georgian economy has shown resilience amidst the economic crisis triggered by the COVID-19 pandemic. With the high rate of growth in the aftermath of the 2020 economic crisis, the Georgian economy has demonstrated a high level of flexibility and adaptability. However, the very factors that enabled Georgia to rebound—meaning its small size, economic openness, and geographic location—also present a set of risks and vulnerabilities. If these shortcomings are not adequately addressed, they could quickly escalate into significant challenges, hindering future economic growth. It is crucial to understand that the factors influencing Georgia's economy are interconnected. While each sector may be impacted by different forces, the interplay between these factors creates the environment in which the Georgian economy functions. Therefore, a holistic approach and understanding are necessary to capture these vulnerabilities and then sustainably address them.

This chapter provides a structured overview of the key vulnerabilities and risks discussed in the previous chapters. While some of the problems are not limited to one policy area, they should be discussed for the whole economy.

7.1. Macroeconomic Situation

Since 2021, the Georgian economy has performed well, with the war in Ukraine even having a positive influence on economic activity. However, expectations for the coming years suggest that the pace of economic growth is likely to slow, although most forecasts still expect Georgia to grow faster than the global average. It is important to note, however, that ongoing domestic political turmoil, combined with regional and international uncertainties, makes long-term forecasting difficult and potentially unreliable.

The challenges facing Georgia's macroeconomic environment can be divided into two categories. The first includes well-known issues that can be anticipated and planned for, such as the negative balance of trade, low productivity, an aging population, workforce outflows, and heavy reliance on remittances.

The second category involves more uncertain challenges. For example, the increased money inflows due to the influx of foreign citizens amid the war in Ukraine could reverse as quickly as they arrived. Another significant risk is Georgia's heavy dependence on the tourism sector, which has been notoriously unstable. Given the increased domestic and regional political tensions, a potential decrease in the number of visitors is a real threat that could severely damage the Georgian economy. The potential worsening of Georgia's political relationship with the EU might further translate into setbacks in trade, investment, and money transfers.

Additional risks include tighter global financial conditions and the growing negative impact of climate change. To mitigate these potential challenges, a prudent monetary and fiscal policy stance, along with sufficient financial buffers, is essential. Moreover, maintaining exchange rate flexibility can help protect reserve levels by enabling adjustments in import demand.

7.2. Financial Sector

Georgia's financial sector faces challenges related to its concentration, particularly with two banks controlling most assets, deposits, and loans. This could lead not only to the dominance of these banks, but also to a lack of diversification across banks, non-bank institutions, and capital markets.

The NBG regulatory framework and conservative approach have ensured a robust macroprudential environment. However, the 2023–2024 developments in NBG's governing structure leave its independence and potential policy planning under question.

The Georgian government has tried to develop the capital markets, a task which is unlikely to be solved anytime soon. Capital market development requires more than just state planning, but also a broader development of the real economy. Additionally, the concentration of deposits in foreign currencies, particularly Russian money in Georgia, poses future threats to financial stability as the future of these accounts remains uncertain.

Currently, Georgia's financial sector is influenced by the geopolitical situation, particularly Russia's invasion of Ukraine. A successful Russian advance would likely increase the risk premium for Georgian financial institutions, potentially leading to higher risks or triggering capital outflows as Russians withdraw their deposits. While Georgia's banking sector is experienced in dealing with economic shocks, and NBG has implemented many of the necessary safeguards to maintain financial stability, the potential damage of the rapid outflow of Russian accounts will be felt in the entire economy.

7.3. External Economic Relations

As described in Chapter 5, external developments have a significant influence on the Georgian economy. The war in Ukraine has affected various economic indicators. For example, the Western sanctions against Russia contributed to the increased re-exports from Georgia to Central Asian countries. While medium-term predictions suggest that the economic effects of the war in Ukraine could have a positive impact on the South Caucasian region, they carry a set of risks. The benefits Georgia currently enjoys from trade routes, which serve to circumvent sanctions against Russia, may not be sustainable in the long term.

Ongoing tensions in domestic politics and the geopolitical reorientation of the governing political elite further threaten Georgia's external economic relations. Trade agreements with the EU have greatly benefited the Georgian economy, alongside visa liberalization and projects aimed at cultural and economic cooperation and integration. However, these relationships have recently stalled due to the Georgian government's negative rhetoric and reluctance to follow EU recommendations. If the Georgian government continues down this path, further deterioration in relations with the EU will be a real possibility. This could severely damage Georgia's economic ties with the EU and potentially leave the country overly dependent on regional markets.

While maintaining economic ties with neighboring countries is essential, relying solely on these markets without viable alternatives would leave Georgia in a vulnerable position. Russia has a long history of using economic relationships for political leverage, so excessive reliance on Russia and the Russian market poses a significant threat.

7.4. Energy Sector

Georgia faces significant challenges in securing a sufficient energy supply to meet its growing energy demand. The energy sector remains heavily reliant on imports. Despite some progress in developing renewable energy sources, these efforts have not kept pace with rising consumption, leading to increased dependency on imported natural gas and oil. This reliance makes Georgia vulnerable to fluctuations in international markets and geopolitical tensions, especially as most of its imports come from a limited number of countries and require further diversification. There has been no tangible change in Georgia's energy portfolio because of the war in Ukraine. Georgia continues to import Russian oil and gas, and the volume of these imports has further increased.

To address this challenge, Georgia must reduce its dependence on imports by developing domestic energy production, particularly through hydropower and other renewables. Diversifying energy imports is also crucial to avoid over-reliance on a single supplier, which jeopardizes energy security. Additionally, upgrading outdated infrastructure, investing in modern technologies, and enhancing energy storage and distribution are essential to building a more resilient energy sector. By tackling these challenges, Georgia can create a more secure and sustainable energy future.

7.5. Other Sectors and Policy Areas

Beyond the core economic sectors, other areas of Georgia's economy also present risks and challenges. The agricultural sector suffers from low productivity and limited access to modern technologies. This sector is highly susceptible to climate change and environmental degradation, which could impact food security and rural livelihoods. The education and healthcare systems, while improving, still lag in terms of quality and accessibility, which could hinder long-term human capital development. Additionally, the labor market faces structural challenges, including high levels of informal employment and a skills mismatch, which could impede future economic growth.

Furthermore, Georgia's political landscape is becoming increasingly polarized, amplifying social anxieties and political instability. The governing political party, informally led by oligarch Bidzina Ivanishvili, has been advancing its agenda of state capture, further deepening divisions within the country. The adoption of the "foreign agent" law, which mirrors similar legislation in Russia, has sparked widespread concern and protest. Arguably, the law is a tool to suppress civil society and independent media, which was visible before the October 2024 elections. The growing authoritarianism threatens to isolate Georgia from its Western allies, risking further deterioration in its democratic governance and complicating its path toward European integration.

In conclusion, while Georgia has made significant steps in developing a democratic and economically independent state since regaining its independence, the threat of losing these accomplishments is real. The economic vulnerabilities must be addressed, but

with the rising risks of political isolation and authoritarianism, economic reforms alone will not be enough. Efforts must be made to strengthen the independence and capabilities of democratic institutions. Who will take on this task, and when, remains an open question that requires further examination.

Chapter 8. Policy Recommendations

8.1. Macroeconomic Policy

Strengthen Fiscal Discipline: Georgia should maintain a tight fiscal policy by keeping budget deficits within manageable limits and reducing public debt levels. This will help build resilience against external shocks, and provide the government with the fiscal space needed to respond to future crises.

Enhance Monetary Policy Tools: The monetary policy of the NBG was quite cautious, especially during and after the COVID-19 pandemic. And it should remain cautious. While lower interest rates have a positive short-term impact on political attitudes to monetary policy, the NBG should not be tempted to rapidly lower them. Monetary easing should not be utilized as a tool of social and political mobilization.

Build Foreign Reserves: The NBG needs to further increase its foreign exchange reserves to create a buffer against potential external shocks, including sudden reversals in capital flows and commodity price volatility. However, the NBG should, in particular, avoid playing to public sentiments through intervention in the FX markets.

Promote Sustainable Growth: The government of Georgia should make an effort to prioritize expenditures that have the potential for high medium- and long-term returns. Education and infrastructure would be good examples of such investments. This will help sustain economic growth and reduce dependency on external factors.

8.2. Microeconomic and Sectoral Policy

Diversify the Economy: Georgia's economy is heavily reliant on a few sectors, such as tourism and agriculture, making it vulnerable to sector-specific shocks. Consequently, efforts should be made to diversify Georgia's economic structure, by promoting manufacturing, new technologies, and high-value services. This will help mitigate risks associated with sector-specific downturns, stimulate economic growth, and potentially reduce the negative trade balance. Policy initiatives to create a favorable environment for tech and manufacturing industries should be based on extensive research and market assessment. Their implementation should be closely monitored to avoid abuse of the policy instruments.

Support Small and Medium Enterprises (SMEs): Data shows that Georgia has a low level of entrepreneurship. There are initiatives aiming to foster SMEs and entrepreneurs in Georgia, but the existing business environment should be assessed and improved. The implementation of targeted policy instruments for supporting SMEs should include access to finance, tax incentives, and capacity-building programs. Strengthening SMEs will contribute to job creation and economic resilience. Furthermore, it will reduce unemployment.

Develop Capital Markets: Banks are the primary source of financing for Georgian companies. Although there have been a few cases of green bond emission by Georgian companies, their scale was small.

The development of Georgia's capital markets and improvement of the existing regulatory framework for securities and bonds could solve this problem. This will provide businesses with alternative sources of financing and reduce concentration in the banking sector. However, such policies are hard to implement and need long-term economic stability in the market, which is problematic in Georgia.

Promote Renewable Energy: Energy security and dependency on Russian energy imports remain key challenges for Georgia. Investing in renewable energy sources, particularly hydropower and solar energy, could partially offset the growing demand for imported energy. However, it is important to note that hydropower projects in Georgia have faced significant public opposition, and addressing these concerns is crucial before investing in any such initiatives.

In addition to expanding renewable energy sources, further investment should be directed toward the development of energy storage infrastructure. Enhancing storage capacity will not only help mitigate the impact of price fluctuations, but also serve as a safeguard against potential disruptions in energy supply.

8.3. Institutional and Legal Changes

Strengthen Democratic Institutions: As Georgia faces the risk of sliding into authoritarianism, strengthening democratic institutions to limit the opportunity of any political party to build a monopoly for political power is more crucial than ever.

Georgia should enhance the independence of the judiciary by implementing reforms that ensure impartiality and reduce political interference. It should also strengthen electoral bodies to ensure free and fair elections. The transparency and accountability of government institutions can be increased through regular audits, public reporting, and open data initiatives.

Strengthening the NBG's Independence: *The independence of this institution, and the impartiality of its decisions, are essential in its activities. Consequently, its ties to political actors should remain limited. In the context of 2023–2024 developments, the NBG should transition to the collegial decision-making model.* It would increase the transparency and accountability of the NBG. By granting decision-making power to a board or committee, the NBG could better resist external pressures and maintain its focus on long-term economic stability rather than short-term political interests. Such a governance structure would align with international best practices and further strengthen the credibility and effectiveness of the NBG in managing monetary policy and safeguarding financial stability in Georgia.

8.4. External Economic and Political Relations

Strengthen EU Integration Efforts: The incumbent government has abandoned the mission of EU integration. However, there is no alternative for Georgia. Therefore, Georgia should return to deepening ties with the EU by adhering to EU recommendations, advancing reforms aligned with the AA, and promoting cultural and economic exchanges. This is the only possible way for Georgia to secure its position within the European community and boost economic opportunities.

Mitigate Risks from Russian Influence: The primary threat to Georgia on the international stage has remained consistent since regaining independence: it is Russia. To counter and reduce any forms of economic and political dependency on Russia, the Georgian government must take decisive action. This includes diversifying energy imports, strengthening trade relations with Western partners, and reducing reliance on Russian markets.

Furthermore, the Georgian government should pay close attention to Russia's soft power tactics, which aim to exert influence through cultural, media, and economic channels. Strengthening Georgia's cultural and political ties with the EU and other democratic allies can help build resilience against these influences. Investments in public diplomacy, education, and media literacy will empower the population to better recognize and resist external manipulation. By proactively addressing these risks, Georgia can solidify its sovereignty and reduce its vulnerability to Russian influence.

8.5. Recommendations for External Actors

International Financial Institutions (IFIs): IFIs have played a crucial role in supporting Georgia's economic development through financial support and technical assistance. These contributions have been essential for economic development, fostering growth, and supporting key reforms across various sectors. To ensure the continuous economic development of Georgia, the IFIs' support must continue. Continued support will help Georgia address its current challenges, including economic vulnerabilities, infrastructure needs, and institutional strengthening. Furthermore, collaboration with IFIs should focus on aligning Georgia's development goals with best practices and international standards, ensuring that the country remains on a path toward sustainable growth and closer integration with the global economy.

European Commission and EU Bodies: While Georgia is going through a period of turbulence, assistance from its Western partners is essential. Understandably, the path to integration has been stalled for the moment, but the EU should not abandon Georgia during this challenging time. While Ukraine and Moldova are making steps toward further integration, Georgia should not be left out. The door to EU membership should stay open, and once the current turmoil in domestic politics is resolved, Georgia should be allowed to catch up with its peers in the EU integration process.

Although the current disappointment is understandable, the EU governing bodies must remember that the Georgian people have pursued EU integration for decades, and this aspiration remains strong despite the political will of the ruling party. The EU should continue to engage with Georgian civil society, support democratic reforms, and provide technical and financial assistance where possible, to maintain the momentum for integration and ensure that the progress made over the years is not lost. Moreover, the EU should send a clear message to the Georgian people that the country's future in Europe remains a possibility, contingent on the restoration of democratic norms and the rule of law. By keeping the door open, the EU can reinforce the hopes of the Georgian people and assist them in their strive for EU integration.

Bilateral Donors: All actors involved in development initiatives in Georgia should bear in mind the current political landscape and the associated risks. While the Georgian government and public agencies are the primary recipients of donor contributions, it is

crucial to understand that such assistance might be exploited for the gains of the political elite. This does not mean that assistance should be stopped, but rather that donors should be aware of where and how their aid is being used, and whether it truly benefits the broader population rather than serving the interests of a few.

This calls for a more transparent and accountable approach to aid distribution, ensuring that funds are directed toward initiatives that genuinely promote development, social equity, and democratic governance. Donors and international organizations should work closely with civil society organizations, independent media, and other non-state actors to monitor the use of their resources and ensure that aid reaches those who need it most. By fostering a collaborative and vigilant approach, external actors can help safeguard the integrity of development efforts in Georgia, ultimately contributing to the country's long-term stability and progress.

Summary

The presented recommendations are dependent on future political and economic conditions. If they change, some recommendations may lose their relevance. Political developments in Georgia in 2022–2024 have shaken the country's political and geopolitical frameworks to their core, raising questions about their stability. The future of Georgia remains an open-ended question, with no definitive answers in sight. Therefore, anyone reading these recommendations must consider Georgia's specific conditions before the 2024 elections. The political climate and outcomes of these elections will significantly influence the feasibility and implementation of these strategies.

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