
Country Report

Georgia

September 2008

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The Economist Intelligence Unit

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Contents

Georgia

- 3 **Summary**
- 4 **Political structure**
- 5 **Economic structure**
 - 5 Annual indicators
 - 6 Quarterly indicators
- 7 **Outlook for 2008-09**
 - 7 Political outlook
 - 10 Economic policy outlook
 - 11 Economic forecast
- 14 **The political scene**
- 20 **Economic policy**
- 22 **The domestic economy**
- 24 **Foreign trade and payments**

List of tables

- 11 International assumptions summary
- 14 Forecast summary
- 21 State budget
- 22 Gross domestic product by sector
- 23 Consumer prices
- 25 Top export commodities, Jan-Jul
- 26 Top import commodities, Jan-Jul
- 27 Main trading partners, Jan-Jul 2008
- 27 Balance of payments, IMF estimates

List of figures

- 14 Gross domestic product
- 14 Consumer price inflation
- 25 Foreign trade, Jan-Jul

Georgia

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Summary

Outlook for 2008-09 The Economist Intelligence Unit expects Mikheil Saakashvili, who was re-elected president in January 2008, to face an increasingly strong challenge to his leadership in 2008-09. Mr Saakashvili's failed attempt in August 2008 to regain the breakaway province of South Ossetia by force, which led to a brief but damaging conflict with Russia, means that there is a high risk that he will lose power over the forecast period. Economic reform efforts will be tempered by the need to make the reforms more palatable to the population, in order to avoid a repeat of the domestic turmoil of late 2007. GDP growth will slow in 2008, owing to the disruptions caused by the conflict, but is expected to recover slightly in 2009. The current-account deficit will remain above 20% of GDP in 2008-09 as strong imports cause the trade deficit to widen.

The political scene The five-day military conflict that took place in August between Georgia and Russia, and its aftermath—which included the recognition by Russia of the breakaway republics of Abkhazia and South Ossetia—will affect profoundly Georgian domestic and foreign policy for years to come. Mr Saakashvili's National Movement won a sweeping victory at the parliamentary election in May, but in early September discontent was growing at Mr Saakashvili's role in the conflict.

Economic policy The state budget recorded a deficit of Lari213m (US\$145m) in January-July 2008, a sharp turnaround from the Lari476m surplus in the year-earlier period. In mid-July 2008 parliament adopted amendments to the 2008 budget, which reversed earlier increases in social spending at the expense of the defence budget.

The domestic economy Real GDP grew by 9.3% year on year in the first quarter of 2008. This was slower than in previous quarters, and only the second time since mid-2006 that growth was not in double figures. After trending downwards mildly in April-June and falling more abruptly in July, headline consumer price inflation shot up in August to a two-year high of 12.8% year on year.

Foreign trade and payments The current-account deficit widened sharply, to US\$737m, in the first quarter of 2008, from US\$411m in the year-earlier period. As a share of GDP, the deficit expanded to 27%, compared with 21% in the year-earlier period.

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Political structure

Official name	Georgia	
Form of state	Georgia was an independent republic between 1918 and 1921, but in 1922 it was incorporated into the Soviet Union, from which it declared its independence in April 1991. The Abkhazian and South Ossetian autonomous territories, created in 1922, have both declared their independence from Georgia. Russia recognised the independence of the two territories in August 2008. A new constitution was approved in Georgia in August 1995, which reinforced the presidential-democratic form of government, providing for a strong executive branch and a unicameral 235-seat parliament. A constitutional court met for the first time in late 1996. The constitution does not address the status of Abkhazia or South Ossetia, but grants autonomous status to Adjara, another separatist region until its reintegration in May 2004	
National legislature	The Parliament of Georgia; from 2008, with 150 members—75 elected by party list and 75 by single-member districts.	
National elections	January 5th 2008 (presidential); May 21st 2008 (legislative); next elections 2012 (parliamentary) and 2013 (presidential).	
National government	The president appoints the cabinet, subject to individual approval by the legislature	
Head of state	President, currently Mikheil Saakashvili.	
Main political parties	National Movement; New Rights; Labour Party; Republican Party; Industry Will Save Georgia; New Way; Christian-Democratic Party.	
Council of ministers	President	Mikheil Saakashvili
	Prime minister	Lado Gurgenidze
	Chair of parliament	Nino Burjanadze
	State minister (EU & NATO integration)	Giorgi Baramidze
	State minister (reintegration)	Temur Iakobashvili
Key ministers	Agriculture & food	Bakur Kvezereli
	Culture & sport	Nika Vacheishvili
	Defence	Davit Kezerashvili
	Economic development	Eka Sharashidze
	Education & science	Ghia Nodia
	Energy	Aleksander Khetaguri
	Environment	Irakli Gvaladze
	Finance	Nika Gilauri
	Foreign affairs	Eka Tkeshelashvili
	Internal affairs	Vano Merabishvili
	Justice	Nika Gvaramia
	Labour, health & social welfare	Sandro Kvitashvili
Central bank president	David Amaglobeli (acting)	

Economic structure

Annual indicators

	2003 ^a	2004 ^a	2005 ^a	2006 ^a	2007 ^a
GDP at market prices (Lari bn)	8.6	9.8	11.6	13.8	16.5
GDP (US\$ bn)	4.0	5.1	6.4	7.7	9.8
Real GDP growth (%)	11.1	5.9	9.3	9.4	12.4
Consumer price inflation (av; %)	4.8	5.7	8.2	9.2	9.3
Population (m)	4.6	4.5	4.5	4.5	4.4 ^b
Exports of goods fob (US\$ m)	830.5	1,092.1	1,472.4	1,666.6	2,088.2
Imports of goods fob (US\$ m)	-1,468.7	-2,007.6	-2,686.6	-3,685.9	-4,984.1
Current-account balance (US\$ m)	-391.4	-429.5	-771.7	-1,255.1	-2,118.5
Foreign-exchange reserves excl gold (US\$ m)	196.2	386.7	478.6	930.8	1,361.2
Exchange rate (av) Lari:US\$	2.15	1.92	1.81	1.78	1.67

^a Actual. ^b Economist Intelligence Unit estimates.

Origins of gross domestic product 2007	% of total	Components of gross domestic product 2007	% of total
Agriculture	13.0	Private consumption	74.6
Industry	28.7	Public consumption	13.9
Services	58.2	Gross fixed investment	29.4
Total	100.0	Net exports of goods & services	-17.9
		Total incl others	100.0

Principal exports 2007	% of total	Principal imports 2007	% of total
Ferrous metals & gold	18.5	Oil & gas	16.3
Copper & scrap black metals	14.2	Automotives	7.1
Automotives	5.7	Pharmaceuticals	2.8

Main destination of exports 2007	% of total	Main origin of imports 2007	% of total
Turkey	16.1	Russia	15.2
US	13.9	Turkey	14.2
Azerbaijan	9.9	Ukraine	8.7
UK	7.4	Azerbaijan	8.7

Quarterly indicators

	2006		2007			2008		
	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr
Central government finance (Lari m)								
Revenue & grants	1,107.6	1,111.3	1,071.6	1,000.6	1,386.0	1,700.5	1,239.6	1,299.7
Expenditure & net lending	1,001.5	1,243.7	930.9	1,117.7	1,315.2	1,873.2	1,260.3	1,469.7
Balance	106.1	-132.4	140.7	-117.1	70.8	-172.7	-20.7	-170.0
Output								
GDP at constant 1996 prices (Lari m)	1,916.1	1,980.8	1,721.7	1,986.6	2,168.5	2,212.1	1,881.8	n/a
GDP at constant 1996 prices (% change, year on year)	9.9	11.1	11.4	13.4	13.2	11.7	9.3	n/a
Industrial production index (1996=100)	176.4	198.5	126.2	196.9	204.5	219.1	n/a	n/a
Industrial production index (% change, year on year)	22.2	9.9	9.8	15.0	15.9	10.4	n/a	n/a
Employment, wages & prices								
Employed ('000)	1,692	1,767	1,659	1,736	1,750	1,746	n/a	n/a
Unemployment rate ^a (% of the labour force)	15.4	17.1	19.2	18.8	17.9	18.9	n/a	n/a
Average nominal wages (Lari per month)	193.2	207.4	223.3	227.1	234.8	275.0	n/a	n/a
Average nominal wages (% change, year on year)	23.5	24.4	30.4	20.2	21.5	32.6	n/a	n/a
Consumer prices (2000=100)	146.1	148.4	154.1	155.3	157.5	165.2	171.5	173.3
Consumer prices (% change, year on year)	13.2	9.6	10.4	7.5	7.7	11.3	11.3	11.6
Producer prices ^b (Dec 2000=100)	146.1	145.0	148.8	155.8	169.7	173.6	177.6	185.4
Producer prices (% change, year on year)	14.7	12.2	11.1	7.2	16.2	19.7	19.4	19.0
Financial indicators								
Exchange rate Lari:US\$ (av)	1.770	1.733	1.712	1.684	1.664	1.622	1.555	1.446
Exchange rate Lari:US\$ (end-period)	1.736	1.714	1.700	1.670	1.658	1.592	1.476	1.418
Deposit rate (av; %)	12.07	11.67	9.87	9.53	9.60	9.07	9.07	10.10
Deposit rate (foreign currency; av; %)	6.43	7.23	6.77	6.80	6.33	9.20	8.27	9.60
Lending rate (av; %)	17.97	19.00	19.67	20.80	21.33	19.83	19.27	21.40
Lending rate (foreign currency; av; %)	21.50	20.63	19.43	17.77	18.20	19.17	21.10	18.27
Money market (av; %)	10.14	12.69	7.80	6.32	7.33	8.00	n/a	n/a
M1 (end-period; Lari m)	1,166.6	1,266.8	1,261.1	1,470.4	1,709.9	1,834.2	1,872.9	1,935.6
M1 (% change, year on year)	25.6	26.7	26.4	28.1	46.6	44.8	48.5	31.6
M2 (end-period; Lari m)	2,448.0	2,689.9	2,705.9	3,281.9	3,748.0	4,027.5	4,075.9	4,234.1
M2 (% change, year on year)	34.2	39.7	33.7	42.2	53.1	49.7	50.6	29.0
Foreign trade (US\$ m)								
Exports fob	232.9	258.6	223.7	320.3	330.5	365.7	330.6	473.3
CIS ^c	80.6	92.6	87.0	125.4	122.0	135.0	n/a	n/a
Imports cif	-1,023.1	-1,085.0	-1,045.1	-1,179.3	-1,317.7	-1,674.6	-1,410.3	-1,765.1
CIS ^c	398.4	390.9	395.3	418.3	444.6	595.7	n/a	n/a
Trade balance	-790.2	-826.4	-821.4	-859.0	-987.2	-1,308.9	-1,079.7	-1,291.8
Balance of payments (US\$ m)								
Merchandise trade balance	-601.1	-545.8	-599.2	-568.5	-694.9	-1,033.1	-846.7	n/a
Services balance	54.8	22.8	21.0	59.7	80.0	0.9	32.3	n/a
Income balance	50.1	69.2	48.1	-49.6	38.1	2.9	-80.9	n/a
Net transfer balance	124.5	117.3	119.0	142.5	157.3	157.6	158.0	n/a
Current-account balance	-371.6	-336.5	-411.2	-416.0	-419.5	-871.8	-737.2	n/a
Reserves excl gold (end-period)	630.4	930.8	1,019.0	1,220.7	1,469.8	1,361.2	1,422.3	1,526.1

^a International Labour Organisation (ILO) "loose" methodology, including "discouraged" workers. ^b End-period. ^c Commonwealth of Independent States.

Sources: TACIS; State Department of Statistics; IMF, *International Financial Statistics*; National Bank of Georgia (NBG).

Outlook for 2008-09

Political outlook

Domestic politics

The Economist Intelligence Unit expects Mikheil Saakashvili, who was re-elected president in January 2008, to face a strong challenge to his leadership in 2008-09. Mr Saakashvili's failed attempt in August 2008 to regain the breakaway province of South Ossetia by force, which led to a brief but damaging conflict with Russia, will lead to questioning of his decision-making by his domestic political opponents. There is a high risk that he will lose power over the forecast period, or at least be forced to call another presidential or parliamentary election. Mr Saakashvili will struggle to rebuild his personal prestige and trust in his leadership skills, both domestically and internationally. His image as a democratic reformer had already been tarnished by his administration's handling of anti-government demonstrations in late 2007, and by some controversy surrounding the presidential and parliamentary elections earlier in 2008. Furthermore, one of the main goals of his presidency, the reintegration of South Ossetia and the other breakaway province of Abkhazia, now lies in tatters. Mr Saakashvili will continue to attempt to co-opt the opposition by offering it a greater say in important political decisions, or to neutralise it by engaging in fiercely patriotic and anti-Russian rhetoric. Engaging in such rhetoric may afford him some short-term political dividends, particularly if Russia is perceived by the Georgian electorate to be pushing for his removal. However, there are already indications that the opposition is unwilling to be lenient with Mr Saakashvili, and the criticisms will intensify in the coming months.

Mr Saakashvili's ruling National Movement won a decisive victory in the legislative election held on May 21st. The boycott of parliament enacted by a large part of the opposition, in protest against perceived fraud, means that the National Movement has a stranglehold on parliament. However, should discontent towards Mr Saakashvili become more widespread, as looks likely, he may choose to call early parliamentary and presidential elections (the next ones are currently scheduled for 2012 and 2013, respectively). At this stage, there are only two politicians who could realistically challenge Mr Saakashvili's hold on power. The first is Nino Burjanadze, one of the leading figures in the "Rose Revolution" that brought Mr Saakashvili to power in 2003, and a former parliamentary chair. Ms Burjanadze distanced herself from Mr Saakashvili earlier in 2008 and is a more conciliatory figure, but she is relatively untested, as she has not held any positions of power.

The second potential challenger to Mr Saakashvili is Levan Gachechiladze, the leader of the nine-party United Opposition bloc, who came second in the controversial presidential election in January 2008. Mr Gachechiladze has built a considerable support base since emerging from the opposition protests of late 2007. It is unlikely that a challenger to Mr Saakashvili could emerge from the National Movement, as the party's prominent figures are all closely tied to the president. Furthermore, Mr Saakashvili has ensured throughout his tenure that the ambitions of emerging politicians from his party are kept in check.

Abkhazia and South Ossetia The prospects for the reintegration into Georgia of the breakaway provinces of Abkhazia and South Ossetia, which were already remote before the conflict between Russia and Georgia, have now vanished. On August 26th 2008 Russia recognised the independence of Abkhazia and South Ossetia. Although not more than a handful of countries are expected to recognise the two provinces' independence, Russia's decision appears to be irrevocable. Russia is likely to accelerate the process of integration of the provinces' military, economic and administrative structures—especially South Ossetia's—with its own, which officially began in April 2008. The Georgian government has denounced Russia's action as illegal, and will maintain a hardline stance towards Abkhazia and South Ossetia by lobbying the international community to help restore Georgia's territorial integrity, and by asking for sanctions to be imposed on companies investing in the two regions.

Diplomatic pressure by the US on Russia is highly unlikely to have the desired effect, as relations between the two countries are likely to remain frosty in the foreseeable future. The EU is concentrating on convincing Russia to pull its troops out of Georgia proper, but appears to have, in effect, taken the issue of Georgia's territorial integrity off its bilateral agenda with Russia. This is not only a result of a decision by the EU that it is not worth jeopardising its overall relationship with Russia because of this issue; it also constitutes, at least implicitly, an acknowledgment that a credible and sustained condemnation by the EU of Russian recognitions of the independence of South Ossetia and Abkhazia has been compromised by the action taken by the majority of EU states on Kosovo earlier in 2008.

Georgia and Kosovo

Kosovo fans the crisis in Georgia

The recognition by most Western states of the independence of Serbia's breakaway province of Kosovo earlier in 2008 humiliated and infuriated Russia, and set it on the road for revenge. It also encouraged and emboldened greatly the South Ossetians and Abkhaz to demand the same for themselves, which in turn alarmed Georgia, contributing to the spiral of rising tensions, which culminated in the conflict in August.

The conflict between Russia and Georgia has resulted in Russian recognition of the independence of Georgia's two breakaway regions, South Ossetia and Abkhazia, a significant development in a process that was unleashed by the recognition of Kosovo. That was the first time since the break-up of the Yugoslav and Soviet federations that borders had been changed, in the sense that some states were prepared to recognise the independence of a sub-republican unit.

Those who argued at the time that Kosovo would lead to a series of similar problems in the region and beyond look to have been proved right. The conflict in the Caucasus, which has now resulted in the break-up of Georgia, is in turn likely to lead to further repercussions for the wider region.

The Kosovo precedent

The conflict in Georgia and its results have lent credibility to the view that independence for Kosovo from Serbia set a dangerous precedent. It has undermined the claim that Kosovo was a unique case. The legal justification for recognising Kosovo's independence was weak, and there was never even much of an effort to provide a legal justification. Similarly, there has hardly been an attempt to give any reasoned explanation for the insistence, often simply repeated as a mantra, that Serbia and Georgia are separate and non-comparable cases. The obvious close parallels between Serbia and Georgia have been ignored or flatly denied. It is worth noting that Georgia, despite being a close US ally, has refused to recognise Kosovo's independence. This suggests that the Georgian leadership perceived strong similarities between the situations in Serbia and Georgia, and found that adopting a stance similar to that of its allies would be counterproductive.

There are many close parallels between the Caucasian cases and Kosovo. In both cases the regions were ethnically diverse, but the majority population wanted nothing to do with the state to which it belonged. There was conflict, population displacement and mutual ethnic cleansing in both cases. For a long period, the sovereign states no longer had *de facto* control over their breakaway territories (this was even longer in the case of Abkhazia and South Ossetia than in Kosovo after 1999). The situations were in part a result of arbitrary decisions by communist-era dictatorships. Conflict and territorial disputes had a long history in both cases, but came to the fore with the break-up of former communist federations. In neither case did the regions enjoy the constitutional right to self-determination or secession, which was reserved for republics in the former communist federations.

A sharp change in Russian policy

Recognising the independence of Abkhazia and South Ossetia marks a turnaround for Russia. In February, as the West prepared to recognise Kosovo's independence, the then president of Russia, Vladimir Putin, said that Russians would not ape the West and do the same for Georgia's breakaway republics. Russian arguments that the Georgian attempt to forcibly reintegrate South Ossetia mean that Georgia forfeited its moral and political rights to the breakaway territories mirror Western arguments over Serbia and Kosovo. Although Russia would in any case have responded militarily to an attempt to recover by force either of the breakaway provinces, it is unlikely that it would have gone as far as recognising their independence had there not been the precedent of Kosovo.

Russia will probably continue supporting the Serbian position on Kosovo by adopting a mirror image of the Western stance on Serbia and Georgia—it will claim that Georgia is unique. Russia has already been arguing that the situations in Kosovo and the two Georgian breakaway regions are completely different. For example, it is invoking Serbian historical and cultural claims to Kosovo in contrast to the two Caucasian breakaways, which it claims never belonged to Georgia. However, the moral and legal strength of this support by Russia has now been undermined.

Many developing countries will have been alarmed by the latest developments in the Caucasus and apparent international free-for-all in which any secessionists with powerful outside backers can achieve independence. Another implication of recent developments is that the process of the dissolution of the former communist federations of the USSR and Yugoslavia is still not at an end. Russia has delivered a stinging rebuke to Western states and an assertion of Russian power, but, as in the case of Kosovo's secession, there could yet be unpredictable consequences across eastern Europe.

International relations Georgian relations with Russia plummeted to a post-Soviet low in August 2008, as the two countries fought a brief but intense conflict and subsequently broke off diplomatic ties. Bilateral relations with Russia will continue to dominate the Georgian foreign policy agenda, but ties between the two countries are unlikely to improve as long as Mr Saakashvili—whom Russia wants tried as a war criminal for his alleged actions in South Ossetia—is in power. Georgia is highly unlikely to lift its veto on Russian accession to the World Trade Organisation (WTO) in 2008-09, and Russia in return will maintain the economic blockade of Georgia in place since late 2006. There is a chance that bilateral relations could improve if a less abrasive figure replaces Mr Saakashvili, but the basic political orientation of Georgia towards Western structures is unlikely to change, regardless of who is in power. This will continue to be an irritant in the relationship between Russia and Georgia, and could lead to a renewed heightening of tensions.

Georgia's desire to join NATO, already high on its foreign policy agenda, has intensified following the conflict with Russia. However, divisions within NATO with regard to Georgian membership prospects have increased, and we do not believe that Georgia will be granted a Membership Action Plan (MAP, the last formal step on the way to possible future membership) in 2008-09. Most west European countries are even more ambivalent about Georgian NATO aspirations after the events of August 2008. These countries would block or

postpone prospects for Georgian NATO membership, both to avoid alienating Russia, with whom they have burgeoning commercial ties, and to avoid the risk of going to war for Georgia (particularly if this resulted from a renewed attempt to recover the breakaway provinces). East-central European countries, along with the US, are far keener on bringing Georgia into NATO, although any push for Georgian membership during the forecast period is likely to fail.

The extent of Russian leverage over Georgia will be partly circumscribed by strong US interest in the country. This will continue to anger Russia, which views Georgia as falling within its sphere of influence. US-Georgian relations were further cemented by the large amount of financial aid pledged by the US in the wake of the Russian-Georgian conflict, and should remain strong even when a new administration takes over in the US in 2009. However, US officials have described Georgia's recourse to military action as unwise, and in time the new US administration may come to view with favour the replacement of Mr Saakashvili with a less impetuous figure. The Georgian leadership will also seek to further its long-term ambition of achieving closer relations with the EU. However, ongoing enlargement fatigue, and especially reservations about expanding into the post-Soviet space, mean that the EU is unlikely to offer Georgia a clear prospect of eventual membership for several years.

Economic policy outlook

Policy trends The Russian-Georgian war caused an inflow of several thousand internally displaced persons (IDPs) from the conflict areas, as well as substantial damage to infrastructure. Public funds, supplemented by a large amount of foreign aid (a total of US\$1.8bn has been pledged so far), will be used for providing humanitarian assistance to the IDPs and for rebuilding military and civilian infrastructure. Once short-term emergency needs have been fulfilled, economic policy will focus once more on efforts to reform the legislative, financial, energy and healthcare sectors. However, these efforts will be tempered by the need to make the reforms more palatable to the population, in order to avoid a repeat of the domestic turmoil seen in late 2007.

Privatisation earnings are set to fall progressively as the government completes sales of remaining state assets, placing into sharper focus the need to strengthen revenue collection and improve public expenditure policy. The government has made progress in bolstering revenue performance, but the unrest in late 2007 pointed to the need to make reform more palatable to the economically disadvantaged sectors of society. The government plans to do this mainly by increasing social expenditure.

Fiscal policy The full-year consolidated budget deficit on a cash basis fell to 2.3% of GDP in 2007, from 2.8% in 2006, owing to a sharper rise in revenue than in expenditure. Despite the greatly increased demand for public expenditure arising from population displacement and damage to infrastructure during the war, we believe that the large amount of foreign aid forthcoming from the US, the IMF and possibly other multilateral organisations will cover most of the additional spending needs. Therefore, the consolidated budget deficit should

only deteriorate modestly as a proportion of GDP over the forecast period. There are nevertheless significant upside risks to our forecast, as the government has undertaken substantial medium-term expenditure commitments beyond those dictated by the post-war emergency. Notably, social welfare obligations will increase, owing to the high level of unemployment and poverty; the government is now even keener than before to modernise the armed forces; and the economy remains in dire need of infrastructure and capital investment.

Monetary policy

The National Bank of Georgia (NBG, the central bank) intends to establish the rate on one-week certificates of deposit (CDs) as its main policy-signalling tool, and is currently targeting a year-end rate of inflation of 8%. The NBG raised the interest rate on one-week CDs by 3 percentage points between January and May 2008, to 12%, as part of its drive to restrain inflation. However, in August it cut the rate to 11% to mitigate the detrimental effects on economic activity of the Russian-Georgian conflict. Although economic activity and capital flows look set to slow in the remainder of the year, supply bottlenecks caused by the conflict, as well as high global energy and food prices, make it unlikely that the NBG will meet its inflation target in 2008. However, the NBG is likely to come under government pressure not to tighten monetary policy, and will only begin to consider raising the policy rate once the economy recovers from the post-war emergency.

Issuance of CDs and open-market operations should gradually help the NBG to absorb a greater amount of liquidity and will eventually facilitate the adoption of inflation targeting. Nevertheless, the development of liquid domestic securities markets, which is essential for the smooth conduct of monetary policy, will take time, and we expect tension to remain over the forecast period between the competing policy objectives of external competitiveness and domestic stability.

Economic forecast

International assumptions

International assumptions summary

(% unless otherwise indicated)

	2006 ^a	2007 ^b	2008 ^c	2009 ^c
GDP growth				
World	5.0	4.8	3.8	3.3
Russia	7.4	8.1	7.5	6.8
Turkey	6.9	4.5	4.5	4.3
Exchange rates				
US\$ effective (2000=100)	92.4	88.8	81.6	82.9
¥:US\$	116.2	117.8	105.5	101.8
US\$:€	1.26	1.37	1.54	1.52
Financial indicators				
US\$ 3-month commercial paper rate	5.0	5.1	2.6	2.8
¥ 3-month repo rate	0.3	0.6	0.7	0.9

International assumptions summary

(% unless otherwise indicated)

	2006 ^a	2007 ^b	2008 ^c	2009 ^c
Commodity prices				
Oil (Brent; US\$/b)	65.4	72.7	110.0	91.0
Gold (US\$/troy oz)	604.5	696.7	895.7	848.8
Food, feedstuffs & beverages (% change in US\$ terms)	16.1	30.9	46.2	-1.7
Industrial raw materials (% change in US\$ terms)	49.6	11.2	5.1	-8.5

^a Actual. ^b Economist Intelligence Unit estimates. ^c Economist Intelligence Unit forecasts.

Annual world GDP growth, measured at purchasing power parity (PPP), edged down to 4.8% in 2007, from 5% in 2006, and we forecast a further slowdown to an annual average of 3.6% in 2008-09 as turmoil on global financial markets inflicts damage on the US and EU economies. We expect Russia's economic blockade of Georgia to remain in place in 2008-09, but Georgia has partially succeeded in diversifying its export markets. Economic growth in Georgia's main export markets will slow in 2008-09, but should remain broadly resilient. We forecast that prices of dated Brent Blend crude oil will average US\$110/barrel in 2008 and US\$91/b in 2009, as the factors constraining supply of oil will be offset by weaker demand, especially from the OECD countries, to a greater extent than we previously expected.

Economic growth

Strong inflows of foreign direct investment (FDI) and workers' remittances fuelled investment and consumption in 2007, helping real GDP growth to rise to 12.4%, the highest rate for several years. Growth had already been slowing in 2008 before the conflict in August, which the government estimates will cost the Georgian economy around US\$1bn in damaged infrastructure and lost output. We forecast that GDP growth rate will fall to 7% for the whole of 2008, as damage to infrastructure and disruption to activity in several sectors—including construction, trade and tourism—constrains growth in the second half of the year. The period of sub-trend growth will extend into the first half of 2009, as FDI in key sectors like tourism and energy infrastructure is held back to some extent by fears of regional turmoil, and flows of workers' remittances decrease as a large number of Georgians working in Russia are forced to leave. Provided that a measure of regional stability can be re-established, we forecast that the economy will return to higher growth rates in the second half of 2009, bringing average growth for the year to 8%.

This scenario is surrounded by more uncertainty than usual. There are several downside risks. Should Mr Saakashvili lose power and a protracted period of political uncertainty—extending to the conduct of economic policy—ensue, foreign investors may shun Georgia for a longer period of time. The same would happen if conflict were to erupt again with Russia over one or both of the breakaway provinces. Finally, a slowdown in Georgia's main trading partners that is more marked than we expect could further dent domestic activity. Nevertheless, there are also a number of processes that underpin favourable growth prospects. First, the privatisation of several important industrial enterprises under the current administration, and some further sales over the forecast period, will result in restructuring and investment, stimulating

economic growth. Second, increased interest in Georgia from Western countries and international financial institutions will continue to attract external financial assistance, which will be used to cover budgetary spending, build up Georgia's infrastructure and implement economic reforms. Finally, overall growth will also be boosted by the continuing emergence of economic activity from the shadows, owing to government crackdowns on smuggling, in conjunction with tax reform.

Inflation Annual average consumer price inflation was little changed, at 9.3%, in 2007, as a result of high food and energy prices, as well as strong economic growth. Inflation rose to around 11% year on year in January-August 2008 and we now expect it to average 11.3% for the whole of 2008 as supply bottlenecks and disruptions to economic activity combine with the lagged effect of several quarters of strong economic growth to keep inflation high. A moderation of economic growth to below trend in the aftermath of the conflict with Russia will push inflation down to single figures in 2009, a process that will be helped by a moderation in global food and energy prices. However, the greater uncertainty surrounding our economic growth forecast for 2008-09 underlines the risk of more marked volatility in rates of inflation.

Exchange rates The lari strengthened further against the US dollar in both nominal and real terms in 2007 and in January-July 2008, as a result of high foreign-currency inflows—particularly of FDI, workers' remittances and external aid. However, the lari's appreciation came to an end in late July, as hostilities in South Ossetia began to flare up, and the lari's exchange against the US dollar has been stable at Lari1.41:US\$1, owing in part to market intervention by the NBG. We expect the lari to depreciate modestly in the remainder of 2008, although on average it will appreciate to Lari1.47:US\$1, compared with Lari1.67:US\$1 in 2007. The lari will then appreciate modestly on average in 2009, as foreign investors' confidence returns gradually.

External sector The current-account deficit reached around 21% of GDP in 2007, and we expect it to widen even further in 2008. We expect the trade deficit to widen markedly in 2008, as export growth is constrained by short-term damage to transport and shipment infrastructure, and imports are boosted by high energy prices, as well as by the reconstruction and rehabilitation of damaged infrastructure. This will be offset only slightly by a rise in the transfer surplus as external aid pours in. In 2009 the trade deficit will rise less markedly as exports recover and global energy prices fall, allowing the current-account deficit as a share of GDP to return to the 2007 level. We believe that FDI inflows will average little over US\$1bn per year in 2008-09, lower than the 2007 figure of US\$1.7bn, as the risk of further instability affects foreign investors' sentiment.

Georgia still has an insufficiently developed industrial base, and the domestic economy is not fully equipped to service the infrastructure projects needed to boost the country's long-term growth potential. Imports of capital and services related to construction, transport and consulting will therefore be high over the forecast period. However, increasing diversification of energy import sources away from Russia should reduce the overall price paid by Georgia for its gas

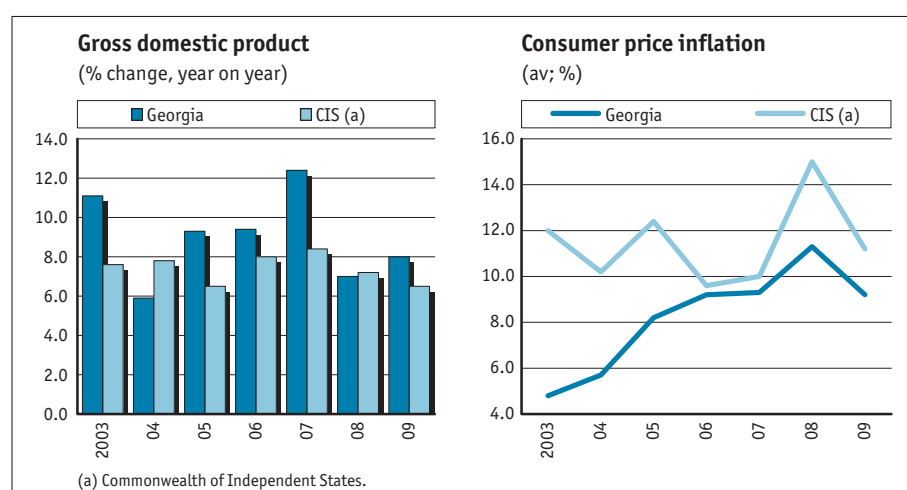
imports from 2008. Export revenue growth should improve as Georgian exporters diversify their markets, and as greater efforts to exploit Georgia's potential for hydropower generation yield an increase in exports of electricity. Barring another military conflict over the forecast period, the services balance will benefit from an increase in hydrocarbons transiting Georgia, as oil and gas pipelines have become fully operational.

Forecast summary

(% unless otherwise indicated)

	2006 ^a	2007 ^a	2008 ^b	2009 ^b
Real GDP growth	9.4	12.4	7.0	8.0
Consumer price inflation (av)	9.2	9.3	11.3	9.2
Lending rate (%)	18.8	20.4	19.0	18.0
Government balance (% of GDP)	-2.8	-2.3 ^c	-3.0	-3.2
Exports of goods fob (US\$ bn)	1.7	2.1	2.8	3.5
Imports of goods fob (US\$ bn)	-3.7	-5.0	-7.3	-8.6
Current-account balance (US\$ bn)	-1.3	-2.1	-3.3	-3.5
Current-account balance (% of GDP)	-16.2	-21.5	-24.6	-21.7
Exchange rate Lari:US\$ (av)	1.78	1.67	1.47	1.44
Exchange rate Lari:€ (av)	2.24	2.29	2.26	2.19
Exchange rate Lari:Rb (av)	0.07	0.07	0.06	0.06

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Economist Intelligence Unit estimates.



The political scene

Georgia and Russia become embroiled in military conflict

The five-day military conflict that took place in August between Georgia and Russia, and its aftermath—which included the recognition by Russia of Georgia's breakaway republics of Abkhazia and South Ossetia—will affect profoundly Georgian domestic and foreign policy for years to come. After an escalation in fighting over the previous two weeks, which had led to casualties on both sides, Georgian troops launched a full-scale offensive on Tskhinvali, the capital of South Ossetia, on the night of August 7th. The timeline of events is still hotly debated, but shortly thereafter Russian tanks and armoured vehicles entered South Ossetia from Russia via the Roki Tunnel in the Caucasus Mountains. Georgian forces briefly took control of most of Tskhinvali, but were forced on

August 10th to withdraw from South Ossetia after being overwhelmed by the Russian onslaught.

Russian troops carried on their advance well into Georgia proper, taking the town of Gori and a number of strategic towns near the main east-west motorway connecting the Georgian capital, Tbilisi, with western Georgia. Russian units also entered the western Georgian province of Samegrelo through Abkhazia, taking the town of Poti, which serves as the main commercial and military harbour in Georgia, and the military base in Senaki. Russian forces and South Ossetian militias also regained control of Akhgori district, which had been a part of the administrative region of South Ossetia during the Soviet period, but had been under the full control of the Georgian government since the first war in South Ossetia in 1991-92. Abkhaz forces with Russian support took advantage of the fighting in South Ossetia to retake full control of the Kodori Gorge, the only part of Abkhazia that remained under the control of the Georgian government.

Ceasefire agreement contains ambiguities

Despite signing a six-point ceasefire plan brokered by the French president, Nicolas Sarkozy, on behalf of the EU on August 12th, which called for both sides to withdraw their troops to the positions they held before the start of hostilities, Russian forces remained deployed deep inside Georgian territory, destroying much of the military (and, according to Georgian sources, some of the civilian) infrastructure in the areas they controlled. Russian forces pulled out of most parts of Georgia proper only on August 22nd, handing over the town of Gori to Georgian police and relinquishing control of the east-west motorway. However, they retained a heavy presence in Abkhazia and South Ossetia, as well as military checkpoints around Senaki and Poti, well outside the conflict zone.

After further talks on September 8th between Mr Sarkozy and the Russian president, Dmitry Medvedev, Russia agreed to withdraw its troops from Senaki and Poti. The Russian government exploited ambiguities in the ceasefire agreement to justify retaining its forces, numbering up to 2,600, in buffer zones inside Georgia proper around the administrative borders of South Ossetia and Abkhazia. According to the EU-Russia deal on September 8th, these forces are scheduled to be withdrawn in October and to be replaced by an international force, including EU monitors. The Russian government insisted that these forces would be stationed inside the buffer zones, but outside the territories of South Ossetia and Abkhazia. Furthermore, Russia will retain a total of around 7,600 troops in Abkhazia and South Ossetia, with the declared aim of deterring Georgia from launching another attack.

The lead-up to the conflict

Tension between Russia and Georgia over Georgia's breakaway republics of Abkhazia and South Ossetia has been simmering since the end of the conflict over Abkhazia in 1994, which in effect marked the end of Georgian control over that region. Tensions had increased steadily in 2008, especially after Kosovo's declaration of independence in February. Russia lifted sanctions on Abkhazia in March 2008, as a response to Kosovo. Soon afterwards, the Duma (the lower house of Russian parliament) held hearings on recognition of Abkhazia and South Ossetia, as well as Transdniestria, a breakaway republic in Moldova. In mid-April the then president of Russia, Vladimir Putin, held out the possibility of recognition for the breakaway republics. There were Russian provocations, as well as Georgian counter-measures, and low-level clashes in South Ossetia.

The central development, however, was the decision on August 7th by the Georgian president, Mikheil Saakashvili, to launch an assault on the South Ossetian capital, Tskhinvali, in the hope he could score a quick victory and internationalise the conflict.

Georgia insists on a different version of events

The Georgian government continues to insist that its attack on Tskhinvali was a defensive response to a Russian military offensive. Mr Saakashvili claims that a column of 150-200 Russian tanks had crossed into South Ossetia during the night between August 7th and August 8th with the intent of overthrowing his government, and that this had left him no choice but to act as he did. However, international and Georgian news agencies did not report any such Russian advance at the time. The Georgian Ministry of Defence announced in the early hours of August 8th that it had begun an offensive to restore constitutional order in South Ossetia, but said that this was in response to a resumption of heavy shelling of Georgian-populated areas by South Ossetian separatist forces despite a unilateral ceasefire by Georgia, making no mention of a Russian offensive. An analysis of news reports around the time suggests that Russian tanks entered South Ossetia after, not before, the beginning of the Georgian offensive.

Russia alleges genocide

The Russian government has accused Georgia of staging an unprovoked attack on the civilian population of Tskhinvali, and of perpetrating genocide. It wants Mr Saakashvili tried as a war criminal, although it has yet to provide substantial proof of its allegations. As most of the ethnic South Ossetian population had been issued Russian passports in recent years, and as a contingent of Russian peacekeepers was present in South Ossetia under an international ceasefire agreement, the Russian government claims that it had to intervene in order to protect its citizens. It thus defined its actions as peace enforcement, never formally declaring war on Georgia. Russia also used this rationale to extend the reach, scope and duration of its operation beyond South Ossetia and Abkhazia into Georgia proper, claiming that it had to ensure that Georgia would be unable to launch another attack.

Russian and Georgian motives

Although the so-called frozen conflict model had for years served Russian interests well, Russia had several possible motives for provoking Georgia. First, it gave Russia a chance to show the West (and the US in particular) that it is the main player in the Caucasus, and afford Russia some payback after a decade and a half of perceived slights and humiliations on the world stage, including the recognition of Kosovo's independence against its wishes earlier in 2008. Second, it would allow Russia to punish, and possibly even push out of power, the much-despised Mr Saakashvili for his enduring attempt to place Georgia firmly outside the Russian sphere of influence. Third, it would show NATO members that Mr Saakashvili is an unreliable partner, and to potential stakeholders in Caspian energy infrastructure that Georgia is a risky place to invest.

The motives behind Mr Saakashvili's decision to attempt to retake South Ossetia by force are harder to fathom, considering that the Russian military is vastly larger and more powerful than the Georgian one, and that Russia had repeatedly warned in recent months that it would intervene robustly to defend its interests in case of a Georgian military move. One possibility is that he had grown frustrated at the lack of immediate pay-off from the strategy of reintegrating the breakaway republics through soft measures, and that he yielded to the hawkish elements in his administration calling for military action. His renewed offer in May to Abkhazia of the broadest possible autonomy within Georgia—which was later incorporated into a failed attempt by the German Foreign Office to broker a deal between the sides—and his attempts to lure South Ossetian separatists to the local Georgian-backed administration by increasing infrastructural investment there had met with no tangible success. This owed in part to Russia's prevarication, but also to the breakaway republics' memory of extreme Georgian nationalism in the late 1980s and early 1990s, and to Mr Saakashvili's enduring habit of mixing peaceful overtures with more belligerent rhetoric (and occasionally actions). Mr Saakashvili may also have felt that his military, after several years of US-sponsored training and re-armament, was now capable of quickly routing the South Ossetian separatists, and establishing a *fait accompli* that Russia would find difficult or costly to overturn. Although there is evidence to suggest that Russia had been preparing for a military confrontation with Georgia, and that it did little to restrain the increasingly belligerent South Ossetian separatists from late July 2008 onwards, Georgia's all-out attack on Tskhinvali ensured that there would be a massive Russian response. This was thus a significant error of

judgement on the part of Mr Saakashvili. A clearer analysis of Georgia's scope for action would probably have suggested that Russia's superior air power would easily overwhelm Georgian military capacity, and that Western support for Georgia's territorial integrity would not go beyond rhetoric. The end result was a defeat for Mr Saakashvili's statebuilding project, the main plank of his presidency, as the already slim chance of Georgia regaining its breakaway provinces has all but vanished.

**Humanitarian consequences
are dire on both sides**

Significant damage occurred to Tskhinvali following the offensive by Georgian forces, and parts of Gori were severely damaged by Russian bombing and subsequent looting by irregular militias from South Ossetia and other provinces in Russia's north Caucasus. Ethnic Georgian villages across South Ossetia were largely cleared of their population, and a large number of Ossetians in Tskhinvali fled to North Ossetia in Russia. Initial Russian estimates put the death toll of civilians in Tskhinvali at up to 2,000, alongside 70 Russian peacekeepers. Official Russian investigators issued in early September a preliminary estimate of 311 civilian deaths. Georgian sources claimed that 215 people had been killed on the Georgian side, comprising 133 soldiers, 13 policemen and 69 civilians. The Office of the UN High Commissioner for Refugees (UNHCR) estimated that 30,000 ethnic Ossetians had been displaced from their homes in South Ossetia, and that 85,000 Georgians had been displaced, including 45,000 from Gori and 15,000 from Georgian settlements in South Ossetia.

**Russia recognises the
independence of breakaways**

Mr Medvedev announced on August 26th that Russia would immediately recognise the independence of Abkhazia and South Ossetia, presenting it as a humanitarian gesture to save lives in the breakaway regions from Georgian aggression. In previous days, the Russian government had said that it would heed the aspirations of the populations in the two provinces, and the two Russian houses of parliament had issued a non-binding declaration asking Mr Medvedev to recognise the independence of Abkhazia and South Ossetia. Although there were signs that Russia was contemplating recognising the two provinces (following the Kosovo example and given perceived difficulties in restoring the status quo ante after the war), the reasons behind Russia's haste are unclear. These may have been dictated by Russia's clear upper hand in the aftermath of the conflict, as well as a lack of perceived alternatives, given that talks on the status of the provinces had been ruled out. Georgia denounced the illegality of the recognitions, breaking off diplomatic relations with Russia on August 29th—after announcing its departure from the Commonwealth of Independent States (CIS) in mid-August—and formally declaring the two provinces to be occupied territories. The Georgian government asked the US and several European states to impose sanctions on companies investing in Abkhazia or South Ossetia.

In early September Nicaragua was the only other country to have formally recognised the two provinces' independence; Venezuela and Belarus have expressed support for the Russian decision, but have yet to extend formal recognition. The countries of the CIS have given lukewarm support for Russia's "peace enforcement" operation, but have not recognised the independence of the two provinces. Georgia's neighbours in the south Caucasus, Armenia and Azerbaijan, have kept a low profile throughout, and have been understandably quiet regarding the status of the breakaway republics, given that they have their

own frozen conflict over Nagorny Karabakh. The US, as well as the EU countries that had recognised Kosovo after its unilateral declaration of independence in February 2008, denounced the Russian stance on Abkhazia and South Ossetia, maintaining that the two cases cannot be compared.

Western governments send mixed signals

Most Western countries verbally supported Georgia during and after the conflict, accusing Russia of reacting disproportionately. However, there was little evidence all along that their response would extend beyond mere rhetoric, and none of them was willing to intervene militarily. Several governments, particularly in western Europe, are reluctant to impose substantive sanctions on Russia, fearing that a political confrontation with their principal supplier of energy could threaten burgeoning bilateral commercial ties, and destabilise their stagnating economies. Among those EU countries in favour of a more robust stance towards Russia were the UK, Poland, the Baltic states and Sweden. However, the large powers, in particular France and Germany, appeared to favour a more pragmatic approach. The statement issued at the end of the specially convened EU summit on September 1st reflected the divisions within the EU. The statement condemned Russia for its actions, but stopped short of sanctions or concrete measures, bar the postponement of the start of talks on a new Partnership and Co-operation Agreement (PCA), which had previously been scheduled for mid-September.

The US reaction to events in Georgia has been more forceful. The US government deployed two warships to the Black Sea port of Batumi to deliver humanitarian aid to Georgia. Russia questioned the decision to deliver humanitarian aid with warships, and anchored its own warships off the coast of Abkhazia, thus briefly raising the spectre of a possible military confrontation between the US and Russia. The more aggressive US rhetoric seemed to have been championed by the hawks in the presidential administration, who are arguably trying to claw back some of the influence they lost following the unpopular campaign in Iraq. The visit to Tbilisi in early September by Dick Cheney, the US vice-president and a leading proponent of a tough stance towards Russia, was noteworthy in this regard, although several US officials have since criticised Mr Saakashvili's decision to use force. The US government announced in early September an aid package for Georgia worth around US\$1bn—making Georgia the third-largest recipient of US foreign aid, after Israel and Egypt—more than one-half of which is to be disbursed immediately. Although the money is ostensibly for the reconstruction of civilian infrastructure damaged during the war, there is concern that a substantial portion of it will be used for military purposes. This would be in line with the Georgian government's stated aim of rebuilding, and possibly upgrading, its armed forces in the wake of the conflict.

Backing for Mr Saakashvili looks to be short-lived

The Russian government's perceived desire to remove Mr Saakashvili from power, confirmed by the refusal to deal with him any further, initially appeared to offset the negative effect of the conflict on Mr Saakashvili's domestic standing. Even those who had hitherto opposed Mr Saakashvili on a number of issues pledged to back him in his confrontation with Russia. At the outset of the conflict, the leader of the opposition New Rights party, Davit Gamkrelidze, who

is usually one of Mr Saakashvili's most outspoken critics, announced a moratorium on confrontation with the authorities, joined subsequently by the leader of the Republican Party, Davit Usupashvili, and other opposition politicians. However, on September 9th Mr Gamkrelidze asked Mr Saakashvili to step down and call fresh presidential and parliamentary elections. Nino Burjanadze, a former parliamentary chair, warned that although the immediate priority was the withdrawal of Russian forces from Georgia, the time would soon come for tough questions to be asked about how the conflict started. In July Ms Burjanadze, one of the leading figures in the "Rose Revolution" that brought Mr Saakashvili to power in 2003, had established a think-tank called the Foundation for Democracy and Development, which several observers believed would soon be transformed into a political party. Following Ms Burjanadze's statement, there has been speculation that she is planning a political comeback following a falling-out with Mr Saakashvili in April.

However, the opposition is also anxious not to be seen as lacking patriotism at such an emotionally charged time. Mr Saakashvili is exploiting this in order to shore up domestic support before the opposition regroup and begins to put him under greater pressure. Since the start of the conflict, he has resorted to even more fiery anti-Russian rhetoric than usual, which plays well with the Georgian electorate at a time when some Russian troops are still present in Georgia proper, and given Russian recognition of the breakaway republics. In late August Mr Saakashvili proposed a "patriot act", possibly along the lines of legislation passed in the US in the aftermath of the terrorist attacks on September 11th 2001, supposedly to prevent the overthrow of the authorities by foreign powers. He failed to provide details of the possible provisions of such an act, although he stressed that it would not infringe civil liberties. He also attempted to co-opt the opposition by proposing the setting up of a joint anti-crisis group that would oversee the distribution of foreign aid, and by revoking the previous cancellation of public financing for political parties that had boycotted parliament after the general election on May 21st.

Opposition routed in the parliamentary election in May

Events since August 7th have overshadowed the other important recent event on the domestic political scene, which was the parliamentary election in May. The relatively slim margin by which Mr Saakashvili had avoided a run-off in the presidential election in January (March 2008, The political scene) gave rise to speculation that the parliamentary election would be more closely contested than previous ones. However, the National Movement, Mr Saakashvili's party, scored an overwhelming victory, taking 59% of the vote and 119 out of 150 seats. National Movement won 48 out of 75 seats contested on a proportional basis, and 71 out of 75 seats contested in single mandate constituencies. The United Opposition bloc, which includes nine parties (June 2008, The political scene), finished a distant second, with around 18% of the vote and 17 seats (including two won in single-mandate constituencies). The newly formed Christian-Democratic Party and the Labour Party both obtained six seats, whereas the Republican Party failed to overcome the 5% barrier required to gain representation through the party list, but gained two seats in single-mandate constituencies. No other party or bloc won representation in parliament. As in

the presidential election, the authorities gained far more support in the regions than in Tbilisi.

Opposition parties denounced the elections as neither free nor fair, claiming that there had been numerous irregularities, and called for mass protests. The Organisation for Security and Co-operation in Europe (OSCE) noted some improvements in the electoral process compared with the presidential election, but remarked among other things that the National Movement made excessive use of the state's administrative and financial resources while campaigning. However, opposition allegations that the election result was totally falsified seem to be exaggerated. Although observers noted irregularities including (in a few cases) ballot stuffing, the fact that the final vote tally was little different from exit polls and parallel vote counts conducted by independent non-governmental organisations (NGOs) suggests that blatant fraud only made a marginal difference to the final result.

The opposition fails to agree on a common strategy

Mass demonstrations organised by the nine-party opposition coalition drew far fewer protesters than similar demonstrations in late 2007 and in January 2008, as many voters had become wary of the opposition's negative campaigning and lack of unity. The opposition also failed to receive the backing of the international community over their complaints, and western governments were again prepared to give Mr Saakashvili the benefit of the doubt. Shortly after the election, the main opposition bloc called on all 31 elected representatives of the opposition to boycott the new parliament, but this met with a mixed response from other groups. The Christian-Democratic Party, led by a former television anchorman, Giorgi Targamadze, refused to join the boycott, drawing sharp criticism from other opposition leaders. However, even the nine-party opposition bloc itself failed to achieve unity, as five out of 17 elected deputies defied their leaders and took their seats. This allowed the National Movement to adopt a "divide and rule" policy towards the opposition, by taking a conciliatory stance towards those opposition members who accepted their parliamentary mandates. On June 12th the National Movement and the Christian-Democratic Party agreed to increase the number of deputy speakers of parliament from four to nine, of which three would be come from the opposition ranks. Furthermore, the two parties agreed that one member of the opposition would sit on the Council of Justice, which oversees the judicial system.

Economic policy

Defence spending is increased again

In mid-July 2008 parliament adopted amendments to the 2008 budget, which reversed earlier increases in social spending at the expense of the defence budget. This change in emphasis was probably the result of reduced opposition pressure on the government after the National Movement's resounding victory in the parliamentary election. The latest amendments boosted total state spending in 2008 by a net Lari237m (US\$168m), with the Ministry of Defence and the Ministry of Internal Affairs being the main beneficiaries. Defence spending for 2008 as a whole was forecast at Lari1.4bn (US\$952m)—although this will be increased in the light of the destruction to military hardware and

installations resulting from the conflict with Russia. Lari46m was allocated for the implementation of a number of regional investment projects. The practice of using budgetary amendments to increase defence spending is a carryover from 2007, when three consecutive amendments to the budget led to an increase in planned defence spending from the original Lari513m to Lari1.5bn by the time the third amendment was passed in October.

The state budget balance deteriorates

In January-July 2008 state budget revenue continued to grow rapidly, by 28% year on year, to reach Lari3bn. This was the result of a sharp increase in tax revenue, which in turn caused a sharp year-on-year increase in the share of total revenue accounted for by tax revenue. Revenue from privatisation increased significantly in the first half of 2008; the Ministry of Economic Development reported that privatisation proceeds in January-June 2008 were US\$352m, from the sale of 544 state-owned assets. This compares with an IMF estimate of around US\$533m in privatisation revenue for 2007 as a whole. Nevertheless, owing to a sharp increase in government expenditure arising from the "United Georgia Without Poverty" campaign (March 2008, Economic policy) and spending pressures from two election campaigns, the state budget recorded a deficit of Lari213m in January-July 2008, a sharp turnaround from the Lari476m surplus in January-July 2007.

State budget

(Lari m unless otherwise indicated)

	2007		2008	
	Jan-Jul outturn	Full-year outturn	Jan-Jul outturn	% change, year on year
Revenue	2,350.4	5,600.8	3,007.2	27.9
Tax revenue (% of total)	71.6	69.4	90.3	-
Expenditure	1,874.8	4,666.1	3,220.4	71.8
Balance	475.6	934.7	-213.2	-

Source: National Bank of Georgia, *Bulletin of Monetary and Banking Statistics*.

The central bank loosens monetary policy slightly

At the end of June 2008 reserve money was growing at 34.9% year on year, compared with a rate of 50% at the end of March. During the second quarter of 2008 there was a net injection of liquidity into the financial system, as the National Bank of Georgia (NBG, the central bank) redeemed around Lari476m of certificates of deposit (CDs) issued in previous quarters, against new issuance of Lari177m. After maintaining its key interest rate on one-week CDs at 12% since April, the NBG decided in August to reduce the rate to 11%. The bank argued that a loosening of monetary policy was needed because of the expected slowdown in economic activity that would result from the conflict in August. However, during the first half of the year, higher demands for public spending associated with the parliamentary elections had kept consumer price inflation in double digits. A sharp bounce back in inflation in August after a drop in July (see The domestic economy), possibly reflecting the emergence of supply bottlenecks in the wake of the Russian invasion, highlighted the policy dilemma in which the NBG finds itself, and helps to explain why the NBG enacted only a modest loosening in monetary policy. At this stage, it looks unlikely that the NBG will meet its objective of a year-end rate of inflation of 8%.

The domestic economy

GDP growth slows in the first quarter of 2008

According to Statistics Georgia, real GDP grew by 9.3% year on year in the first quarter of 2008 (the latest available data). This was slower than in previous quarters, and only the second time since mid-2006 that growth was not in double digits. After growing strongly for several quarters, agriculture and manufacturing slowed markedly in the first quarter of 2008, whereas transport recorded a contraction. Transport in particular suffered from a negative base effect, as in 2007 it had grown much faster than the norm for the time of year. Construction activity slowed compared with the two previous quarters, but still grew at a double-digit pace. Financial services, wholesale and retail trade, hotels and restaurants, and communications all grew faster than in the previous quarter, as they benefited from rising average household incomes and the ongoing deepening of the financial sector—at the end of the first quarter, bank assets were still only equivalent to about 43% of GDP. Available economic indicators for the second quarter gave mixed indications, as growth in monetary indicators slowed, but export strength remained robust. GDP growth may have slowed further in the second quarter, although not by a significant amount.

Gross domestic product by sector

(constant 1996 prices; % change, year on year)

	2006 4 Qtr	2007 1 Qtr	2 Qtr	3 Qtr	4 Qtr	2008 1 Qtr
Agriculture	-6.7	-6.5	6.0	15.8	19.6	9.2
Manufacturing	14.2	9.4	16.9	14.6	12.4	0.7
Construction	7.6	12.1	7.0	20.8	15.0	11.4
Trade	28.5	13.9	17.8	11.5	6.2	16.9
Hotels & Restaurants	2.9	4.7	19.5	22.3	5.5	15.3
Transport	17.5	23.2	16.8	10.4	9.3	-7.9
Communications	13.8	5.6	14.0	13.3	4.5	15.0
Financial sector	39.7	18.2	33.2	21.3	-3.1	15.8
Government sector	8.1	10.8	6.8	10.8	28.9	16.1
Real GDP	11.4	11.4	13.4	13.2	11.7	9.3

Source: Statistics Georgia.

The boom in real estate is set to slow

The real estate sector has experienced unprecedented growth in recent years, with property prices increasing dramatically in the capital, Tbilisi. The average price of real estate in central Tbilisi has risen from US\$250 per sq metre to around US\$3,000 per sq metre over the past five years. There is increasing demand for high-quality commercial and residential properties, as well as tourist facilities—mainly hotels and recreational complexes—in Tbilisi, Adjara (on the Black Sea coast) and around the eastern town of Sighnaghi, which has recently been redeveloped for tourism. According to official estimates, 29% of foreign investment in Georgia in 2007 went into construction. The government has strongly favoured the real estate boom, selling government-owned properties and deregulating the construction sector. In new proposals announced by the government in June, the time needed to receive a construction permit was to be reduced to 20 days for the smallest projects, and would be no more than 60 days for the largest constructions. However, the

crisis unleashed by the military hostilities over South Ossetia is likely to have a negative impact on real estate, as tourism will be discouraged in the short term. According to data from the Public Registry, the average daily number of real estate registrations fell sharply, from around 1,900 in January-July 2008 to just 250 in the days following the conflict, before recovering to around 650 in the week beginning August 18th.

Inflation spikes in August

After trending downwards mildly in April-June and falling more abruptly in July, headline consumer price inflation shot up by 3 percentage points in August to a two-year high of 12.8% year on year. Although no breakdown was available for August at the time of writing, it is likely that the Russian advance, which blocked traffic of goods on vital transport arteries, caused bottlenecks in the supply to markets of food and other goods. In previous months price growth in food and utilities had been slowing from a very high pace, as global energy and food prices began to level off. Nevertheless, inflationary pressures in other components, such as transport and communications, failed to abate between April and July, probably as a result of buoyant activity and increased demand for telecommunication services. Producer price inflation levelled off at around 20% year on year in the first half of 2008 after rising sharply in late 2007. This suggests that downstream price pressures will continue in the next few months, compounded by the effects of the conflict on the production and delivery to market of basic commodities.

Consumer prices

(% change)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual average
2005													
Month on month	2.1	0.3	0.6	0.5	-1.4	-1.4	-2.0	0.6	1.9	1.8	1.3	1.8	-
Year on year	9.3	9.2	9.7	10.3	8.9	9.0	6.0	7.2	7.7	7.8	7.9	6.2	8.2
2006													
Month on month	1.2	0.2	0.1	1.8	2.4	-0.2	0.8	-0.4	0.0	0.8	1.0	0.9	-
Year on year	5.2	5.1	4.6	6.0	10.0	11.4	14.5	13.4	11.2	10.2	9.7	8.8	9.2
2007													
Month on month	2.7	0.7	-1.1	0.3	1.6	-0.2	0.1	0.6	1.2	2.8	1.4	0.3	-
Year on year	10.4	11.0	9.7	8.1	7.3	7.3	6.6	7.7	9.0	11.2	11.6	11.0	9.2
2008													
Month on month	2.5	0.9	0.1	0.3	0.7	-0.1	-1.2	3.4	-	-	-	-	-
Year on year	10.7	10.9	12.3	12.2	11.2	11.3	9.8	12.8	-	-	-	-	-

Source: Economist Intelligence Unit calculations based on data from the National Bank of Georgia.

The central bank intervenes to stabilise the lari

The long-term appreciation of the lari against the US dollar continued in May-July 2008, with the bilateral exchange rate peaking at Lari1.396:US\$1 towards the end of July, compared with Lari1.46:US\$1 at the end of April. However, the lari then began to depreciate slightly, broadly coinciding with the flaring-up of hostilities in South Ossetia. Since the conflict with Russia began, the bilateral exchange rate has been virtually steady at Lari1.41:US\$1. Official foreign-exchange reserves fell to US\$1.1bn at the end of August from US\$1.5bn at the end of July, indicating that, had the authorities not intervened, a sharper correction in the lari would have ensued. The lari's stability against the US

dollar allowed it to appreciate slightly against the euro, which has lost some ground against the US dollar in recent weeks.

At the end of July 2008 the real exchange rate of the Georgian currency against the US dollar had appreciated by 23% year on year. The lari's broader real effective exchange rate (REER), computed by the National Bank of Georgia (NBG, the central bank) from data on trade with Georgia's 12 main partners, appreciated by 6.7% over the same period.

Deposit growth slows, but is skewed in favour of lari

The growth of total (demand plus time and savings) deposits in the banking system has slowed markedly in recent months, falling to 24% year on year in June 2008 from 54% in December 2007. Total deposits stood at Lari3bn (US\$2bn), or around 18% of GDP, at the end of the first half of 2008. Nevertheless, the growth of lari-denominated deposits fell less than the growth of deposits denominated in foreign currencies, which was possibly a result of increased confidence in the lari owing to its long-term appreciation. The volume of deposits denominated in foreign currency contracted in the first six months of 2008, resulting in a year-on-year growth rate of just 11% at the end of the second quarter, compared with 45% at the end of 2007. At the end of June 2008 foreign-currency deposits made up 60.2% of total deposit liabilities, down from 67% one year previously.

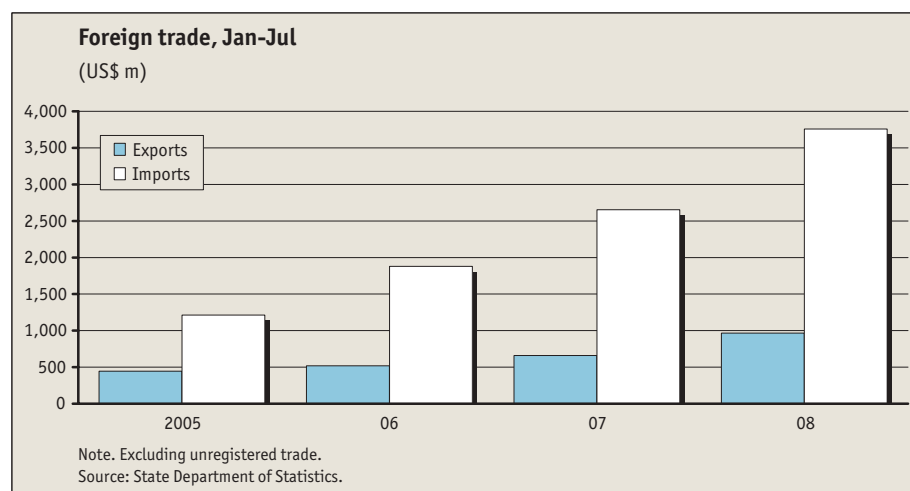
Claims on the private sector grew by 63% year on year in the first half of 2008, to Lari5.8bn, meaning that the deposit base only covers about 52% of private-sector claims. This ratio has been steadily deteriorating as banks have expanded their loan book in recent years, and deposit growth has largely failed to keep pace: in December 2006, deposits covered 69% of private-sector credit. Georgian banks have funded the surge in private-sector credit by borrowing abroad. Between end-2006 and March 2008 the foreign debt of banks almost trebled, to US\$1.5bn, comprising over 40% of the total increase in Georgia's foreign debt over that period. Nevertheless, most of the new debt incurred by banks is long-term debt, and profitability indicators in mid-2008 had yet to show signs of substantial deterioration. The banking sector's aggregate return on equity (ROE) stood at around 9%, against an average of 13% over the past six years, whereas the capital adequacy ratio was 16%, compared with an average of 19%.

Foreign trade and payments

Exports grow strongly in the year to July

According to data from the National Bank of Georgia (NBG, the central bank), total exports reached nearly US\$1bn in January-July 2008. This was a 47% year-on-year rise, which maintained the strong growth observed earlier in the year. By comparison, exports had grown by 20% year on year in January-July 2007. The total value of imports stood at US\$3.8bn in January-July 2008, a 42% year-on-year increase. Given the large difference, the higher growth rate of exports compared with imports was insufficient to prevent a widening of the trade deficit, to US\$2.8bn in January-July 2008 from US\$2bn in the year-earlier period. The coverage of the import base by export revenue increased slightly year-on-year in January-July 2008, to 25.5%, continuing the encouraging trend observed in the first quarter. These figures provided further evidence of an

upturn in Georgian exports up to the days immediately preceding the brief war with Russia, but it is likely that the disruption to transport and logistical infrastructure caused by the conflict will play havoc with foreign trade figures in the next few months.



Exports of ferrous metals and fertilisers grow strongly

The trend of rapid growth in exports of ferrous metals and fertilisers was maintained in the first seven months of 2008. The value of exports of ferrous metals increased nearly threefold over this period, making up 18% of total export value, whereas exports of fertilisers doubled over the same period, to reach 7% of the total. This is because of the rehabilitation of several large industrial plants that produce these materials, such as the Rustavi Metallurgical Plant, the Zestaponi Ferroalloy Plant and the Azoti nitrogen fertiliser plant, as well as a rise in the global price for iron ore. Gold exports doubled year on year, benefiting from the steep rise in gold prices in 2008. Exports of alcoholic beverages, however, slumped despite a good grape harvest in 2007, with exports falling from 4.8% of the total export market in January-June 2007 to just 2.9% in the corresponding period of 2008. This suggests that after some initial success in finding new markets for Georgian wines (in Ukraine and Kazakhstan, for example) after the Russian boycott in 2006, wine exporters have yet to conquer European markets.

Top export commodities, Jan-Jul (fob)

	2007		2008	
	US\$ m	% of total	US\$ m	% of total
Ferrous metals	73.7	11.2	177.0	18.3
Scrap black metals	60.9	9.3	104.4	10.8
Copper ores & concentrates	55.8	8.5	85.5	8.9
Cars	40.2	6.1	69.8	7.2
Fertilisers	32.6	5.0	68.3	7.1
Gold	30.1	4.6	60.3	6.2
Total incl others	658.3	-	965.7	-

Source: State Department of Statistics.

The value of gas imports continues to fall

The value of gas imports in US dollar terms continued to contract in the second quarter of 2008, registering a 36% year-on-year reduction in January-July 2008, and comprising just 3% of the total value of imports. This provides further evidence that Georgian consumers are switching from gas to other sources to heat their homes (June 2008, Foreign trade and payments). Alternative sources include petroleum products, and imports of crude oil and petroleum products registered a strong year-on-year increase, to become the largest import category in January-July 2008. Imports of cars also increased significantly: the total value of car imports in January-July 2008 was US\$386m, making cars the second most important import commodity. This is an indication of the effect of rising average incomes on household consumption. Imports of telecommunications hardware also continued to grow strongly, reflecting the increasing popularity of mobile telephones and satellite television.

Top import commodities, Jan-Jul

(cif)

	2007		2008	
	US\$ m	% of total	US\$ m	% of total
Crude oil & oil products	275.9	10.4	481.4	12.8
Cars	203.6	7.7	386.4	10.3
Natural gas	182.4	6.9	116.6	3.1
Medicines	79.2	3.0	109.7	2.9
Electronic goods ^a	50.1	1.9	109.6	2.9
Iron and steel	39.8	1.5	78.6	2.1
Total incl others	2,654.0	-	3,756.8	-

^a Sum of transmission apparatus for radio telephony, radio telegraphy, radio broadcasting or television, and automatic data processing machines and units thereof.

Source: State Department for Statistics.

Turkey is Georgia's leading trade partner

In January-July 2008 Turkey further consolidated its position as Georgia's leading trade partner, comprising 15% of total trade turnover. Turkey is now both the main supplier of Georgian imports and the top destination for Georgian exports. Azerbaijan ranks as the second most important trading partner. A significant component of Georgian exports to Azerbaijan is cars, many of which are bought in Germany and then sold on to Azerbaijan. Ukraine ranked as Georgia's third most important trading partner, as it is a significant supplier of Georgian imports, especially lorries and some consumer goods. Russia's role as a trading partner has diminished compared with previous years. Bulgaria is an increasingly important destination for Georgian exports, as it absorbs an increasing amount of copper ores and concentrates.

Main trading partners, Jan-Jul 2008

	% of total trade	Exports		Imports	
		US\$ m	% of total	US\$ m	% of total
Turkey	15.0	188.7	19.5	520.6	13.9
Azerbaijan	10.4	125.0	12.9	368.3	9.8
Ukraine	9.8	71.0	7.4	390.5	10.4
Germany	7.0	25.6	2.7	304.9	8.1
Russia	5.8	19.0	2.0	256.8	6.8
US	5.1	70.9	7.3	170.4	4.5
Total incl others	-	965.7	-	3,756.8	-

Source: State Department of Statistics

The current-account deficit continues to expand

The current-account deficit widened sharply, to US\$737m, in the first quarter of 2008, from US\$411m in the first quarter of 2007. The deficit expanded to 27% of GDP, compared with 21% in the year-earlier period, and in 2007 as a whole. The widening in the deficit was caused mainly by a wider trade deficit, which expanded to US\$847m (equivalent to 32% of GDP), from US\$599m in the first quarter of 2007, owing to strong growth in imports. According to data from the NBG, net income from remittances grew by 38% year on year in the second quarter of 2008, reaching US\$226m, up from 27% in the first quarter. Over 60% of remittances came from Russia, in line with recent trends. The flow of remittances from Russia, which has been helping to boost household consumption in Georgia for several years, may decrease sharply in the near future, after Russia decided in early September not to extend after expiry the visas of Georgians working there.

Balance of payments, IMF estimates

(US\$ m unless otherwise indicated)

	2007				2008
	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr
Trade balance	-599	-569	-695	-1033	-847
Exports fob	389	546	548	606	536
Imports fob	-988	-1,114	-1,243	-1,639	-1,382
Services balance	21	60	80	1	32
Services: credits	207	266	325	296	286
Services: debits	-186	-207	-245	-295	-254
Income balance	48	-50	38	3	-81
Current transfers (net)	119	143	157	158	158
Current-account balance	-411	-416	-420	-872	-737
Foreign direct investment (net)	329	362	376	586	386
Capital & financial account balance	439	595	552	739	838
Net errors & omissions	13	17	33	-74	-81
Overall balance	41	196	165	-207	20
Changes in gross reserves (a minus sign indicates increase)	-41	-196	-165	207	-20

Note. Totals may not sum, owing to rounding. Balance-of-payments export and import figures include an estimate of unregistered trade and therefore differ from customs figures.

Source: IMF, *International Financial Statistics*.

FDI covers less of the current-account deficit than before

The current-account deficit was covered by a surplus in the combined capital and financial account balance, resulting from inflows of foreign direct investment (FDI), as well as from portfolio and other inflows. FDI increased

from US\$328m in the first quarter of 2007 to US\$394m in the first quarter of 2008, but this was lower than the figure forecast by the government in recent months. This possibly reflects political uncertainty associated with the presidential election and the subsequent political turmoil. As a result, net FDI only covered 52% of the current-account deficit, much lower than in previous quarters. This has increased the likelihood that the government will have to revise downwards substantially its ambitious plan to attract US\$2bn per year in FDI inflows in 2008-12 (June 2008, Economic policy). This would increase Georgia's reliance on external debt flows to cover balance-of-payments deficits. Gross external debt amounted to US\$2.4bn at the end of June 2008. This included the proceeds from Georgia's first Eurobond in April. External debt was equivalent to an estimated 23% of GDP in June 2008, a sharp rise from 18% in June 2007.