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**GEORGIA
JOINT NEEDS ASSESSMENT**

**Donor Funding in Support of
Post-Conflict Recovery and Reconstruction**

A SECOND PROGRESS REPORT

June 15, 2010

**The United Nations
The World Bank**

With the participation of
**The Asian Development Bank
The European Bank for Reconstruction and Development
The European Commission
The European Investment Bank
The International Finance Corporation**

Georgia: Donor Funding in Support of Post-Conflict Recovery and Reconstruction

A Second Progress Report

Prepared by the United Nations and the World Bank¹²³

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¹ The United Nations and the World Bank, together with the European Commission, constitute the core team responsible for the preparation of the Joint Needs Assessment and for reporting on developments on donor pledges. This note has been prepared with the participation of the Asian Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank, and the International Finance Corporation.

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³ This document will be placed on the websites of the Government of Georgia, the United Nations and the World Bank.

Introduction

A donor conference to support Georgia's financing needs for post-conflict recovery and reconstruction took place in Brussels in October 2008 chaired jointly by the European Commission and the World Bank. A *Joint Needs Assessment (JNA)* document was prepared for the conference by international institutions. A first progress report on developments since the conference was prepared at end-June 2009. It covered the period from October 2008 to end-March 2009, i.e., the period identified in the *JNA* as the immediate, post-conflict period, when critical damage-related needs and needs arising from social displacement had to be addressed. The report reviewed financing committed and disbursed by donors in light of their pledges as well as the activities on the ground supported by the financing.

The first progress report found that the recovery and reconstruction program had got off to an encouraging start with donors having followed through with financing for the immediate period in amounts corresponding to their pledges and to the requirements as assessed by the *JNA*. The activities on the ground also showed promising results. It identified the critical need as obtaining the donor funding that was pledged for budget support. The paper also found that the authorities had risen to the challenge of managing the recovery and reconstruction program and donor financing. They were advised to continue to show flexibility in macroeconomic management as the international economic climate evolved. Furthermore, greater attention to the institutional dimensions of reform needed to be paid so as to maximize the benefits of donor support.

This report provides an update on developments to end-March 2010,⁴ and also contains an outlook for the remainder of 2010 as well as an indication of evolving priorities and consequent shifts necessitated for donor assistance, particularly in light of the emergence of the economy from the international economic crisis.

This paper is a joint product of the United Nations and the World Bank. It is based on data supplied by the Georgian authorities supplemented by information provided by the principal donors and the humanitarian community in Georgia. While not complete in every detail, it captures the overwhelming part of the donor assistance. This paper would not have been possible without the cooperation of the ministry of finance of Georgia. The United Nations and the World Bank are solely responsible for the text of this document.

Summary and Conclusions

The principal conclusions of the second progress report are:

The record to end-March 2010: activities and funding

- The implementation of the recovery and reconstruction program continues to be impressive, with donors having followed their pledges with commitments and with the amounts for budget support having been adequate. The pace of disbursements related to the implementation of the programs and projects has been brisk, attesting to the speed and

⁴ The *JNA* identified the period September 2008-March 2009 as "immediate post-conflict" (corresponding to emergency needs) and the 12-month period to end-March 2010 as the second phase of the recovery and reconstruction program. The coverage of the progress reports corresponds to these periods.

efficiency of project implementation by the authorities. The economy has absorbed the stepped-up investment spending efficiently, with the externally-funded stimulus supporting economic activity and employment. Over the period October 2008-March 2010, the *JNA* identified total funding required for the public sector at \$2.2 billion, and for the banking sector at \$700 million. Donor commitments over this period amounted to \$2.5 billion for the public sector and \$673 million for the banking sector. Disbursements to the public sector amounted to \$1.1 billion and to the banking sector \$446 million.

- Over the period covered in this *Progress Report*, budget support envisaged within the Brussels pledge framework amounted to \$618 million (*JNA* estimate: \$930 million); in addition, the IMF provided \$323 million to the budget as part of a standby arrangement. Thus, budget support aggregating in excess of \$940 million made a vital contribution to underpinning the counter-cyclical fiscal policy stance. Increased budgetary outlays were directed to social spending, resettlement of IDPs and public investment (such as roads and municipal services).
- Donor commitments for IDP return and resettlement as well as for the social sectors exceeded *JNA* estimates significantly. Striking progress was made in the construction of new durable housing for IDPs and the long-standing needs of the first wave of IDPs from the wars of the early nineteen-nineties began to be addressed. Deficiencies in income generation and livelihoods provision for IDPs, which are essential for sustainable (re)integration, were dealt with in a limited way and are to receive full attention in parallel with a sustained effort to continue improving housing conditions for both the new and old caseloads of IDPs.
- Commitments in transport greatly exceeded *JNA* estimates and a fast pace of investments in transport yielded impressive results. However, the capacity to plan and implement is being stretched and greater attention must be paid to evaluating end results. Though commitments in energy were strong, project initiation has been slow, but will likely advance well in the course of this year. Municipal programs in water and sewerage have made large gains. There has been a swift restoration of agriculture from the post-conflict damage.
- The recovery of the private sector has been slower than envisaged, given the depth of the international crisis, the weakness in international demand and the fall off in foreign direct investment. Rapid and large-scale support by IFIs for local banks through equity and debt infusions neutralized refinancing risks and bolstered the resilience of the system.
- The Action Plan adopted in May 2009 now focuses on providing durable housing solutions also for people displaced in the early 1990s including options such as rehabilitation and privatization of collective centers, resettlement, lump sum financial assistance, as well as integration and improvement of the socioeconomic conditions of IDPs;
- Coordination of a variety of initiatives undertaken by a broad range of actors has been crucial. An MRA-led Steering Committee for the implementation of the Action Plan, complemented by specific formal and informal working groups, has served as a forum for this and facilitated the discussion of longer-term vision and design.

The record to end-March 2010: institutions, results, lessons

- Over the post-*JNA* period, the government has taken steps to strengthen donor coordination, with the *JNA* framework promoting pooled arrangements, harmonization, predictability and efficiency on the side of donors and of the government. The ministry of finance drives government-donor discussions with respect to project-specific and medium-term operational strategies and to all significant assistance items. The ministry also tracks assistance to the private sector. Monitoring and results measurements of programs and projects are at an early stage of implementation and are donor-driven. Consultations with civic society have deepened over the course of the period, with full disclosure of key information and *Progress Reports*.
- Tentative conclusions can be drawn as to the results of the large-scale donor interventions over this period. Budget support has averted a collapse of domestic demand triggered by reduced consumer and lender confidence and has significantly supported employment. The resettlement of IDPs is tangible and impressive, though serious problems persist in areas close to the administrative line with South Ossetia; and a more coherent and stronger effort remains to be made on ensuring sustainable livelihoods. The integration of IDPs into the social protection network and social services has avoided the creation of a permanent under-class of citizens. A replication of this achievement for the first wave of IDPs is now necessary and this underlines the importance of sustained donor support in this area. Results in infrastructure can be measured by miles of highways built or repaired, water supplies laid, and other physical gains, but deeper results in terms of time savings, contribution of human capital and to economic productivity and growth remain to be evaluated at a later stage of implementation. The support for banking has still to be translated into results in credit expansion for private sector investments, but as recovery takes hold and risk perceptions diminish, the banks will be well poised to support a strong upturn.
- A number of lessons from the post-*JNA* experience can be drawn. Rapid disbursements into a budget that is macro-economically sound and socially responsible, accompanied by appropriate safeguards, provides a highly efficient channel for supporting social and infrastructure spending and providing a counter-cyclical stimulus. IDP-support activities in particular benefitted from budget support operations. Such activities need to be addressed in a holistic manner (going beyond the priority for shelters and housing) to encompass livelihoods and social protection as well as provision of full information on rights (for example on privatization of shelters) and attention to the fuller participation of IDPs in decisions that affect them. Thus, a deep socio-economic integration leading to flourishing communities, especially in remote areas, remains on the unfinished agenda, as do the needs of a significant number of returnees in areas of dubious security. Georgia is a leader in consolidating the management of a range of social benefits using a single registry and application system, which is applied to health insurance vouchers, the targeted social assistance, IDP benefits, and electricity vouchers.
- Infrastructure spending was ramped up by determined efforts and smooth coordination within donors and between donors and the government, utilizing well tested approaches of implementing agencies and the Municipal Development Fund. A key lesson is that greater attention has to be paid on complementary spending such as maintenance outlays and on safeguards such as environmental clean-ups. These will require particular and continuous managerial attention. Moreover, the results of existing investments both on the main corridor

and on secondary roads need to be evaluated; and the evaluation must then inform the balance between emphasis on the main corridor and secondary roads.

- The financial sector requires technical assistance in promoting local currency intermediation and fostering a range of much-needed and under-developed non-bank activities (pensions, micro-finance, insurance). Together with intermediated lending through commercial banks, sustained effort is required to foster direct donor lending to and investment in real sector entities, especially in sectors of Georgia's relative competitiveness and in high-growth potential segments of the economy.
- Institutional change has been stimulated by large-scale donor assistance, but requires committed support from donors in the form of well coordinated TA (for example, in municipal water and waste water management). Initiatives to extend the reach of the private sector in public services have proven to be difficult given prevailing economic circumstances, and will require determined efforts from the government. The level of trust between the government and civic society appears to have been bolstered with the implementation of an open approach to information disclosure.

Reaffirmation of priorities in the next JNA phase

- Looking to the remainder of 2010 and beyond, the essence of the *JNA* priorities continues to be valid and deserving of generous donor support. The major new priority relates to the need for fresh budget support over this period in light of the still-weak international recovery and the need to support social and investment activities through the budget. While this new call for budget support is being addressed, *inter alia*, by a large, new commitment from the IMF (not envisaged in the *JNA*, as the Fund was not then prepared to lend into the budget), other donors are strongly encouraged to continue providing budget support through longer-term lending and grants to the government in order to avoid excessive crowding out of fiscal space as the country pursues implementation of the Brussels pledge in the context of the ambitious fiscal consolidation program being supported by the standby arrangement.
- Support for infrastructure and municipal investments in 2010 and beyond is projected to be remarkably close to what was estimated in the *JNA*. In the full third post-conflict phase (the eighteen months from April 2010 to September 2011), donor support is likely to exceed *JNA* requirements.

JNA Findings and Proposals for Financing

The *JNA* found that prior to the conflict of August 2008, the Georgian economy was on a strong growth track, with GDP rising by 10½ per cent annually. However, the conflict dealt a shock to the key pillars of economic growth. There occurred a weakening of investor, lender and consumer confidence, a contraction of liquidity in the banking system, with banks all but ceasing to extend credit, stress on public finances, damage to physical infrastructure, and increased numbers of internally displaced persons.

The major impact of the conflict had been a fall in investment, domestic and foreign, and a steep decline in economic growth amidst rising unemployment. The economic downturn led to a fall in fiscal revenues, thereby jeopardizing critical programs and fiscal stability. The social burden arose chiefly from a high number of the initial internally displaced persons, which led to the need for shelter, food and social services programs. The resettlement of the long term displaced from the conflict of the 1990s and the recent one remained a persistent challenge.

Physical damage to the infrastructure sectors and the environment was tangible but not large. Critical sectors such as energy and roads would remain vulnerable to exogenous shocks. Thus, economic security was heightened as a public policy concern.

The government launched a swift and effective post-conflict recovery program. The authorities relaxed the fiscal stance as a counter-cyclical response to the investment and output shocks, provided immediate liquidity and regulatory support to banks, and rapidly arranged for international support. Repair to and rehabilitation of damaged infrastructure was undertaken. The social burden from the internally displaced and other conflict-affected people was met by providing temporary shelters that were being gradually transformed into durable housing, food and cash support, and access to targeted social assistance. A comprehensive approach to addressing the social needs of the current and the older set of the internally displaced was put into implementation.

The *JNA* identified the need for donor support in three major areas:

- **Support for the rapid restoration of confidence.** With growth, Georgia would generate internal resources for investment and poverty reduction. Donors could help best by providing resources for the budget to support the counter-cyclical budget policy and thereby ensure funding for critical economic and social needs. Moreover, donors needed to consider equity, debt or guarantee support to domestic banks so that lending to enterprises and consumers could be re-ignited.
- **Support for social needs.** The resettlement of the internally displaced and the needs associated with other conflict-affected populations put an unsustainable burden on fiscal resources. Through support for housing, social protection and other social programs identified in the *JNA* as well as via budget support, donors could make an important contribution to economic and social recovery.
- **Support for critical investments.** The *JNA* found that certain high value and high yield investments were essential to maximizing recovery prospects – the “core investments” in the report. Donor financing for such investments was essential as a bridge to the period when the private sector resumed investing. Such financing would also help to enhance the economic security of the country by broadening choices in energy and transport.

The *JNA* proposed that donors extend new financing in the amount of \$3¼ billion over a three year period (Annex I).⁵ Of this amount:

- Budget support was estimated at \$930 million (\$480 million in 2008 and \$450 million in 2009).

⁵ Throughout the paper, reference is made to the US dollar.

- Social sector needs were estimated at nearly \$1 billion, of which \$300 million, corresponded to immediate needs (including amounts in the UN revised Flash Appeal), i.e., were required by spring 2009.
- Infrastructure support, including urban and municipal, was estimated at \$1¼ billion, of which \$120 million (damage and immediate needs) was required by spring 2009.

In addition, the *JNA* indicated that \$700 million in donor support for the banking sector would be required. This support would be in the nature of contingent costs: unlike donor support in the three categories indicated above, banking sector support takes the form of provision of liquidity or guarantees.

Pledges at the Donor Conference

At the Brussels conference, donor pledges exceeded expectations: pledges for the public sector totaled \$3.7 billion for the purposes of budget support (\$586 million), social needs (\$450 million) and infrastructure and other core recovery (\$2.6 billion). An additional set of pledges of \$800 million to support the private sector, including \$750 million for the banking system were made.

The largest bilateral pledges were made by the governments of the United States (\$1 billion) and Japan (\$200 million). The European Commission pledged almost euro 500 million. International financial institutions announced contributions of a total of \$2.4 billion – this group encompasses the ADB (\$300 million), EBRD (\$927 million), EIB (\$330 million), Council of Europe Development Bank (\$1.3 million), and the World Bank Group (\$880 million). While not part of the pledging, the IMF had extended a \$750 million stand-by program in September 2008.

Other countries which pledged contributions were Austria, Belgium, Bulgaria, Canada, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Norway, Poland, Romania, Slovenia, Spain, Sweden, Switzerland, Turkey, the Ukraine, and the United Kingdom.

Economic Developments

Economic trends and shifting priorities in public spending. The August 2008 conflict and the global economic crisis resulted in a sharp economic downturn after four years of strong growth between 2004 and mid-2008. The economy contracted by 3.9 per cent in 2009 – a sharp reversal from the strong average growth of the preceding four years.

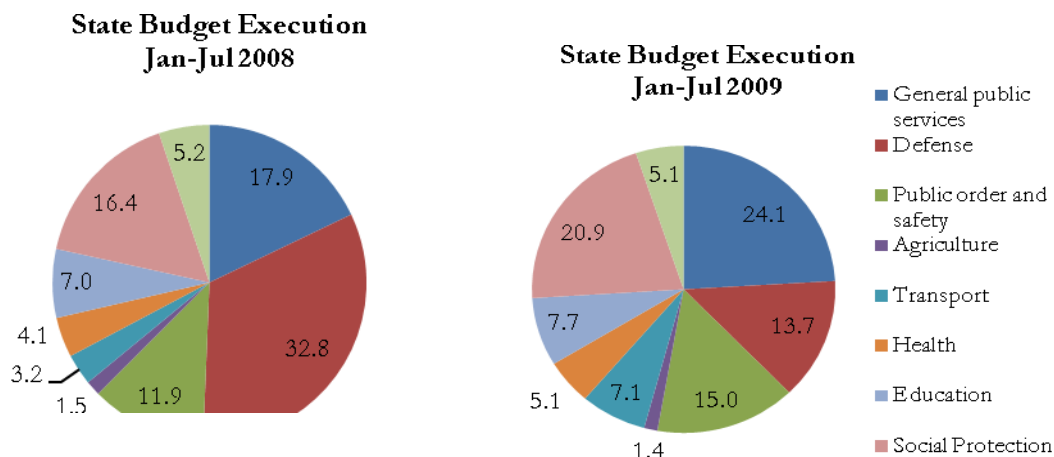
Table 1: Georgia - Macroeconomic and Fiscal Trends

	2007	2008	2009	2010	2011	2012	2013
	Actual	Actual	Prel.	Proj.	Proj.	Proj.	Proj.
GDP Growth Rate	12.3	2.1	-3.9	4.5	4.0	5.0	5.0
CPI (e.o.p.)	11.0	5.5	3.0	5.5	5.0	5.0	5.0
GDP deflator	9.7	9.7	-2.0	4.8	5.0	5.0	5.0
Nominal GDP (million GEL)	16,994	19,075	17,949	19,657	21,465	23,665	26,091
Nominal GDP (million USD)	10,227	12,867	10,745	11,285	12,133	13,106	14,174
Current Account Balance (% of GDP)	-19.7	-22.7	-11.9	-12.8	-12.6	-12.4	-11.6
Trade Balance (% of GDP)	-28.3	-29.8	-22.3	-22.9	-21.7	-21.0	-19.8
Nom Ex Rt (GEL/Dollar p.a.)	1.7	1.5	1.7				
Foreign Debt (% of GDP)	17.6	20.9	31.5	38.8	38.9	36.4	33.2
Consolidated General Government (% of GDP)							
Revenues and Grants	29.3	30.7	29.3	29.5	28.9	28.2	28.0
Tax Revenues	25.8	24.9	24.5	24.4	25.6	25.6	25.6
Expenditure and Net Lending	34.0	37.1	38.6	36.3	33.9	31.7	30.5
Current Expenditure	25.0	28.3	30.1	27.6	26.5	25.5	24.8
Capital Expenditure and Net Lending	9.0	8.8	8.4	8.7	7.4	6.2	5.7
Overall Fiscal Balance	-4.7	-6.4	-9.2	-6.8	-5.0	-3.5	-2.5
Privatization Receipts	5.2	3.7	2.0	1.3	0.7	0.4	0.2

Source: World Bank staff estimates as of end -May 2010

Growth is projected at 4.5 percent in 2010 and 4-5 percent in 2011-13. The signs of a pickup in economic activity include both exports and remittances up by 55 percent (y-o-y) in the first quarter of 2010, as well as upticks in construction permits, electricity consumption, and recently improvement in banks lending portfolio, which were all down sharply for most of 2009. Bank deposits remain stable after having picked up to pre-crisis levels by mid-2009 and the yield on Georgia's Eurobond declined significantly reflecting improved investor confidence in emerging markets. At the same time, there is significant uncertainty regarding the pace and timing of economic recovery, as the economy continues to exhibit weakness along key dimensions, including foreign direct investment and imports. Economic recovery is expected to come from improvements in investor confidence and the external environment, leading to a pickup in exports, FDI and other private capital inflows. The improved growth outlook should also help fiscal adjustment, provided the authorities stick to the nominal expenditure plans.

Figure 1: Pre-Crisis and Post-Crisis Execution of Expenditures



The patterns of public expenditures have witnessed a marked change in the aftermath of the August 2008 conflict as the authorities have implemented a fiscal stimulus. Expenditures on transport infrastructure, as well as on education, health, and social protection have been scaled up significantly, with the fiscal space for these increases coming from a low initial level of external public debt and from a marked reduction of defense expenditures. This can be best seen by comparing the 2008 and 2009 state budgets and by comparing state budget execution for the Jan-Jul 2008 (pre-crisis) and Jan-Jul 2009 (post-crisis) periods. The share of state budget execution on social protection increased from 16.4 percent during Jan-Jul 2008 (pre-crisis period) to 21 percent during Jan-Jul 2009 (post-crisis period). The share of health expenditures increased from 4.1 percent to 5.1 percent and the share of transport expenditures increased from 3.2 percent to 7.1 percent. In contrast, the share of defense expenditures fell sharply from 32.8 percent during Jan-Jul 2008 to 13.7 percent during Jan-Jul 2009.

The fiscal deficit. The overall fiscal deficit widened to the equivalent of 9.2 percent of GDP in 2009. Notwithstanding the marked changes in the composition of public expenditures, the overall nominal level of expenditures in 2009 is essentially unchanged from 2008. Thus, the increase in the overall fiscal deficit (as a share of GDP) can be attributed primarily to the fall in GDP and in tax revenues (down by 12 percent during Jan-Jul 2009). The higher deficit in the post-crisis period was financed primarily through external borrowing (including, importantly, budget support financing from donors), thus leading to an increase in external public debt from 17 percent of GDP in 2007 to 32 percent in 2009. This increase in debt was compounded by the winding down of privatization proceeds which had previously more than fully financed the budget deficit in 2007.

The authorities are committed to significant fiscal adjustment over the medium term, starting with the 2010 budget, which projects a decline of the overall fiscal deficit to 6.8 percent in 2010⁶, 5.0 percent in 2011, and 2.5 percent by 2013. This will require a reduction of total expenditures from about 39 percent of GDP in 2009 to 36 percent in 2010 and further to 34 percent by 2011. Tax revenues are projected to increase to pre-crisis level of GDP ratio by 2011 after sharp drop in 2009 to 24.5 percent of GDP. Privatization proceeds as a source of financing are projected to decline further from 1.4 percent of GDP in 2009 to 0.3 percent by 2011.

⁶ Estimates As of end-May 2010

Donor Funding to end-March 2010

As noted, this progress report covers the period to the end of the second phase identified in the JNA. Over this period (October 2008-March 2010), total funding required for the public sector was identified as \$2.2 billion (Annex 1), and for the banking sector as \$700 million. Donor commitments over this period amounted to \$2.5 billion for the public sector and \$673 million for the banking sector (Table 2).

Table 2: Committed /Disbursed to end-March 2010 - Amounts in US\$ (million)

SECTOR	Committed	Disbursed	Donor Organization & Committed Amount 1/
	2008/ March 31	2008/ March 31	
	2010	2010	
1. General Budget Support	677.6	617.7	1. World Bank – 125
			2. ADB – 150
			3. US Government - 250
			4. European Commission – 135.7 (EURO 93 million)
			- PFM budget support – 14.9 (EURO 10 million)
			- Criminal Justice Reform budget support – 22.4 (EURO 15 million)
			Food Security Program – 6.7 (EURO 5 million)
			Vocational Education and Training (VET) - 25.7 (EURO 17 million)
			Macro-financial Assistance - 66 (EURO 46 million)
			5. Dutch Government - 6.8 (EURO 4.5 million)
			6. Ukraine - 10.4
2. Internally Displaced Persons	237.3	211.9	1. EC- 85.3 (EURO 60.7 million)
			2. KfW - 8.7 (EURO 6 million)
			3. GTZ - 11.3 (EURO 8 million)
			4. UN – 132
3. Core Recovery of the Georgian Economy			
Infrastructure- Transport	672.5	136.1	1. World Bank –295
			2. ADB - 120.5
			3.JICA – 197
			4. MCC – 60
Infrastructure- Energy	488.8	-	1. MCC – 13
			2. USAID – 120
			3. EIB - 110 (EURO 80 million)

			4. EBRD - 110 (EURO 80 million)
			5. KfW – 135.8 (EURO 100 million) 2/
Urban and Municipal	220.5	74.7	1. World Bank – 40
			2. ADB – 66.7
			3. KfW – 66.5
			4. EBRD - 21.3
			5. MCC – 26
Environment	7.2		1. KfW – 7.2 (EURO 5 million)
Agriculture & Livelihood	13.0	13.0	1. Japan (non-project grant) – 13.0
Other	233.9	68.1	1. US Government - 215
			2. MCC – 1
			3. France - 6.3 (EURO 4.7 million)
			4. GTZ - 11.6 (EURO 8.0 million)
Total Public Sector	2,550.8	1,121.5	
Private Sector			
4. Banking and real sector	673.1	446.4	1. EBRD 278.8 (EURO 210 million)
			2. IFC – 208
			3. OPIC - circa 176.3
			4. FMO – 10
Grand Total (Public and Private)	3,223.9	1,567.9	

Source: Bank calculations based on data supplied by the Ministry of Finance, Georgia, and UN estimates. Note that this table cannot capture numerous small scale projects implemented by some donors – these projects are largely self-managed and do not enter the government data system. IMF budget support disbursed in the reporting period (\$323.3 million) is not included in the calculations as it was provided outside Brussels’ pledge framework. Private sector support figures are of indicative nature, given the special features of the private sector donor assistance modalities.

1/ Where applicable, exchange rates are as of the date of actual signing

2/ Loan and Financing Agreement with KfW was signed on April 13, 2010

The *JNA* had estimated budget support requirements at \$930 million; commitments amounted to \$678 million. The estimated requirement of \$316 million (adjusted for budget support) for return, relocation and resettlement of internally displaced persons (IDPs) was met to the tune of \$237 million. Infrastructure requirement was estimated at \$417 million (adjusted for taxes), but commitments exceeded \$1.1 billion.

Disbursements to the public sector amounted to \$1.1 billion or 44 per cent of commitments – an impressive rate of implementation. The disbursement ratio ranged from 91 per cent for budget support to 89 per cent for IDP activities and 12 per cent for infrastructure. For the banking sector, the ratio was 66 per cent. These figures represent a highly commendable rate of disbursement as well as absorption of funds into the economy.

Budget support. In the period to end-March 2010, donors committed \$678 million in budget support, of which \$618 million was disbursed. The US was the principal donor – it provided \$250 million in grants for general budget operations. The ADB disbursed \$150 million, the European

Commission disbursed \$73.4 million, and the World Bank disbursed \$127.1 million. On top of the pledges IMF augmented its original standby arrangement of September 2008 to provide budget support in an amount of \$323.3 million over this period. While such support accrues to the general budget and is not earmarked for specific spending, it is notable that in the revised budget adopted by parliament in 2008 for the post-conflict period spending was raised significantly for internally displaced persons and related social needs.

Table 3: Georgia: External Financing of the Public Sector, 2008-10
(Gross disbursements in millions of U.S. dollars)

	2008	2009	2010 estimated
Total	1368	1025	1082
IMF	257	340	470
<i>Of which Budget Support</i>	--	102	390
WB	126	274	191
Other Multilateral Institutions	135	237	189
Bilateral Partners	350	172	231
Eurobond -2013	500		
Memorandum items:			
<i>Grants</i>	388	259	282
<i>Loans 1/ 2/</i>	723	528	721
<i>Budget support financing 2/</i>	426	375	551
<i>Project financing</i>	185	412	452

Source: Bank and Fund staff estimates

1/Includes Eurobond in 2008

2/Includes only the budget support part of the IMF SBA purchases

3/ as of end-May 2010

The total budget support requirement in 2008 and 2009 was almost fully met through donor financing, with the IMF allocating \$102 million in 2009 as budget support (Table 3).

Return, relocation and resettlement.⁷ Donor commitments under this category for the period to end-March 2010 were \$237 million of which \$212 million were disbursed (Table 2).⁸ The *JNA* had called for commitments of \$316 million (adjusted for budget support). The bulk of this amount (i.e. Euros 98 million) was provided by the European Commission and channeled through the government (Euros 49 million), UN agencies (Euros 23.1 million) and NGOs/consultancy firms

⁷ As in the *JNA*, the discussion in this report relates to the IDPs originating from the conflict of 2008. An earlier cohort of IDPs numbering 230,000 remains from the civil conflicts of 1992 and is expected to be fully resettled within feasible period of time. Details on both cohorts of IDPs can be found in Annex II.

⁸ It is not possible to estimate spending under this category with precision as such spending is categorized under various headings, for example, some of it falls under agriculture and livelihoods. Thus the figures cited are certainly underestimates.

(euros 15.4 million). Support through the United Nations, including its Flash Appeal which was heavily supported by donors as an integrated element of the *JNA*, was notable.

The overarching priorities have been (i) the facilitation of the return of IDPs to their original homes and (ii) for those unable to return, integration into local communities through a housing response strategy that combined temporary shelter (pending solutions) and durable housing supported by socio-economic integration measures. Moreover, priorities included providing IDPs with information on various prospects available to ensure informed decision making; promoting clear selection criteria and assistance as an integral part of a resettlement and relocation process; rehabilitating collective centers that temporarily housed IDPs; and ensuring protection of IDP interests in the formulation and execution of public policies (such as privatization) and their human rights. The government, together with the EU, UNHCR, OHCHR and IOM and their implementing partners, made provision of durable housing options for IDPs based on agreed standards; applied internationally-accepted IDP Guiding Principles throughout the process; supported social integration; and provided targeted humanitarian assistance.

Table 4: Georgia: Relocated IDPs, Remaining IDPs and People in IDP-like Situation

Relocated or Compensated IDPs	21,456
Relocated IDPs, including:	
Granted IDP status and relocated to settlements	13,820
Granted IDP status and provided with monetary compensation	2,082
Allocated government cottages but with status pending	5,554
Returned People in IDP-like situation ⁹	34,186
Returned IDPs to South Ossetia ¹⁰	4,186
Returned IDPs to area adjacent to South Ossetia	30,000
Remaining IDPs (Status Unconfirmed)	13,472
- from 2008 (status pending)	3,472
- in South Ossetia ⁹	10,000

Source: United Nations

Some 138,000 people were displaced by the August conflict of which 75 per cent have returned home, and they received assistance in the rehabilitation of damaged and destroyed houses, in the restoration of food security and livelihoods and in household items. Of these 103,000 returnees, around 30,000 returned to such a volatile security situation in the areas adjacent to South Ossetia that they continue to live in IDP-like situations and continue to need humanitarian assistance to survive (Table 4). A key lesson learned is the need for a flexible response to cater to the requirements of the IDP-like community.

The IDPs that have been resettled number 21,456. They have received an offer of a durable housing solution, i.e. a government-built housing unit (often through EC budget support) or monetary

⁹ According to national law, this category of people has IDP status and is included as such in government statistics. UNHCR, following international practice and frameworks for assistance, categorizes these persons of concern to its Office as people in IDP-like situations, i.e. people who are on the verge of realizing a durable solution but who continue to need, for a period of time, humanitarian support. This categorization in no way impacts on their right to return.

¹⁰ This is an estimate due to lack of humanitarian access into South Ossetia

compensation to acquire property. From this group, 19,374 were resettled through the allocation of government housing in 38 newly built settlements in Shida Kartli, Kvemo Kartli and Mtskheta-Mtianeti regions, whilst 2,082 people who were granted IDP status by the Government opted for monetary compensation in lieu of durable housing provision. A remaining 3,472 IDPs have not yet had their status confirmed. At the same time, the government started an ambitious program for the rehabilitation of collective centers inhabited by old caseload IDPs. So far, the EC provided euros 59.5 million in budget support for this program.

Impressively, the new settlements for IDPs were constructed by the government in a rapid time frame of less than four months, with 6,000 housing units being built and the settlements supplied with electricity and water. IDPs were relocated in a well organized process. However, the new settlements remain in need of further investment in complementary infrastructure with water and sanitation facilities and other facilities as shown in a 2009 study, which will be updated in mid-2010 to review progress. Efforts to address the existing gaps are under way. The key factors behind this success are a highly effectively functioning Municipal Development Fund, smooth government coordination, and rapid spending made possible by procurement flexibility.

In the new settlements for IDPs model shelter projects have been implemented with the assistance of UNHCR that are based on community mobilization and dialogue with the government. As a result, self-privatization and improved rehabilitation standards have been agreed. A key lesson learned is the importance of empowering communities to express their opinion in a structured way with the authorities and to respond rapidly to government policy proposals that may affect their lives. Yet the resettlement process is far from complete: a greater emphasis on the income generation component of resettlement in order to facilitate IDP transition to social and economic self-reliance remains on the agenda. Having provided over euros 10 million, the EC is taking the lead in fostering socio-economic integration of the IDPs. In addition, monitoring is required of emerging disparities in the resettlement process as IDPs resettled in remote, less accessible locations face fewer options in livelihoods.

Social spending. Social protection spending to end-March 2010 was met through the budget. Hence, no separate figure for donor-supported spending can be provided, but the *JNA* requirement of \$87 million can be confidently considered to have been met.

Total social spending has risen in real terms by 10 per cent in the post conflict period (2008-10), despite overall budget cuts resulting from the crisis. The monthly old-age pension benefit was increased by 36 per cent in real terms over 2008-10, the targeted social assistance cash benefit for vulnerable families was doubled for additional (non-head) household members, and the number of recipients of health insurance vouchers was also increased to about 900,000. These are significant accomplishments in the face of severe fiscal pressures.

Table 5: Georgia: Central Government Social Expenditures in Real Terms (change,%)

	2008	2009	2010 (budget)
Health	15.7	13.1	19.0
Budget share (%)	4.4	5.3	6.4
Education	5.1	6.8	9.0
Budget share (%)	6.5	7.3	8.2
Social protection	41.7	6.1	-5.4
Budget share (%)	17.8	19.9	19.4

Source: Bank calculations based on Ministry of Finance data

Georgia has continued to implement an innovative model of integrated social benefits administration. Old-age, survivor, and disability pensions, health insurance for the poor, targeted social assistance (TSA) and IDP benefits (among others) are all administered by a single agency. The TSA, based on a proxy means test, is among the best targeted cash benefit programs in the region, but there is room for improvement of its coverage rate of the poor and extreme poor (mainly because many are not applying to the database). Further investments are required, however, to complete the transition to a unified registry, and to fund ongoing rehabilitation of local SSA offices which offer a 'one-stop shop' approach to social benefit administration. The required investments would lead to improved targeting and reduced fraud.

A key lesson learned in social protection is the priority to be accorded to improved data collection, monitoring and evaluation of programs. Strengthening the regular household survey, undertaking evaluations of social policies and programs (including for IDPs), and supporting the next population census are all areas where stronger coordination efforts by donors and government could reap substantial benefits. Donor technical and institutional support in these areas is vital. An important effort is still needed to integrate all the IDP data into the TSA system. So far most of the IDP receive separate IDP benefits, which are status based and do not consider the vulnerability of a person.

In health, the key lesson is the importance of developing new mechanisms to facilitate the transparent and effective operation of the health insurance and pharmaceutical markets. In terms of funding needs, a key challenge is how to leverage or restart the flow of private investment in health facility infrastructure that dried up during the global economic crisis.

In education, the key lesson relates to the overall coherence of the reform effort. The government continues to implement a series of reforms, such as in teacher certification or professional development and in curriculum, and it needs to continue with a clear and comprehensive strategy that sets out the analyses, objectives, challenges and targets for the sector as a whole. Vital areas to be included are early childhood, general education, vocational training and tertiary education. It is also evident that government communications about the motivation behind and expected benefits from these far-reaching (and often crucial) reforms have not always been effective in building support with the general public. Therefore, anchoring the strategy setting exercises with a solid, broad-based consultative process and communication strategy will help in this regard. As for investments and donor support, while infrastructure, materials and emergency needs remain high on the list, reforms (training, teacher certification, international assessments of student learning, electronic management information systems) at all levels of schooling remain important.

Evidence on the impact of the crisis and the associated policy responses on poverty is only beginning to emerge. A Welfare Monitoring Survey undertaken by UNICEF in May-June 2009 estimates a poverty headcount rate of 25.7 percent, and an extreme poverty rate of 9.9 percent; however, these results are *not* comparable with the LSMS 2007 headcount estimate (23.7 percent) due to different survey methodologies. Subjective measures of poverty, which are comparable across the two surveys, indicate increasing hardship. Better evidence of poverty trends through the crisis must await the availability of GeoStat 2009 data in June 2010. Given the evidence on their poverty impact, the increased expenditures on safety nets can be expected to help mitigate the impact of the economic downturn on the poor. According to simulations, public expenditures on social protection

have a significant impact in mitigating the incidence of poverty in Georgia. For example, without pension payments, poverty in 2007 would have been almost 10 percentage points higher; without targeted social assistance (TSA), poverty would have been about 2 percentage points higher.

Internally displaced persons (IDPs) from both cohorts receive monthly cash benefits disbursed by the Social Services Agency (SSA). As of end-2009, a total of 218,117 individuals received this benefit. In addition, those from both IDP cohorts living in the collective centers also receive 100 kWh of free electricity per household (until recently this had been unlimited). Also, between November 2008 and May 2009, the SSA provided one-time disbursements of GEL 200 to over 18,000 households to help them settle into the collective centers.

Harmonizing IDP cash benefits with the TSA cash transfer program for vulnerable families has encountered certain challenges. The eventual aim is to prioritize means-testing over categorical or political considerations in the allocation of Georgia's social spending envelope. At present, IDP households are given the choice to *either* receive the IDP benefit or the TSA, but not both. Some households are not sufficiently familiar with both programs to make the right choice, and there have been concerns about whether it is appropriate to include IDP cash benefits and/or host family assets in the calculation of the TSA proxy means test assessment for IDP families.

There is also partial overlap between IDP status and other social programs -- health insurance and pensions. During 2009, IDPs from the 2008 conflict were given health insurance vouchers that provided access to the same benefit package offered to vulnerable families. In December, this was extended to provide coverage in 2010 as well. IDP households from the first cohort can also receive health insurance if they have a score below 70,000 – the same criteria that is applied to the general population. As of December 2009, about 25,000 families or 77,000 IDP individuals were receiving health insurance. Lastly, IDPs receive a top-up to the basic old-age pension depending on their age, in place of the 'long-service bonus' provided to the rest of the population.

Box 1: Averting the Threat to Livelihoods in the Gori Valley

The *JNA* described the acute emergency being faced by farmers in the regions affected by the conflict arising from the diversion of irrigation water flows, the interruption of the agricultural cycle that affected winter sowing and the lives of farm animals, and the severe threat to livelihoods in a particularly poor part of the country – the Gori Valley. It pointed to the necessity for immediate donor action, in partnership with the government, to avert an incipient tragedy. The results of actions taken by the authorities with the strong support of USAID, Italy, and activities undertaken by the ICRC have been highly encouraging. Sustainability in livelihoods is on the way to being assured, despite obstacles posed by unexploded ordnance and explosive remnants of war and a still volatile security situation.

Winter wheat. The plowing, seeding and fertilizing of the winter wheat crop for all farmers in the conflict-affected zone who traditionally engage in winter crop cultivation has been completed. In total, 12,650 hectares, benefiting 7,600 farm families, were planted; the yield and quality of the wheat crop was even greater than expected. The harvested crop provided \$11 million in revenue for farmers affected by the conflict.

Spring seeding. At the end of March 2009, USAID launched a follow on program to provide spring agricultural production assistance to farmers in the Shida Kartli conflict zone and to IDPs in the newly-built settlements, following on from the winter wheat support program. Assistance includes machinery services, corn seed and fertilizer for farmers who own arable land and plant protection products for orchards. More than 29,000 additional farm families benefited as a result of this assistance, 9,200 hectares of corn was planted (including 800 hectares for IDPs) and inputs were provided for 11,400 hectares of orchards.

During the fall of 2009, the final phase of support provided the winter wheat assistance to around 2,800 IDP and farm families who could not obtain access to their land in time for spring planting due to security issues or unexploded ordnance. Under this phase 2,750 hectares of wheat has been planted and cultivated. The total value of the harvest that will be made possible as a result of spring and fall assistance is estimated at more than \$29 million and about \$13 million was injected into the local agricultural economy for agricultural services.

Animal fodder. By late March, distribution of animal feed to conflict-affected small-scale farming households in the Shida Kartli region was completed, with a total of 4,240 metric tons of animal feed distributed to all livestock owners, totaling 18,248 beneficiaries in 127 villages from the buffer zone, and significant de-worming of cows took place. These activities were vital to ensure the productive capacity of livestock in the conflict-affected regions of Georgia, a main source of income for farmers. During the winter of 2010 an additional 300 metric tons of animal feed was distributed to 2,994 beneficiaries from the areas bordering to South Ossetia that lost access to pastureland and arable land; follow up de-worming of cattle was also performed.

Irrigation. The development of new irrigation schemes was vital to survival of livelihoods. The construction of a new irrigation headwork and pumping station, funded by the government is completed. The new headwork is located downstream of the original one, with the capacity to provide irrigation water to around 28 000 ha during 2010.

Transport. Commitments in the period to end-March 2010 (\$673 million) greatly exceeded the *JNA* recommendation (\$203 million, adjusted for the tax component).

The central priorities of the government are to complete upgrading of the East-West Highway from two lanes to four lane motorway all way from Red Bridge to the Poti port and the Turkish Border in Sarpi, and rehabilitation of selected sections of secondary and local roads. The government has

communicated its priorities to its partners clearly. It has committed itself to increasing funding of the road sector to stimulate the economy through short-term job creation and to have a long term impact through improved road infrastructure and improved connectivity.¹¹

Donor commitment to the critical *transport sector* – vital to the economic security of the country and to economic growth in view of the large export of transit services -- remained strong. Within the “immediate period”, a \$20 million additional financing credit was provided by the World Bank for improvement of the east-west highway and a \$60 million grant was made available by the Millennium Challenge Corporation for Samtkhe-Javakheti road construction. The World Bank provided an additional \$70 million loan for secondary and local roads as post-conflict assistance to finance 450 km of secondary and local roads throughout Georgia to improve connectivity and create temporary employment. The government roads budget has also increased in 2009 and targeted rehabilitation of secondary and local roads, including testing new cost-efficient technologies.

Core investments in the sector in “the second phase” greatly exceeded the JNA recommendations. In July 2009 the World Bank provided a loan of \$147 million for upgrading the Sveneti-Ruisi Section of east-west Highway, followed in October 2010 by \$30 million for rehabilitation of Kakheti regional roads and by \$28 million for rehabilitation of the Rikoti Tunnel (total of 205 million from the World Bank). The Asian Development Bank approved a \$119 million loan for the modernization of Ajara by-pass roads. The Japanese International Cooperation Agency approved a \$197 million loan for upgrading the Zestaponi-Kutaisi-Samtredia road.

Table 6: Georgia: Donor funding for Roads

Donor and Project Title	Oct 2008- March 2009	March 2009- March 2010
WB - Additional Financing for Second East-West Highway Project (Igoeti-Seveneti)	\$20 million	
WB - Additional Financing for Secondary and Local Roads	\$70 million	
WB- Third East-West Highway Project (Sveneti-Ruisi)		\$147 million
WB- Kakheti Regional Roads Upgrading Project		\$30 million
WB- Additional Financing for the First East-West Highway Improvement Project (Rikoti Tunnel)		\$28 million
MCC- Javakheti Road Rehabilitation Project Additional Financing	\$ 60 million	
ADB - Ajara By-Pass Roads		\$119 million
JICA - Rehabilitation of the Zestaponi-Kutaisi-Samtredia Section of East-West Highway		\$197 million
TOTAL	\$150 million	\$521 million

¹¹ In order to withstand the negative effects of the global economic crises the government introduced a stimulus package under which substantial funds were committed to creation of immediate jobs through road rehabilitation works across the country. Donor funds committed for JNA activities strongly supported this new initiative. For example, about 15,000 man/months of temporary jobs were created under the SLRP Additional Financing between March 2009 and January 2010.

The overall implementation progress of road program has been satisfactory, with the speed and pace of implementation being impressive, reflecting the strong commitment of the government and the high priority accorded to this sector. The procurement and implementation under the World Bank financed projects has been rapid and satisfactory.¹²

A number of factors account for the impressive performance in the construction of roads. The strong commitment of both the government and of donors in providing for economic security is evident. Coordination in planning and implementation across donors has been effective. Implementing institutions have been empowered. Accelerated spending was made possible through procurement flexibility. The slack in economy in 2009-10 meant that labor, capital equipment and other inputs were abundantly available.

While the sector institutions have managed to implement a greatly stepped-up investment program, the *capacity of institutions* and specifically of the Roads Department of the ministry of regional development and infrastructure (RDMRDI) has come under strain. A Foreign Projects Unit was created in the RDMRDI in August 2009 to deal with all donor funded investment projects. Substantial capacity building is involved in each donor-funded investment operation through TA. The assistance under the Bank financed projects includes (i) building local government's capacity in management and maintenance of local roads; (ii) creation of an inventory of the road network; (iii) development and piloting of Performance Based Contracting (PBC) for management and maintenance; (iv) improvement of the legislative framework of the sector, and (v) addressing other institutional and capacity issues for improving the asset management system.

Hence, a key lesson lies in planning and implementing capacity fortifications, where gaps exist, simultaneously with the investment effort so as to maximize the efficiency of investments.

Similarly, the demand for *environmental management* has risen commensurate with investments. Environmental management of the ongoing road investment projects has been somewhat deficient. With a partial outsourcing of environmental supervision and monitoring to construction supervision contractors, RDMRDI sought to improve environmental compliance of works though more concerted effort is needed. The WB financed projects target strengthening of environmental management capacity of the institution.

Thus, a further key lesson is the need to pay attention to environmental and other fiduciary responsibilities in parallel with investment planning and to ensure the build-up of the necessary capacity.

Finally, after growing for a number of years, the *maintenance budget* decreased in real terms by 17 per cent between 2009 and 2010 due to the fiscal constraints facing the government, with relative decreases in most categories of maintenance and rehabilitation, at a time when investment spending has risen several-fold. Going forward, ensuring adequate maintenance budgets and improving the efficiency of maintenance expenditures will need to be a government priority. Without proper funding of operations and maintenance the road network will start to deteriorate and sustainability

¹² As an example – the SLRP Additional Financing was approved by the Bank Board in March 2009 and by the end of calendar 2009 all contracts for rehabilitation of the 450 km of secondary and local roads had been successfully signed; moreover, civil works were completed on over 150 km of roads.

of investments will be jeopardized. Increasing efficiency of road maintenance represents one of the priority areas for strengthening in the sector. Under the TA from donor projects new maintenance methods and standards are being developed to be adopted as national guidelines. In addition, new maintenance arrangements are being assessed and piloted such as Performance Based Contracting (PBC), or the microenterprise mobilization approach to maintenance of local roads.

The lesson here is the importance of ensuring adequate funding for maintenance *pari passu* with the planned investments, particularly at periods of a rapid rise in investments.

Funding for *the overall roads sector* has been adequate. The roads budget has been steadily increasing: 2009 spending was tenfold larger than the 2004 level. However, the overall financing of the local road network is inadequate. Local governments, who are in charge of local road management and maintenance since 2008, lack resources to ensure capital investments as well as maintenance needs of the network. They also lack capacity to undertake management and maintenance responsibilities, therefore the local road network remains in poor condition. Some donors are providing TA to local governments in order to increase their capacity in management and maintenance of the local road network, including development of a respective guidebook.

In 2009 the road construction sector observed substantial decreases in the prices of major construction materials such as steel, bitumen, and cement. The global financial crises also created incentives for private companies to bid aggressively for contracts at a low profit margin. These two trends led to tenders being completed with actual prices much less than projected. As an example, the civil works under the \$100 million 450 km secondary and local roads program (WB financed SLRP project) were contracted by December 2009 with about \$20 million cost savings, allowing for the possibility of funding about another 140 km of roads under the project.

The lesson that emerges is the need for agility and flexibility in awarding contracts and in speeding up implementation at periods of weak input prices so as to maximize the potential gains.

The government's program to rehabilitate its transport corridor and feeder roads is a multi-donor effort which benefits from strong *coordination* on the basis of a well developed government strategy and identification of financing gaps. Coordination is particularly important to ensure that each of the transport corridor segments is financed with compatible technical standards, social and environmental safeguards, and road safety measures. The ADB, World Bank and JICA coordinate closely on key issues: (i) the ADB is considering similar road safety activity in their upcoming project on the E-70 to the one proposed under the Bank-financed Third East-West Highway Improvement Project for the E-60 highway; (ii) the ADB, the World Bank, JICA agreed to apply similar implementation arrangements; and (iii) the three organizations will coordinate approaches on overall TA and training.

A further lesson is that an assessment of results from an early stage is of importance. A focus on results will help to maintain attention to quality and to allow enough time for design and contract implementation. The results of the existing investments on both the main network and on secondary roads needs to be evaluated; and such an outcomes-based evaluation would shed light on whether the current emphasis on one major corridor was justified. Donor support will help the government carry out evaluations that encompass a thorough review of the infrastructure condition, the demand side and improvements to investment solutions, and the government should seize such opportunities to improve infrastructure management.

The government has been exploring ways to increase *private sector participation* in the transport sector. Tbilisi and Batumi airport concessions (financed by the EBRD and IFC) and port concessions and privatization are example of such attempts. Public private partnerships in roads are also being explored and the IFC Infrastructure Advisory Facility has undertaken a study assessing feasibility and best options of roads PPPs.

In the *aviation sector*, France provided about Euro 4.7 million for the procurement and installation of the new radar for Tbilisi International Airport in 2009. The government is discussing options for the rehabilitation of the existing runway or the construction of a new runway at this airport (project mentioned in the JNA).

Ports are privately operated. EBRD provided debt financing in the amount of euros 8 million for the rehabilitation of berth 14 of the port of Poti.

EBRD has extended a euro 100 million non-sovereign loan for the *Georgian Railways* (GR), a state-owned enterprise, for construction of the Tbilisi by-pass rail line, which is co-financed by the EU with euro 8.5 million. An EBRD loan for euro 100 million was signed in March 2010 during the EBRD President's visit to Georgia. The railway is considering further financing to upgrade and rehabilitate GR's track, rolling stock, and other assets and systems. GR in cooperation with the regional IBRD team has identified a high-priority US\$80 million self-sustainable phase of the project and requested IFC to consider providing US\$60 in debt financing (US\$20 million is expected to be financed by the internal cash generation). The project involves track (165 km) rehabilitation and, GR expects, would result in operational improvements, reduced maintenance costs, and increased safety for the railroad.

In assessing future priorities and plans (table 7), there are no signals of a change in priorities in the transport sector. Road network improvement and related activity benefits from strong government commitment. Railways and ports are encouraged to seek non-sovereign financing. Financing of infrastructure of airports may be considered through PPPs.

Table 7: Georgia: Five Year Road Program

		Length	Estimated Cost	Secured Donor Funding
	Roads	(km)	(US\$ million)	(US\$ million)
1	Sveneti-Rikoti	64	350	171+20% Geo cofinancing
2	Zestafoni Bypass	9	80	197+20% Geo cofinancing
3	Zestafoni-Kutaisi	23	69	
4.	Kutaisi Bypass	16	43	
5.	Kobuleti and Batumi Bypasses	30	284	259+20% Geo cofinancing
6.	Tbilisi-Gombori-Telavi	63	30	30+20% Geo cofinancing
	Total for Main National Road Network	205	856	657+20% Geo cofinancing
7.	Batumi-Shuakhevi-Adigeni-Akhalsikhe-Akhalkalaki-Ninotsminda	165	95	
8.	Mtskheta-Gori (alternative south of the river)	33	14	70+30% Geo cofinancing
9.	Gori-Osiauri (alternative south of the river)	45	20	
10.	Rehabilitation of 300 km of priority secondary roads	300	60	
	Total for Alternative Road Network	543	189	70+30% Geo cofinancing
	Total	748		

Source: Staff calculations based on official data.

Energy. Commitments in the period to end-March 2010 (\$353 million) exceeded the *JNA* recommendation (\$76 million), but no disbursements have taken place as the projects have only recently been agreed.

In the immediate period, conflict-caused damage in power and gas distribution was repaired. Backup fuel (mazut) for the Gardabani thermal power station was procured (50,000 tons have been procured since the last *JNA* update, in addition to the existing 12,000); this volume is sufficient to run the thermal power station.

The MCC funded a *natural gas storage* study which identified the Ninotsminda depleted oil field as a suitable site. The MCC also is funding a design study (\$3.3 million) that will be completed within a year. The estimated cost of the gas storage project is \$100-150 million, with project completion taking about four years. The source for the financing of the gas storage project has to be identified within the next 12 months. The government needs to reach an agreement with the private operator of the field.

The Black Sea transmission line which will increase connection capacity with Turkey is jointly financed by EBRD, KfW, EIB and EU. Cost of the line is anticipated to be in the vicinity of Euro 260 million. Agreements with EBRD (Euro 80 million sovereign loan) and with EIB (Euro 80 million sovereign loan) were signed in March 2010 and an agreement with KfW (Euro 100 million sovereign loan) was signed in the beginning of April 2010. An EU-NIF grant (Euro 8.5 million) was made available and it is administered by KfW. The line is expected to be completed by 2013. Construction of the line began prior to the finalization of donor financing agreements. About 30 km section of the line has already been rehabilitated and procurement of various components of the line for the next stage of construction has been initiated. This project has demonstrated strong commitment by

both the government and donors with smooth cooperation from all sides. The government actively participated in the public consultations and showed strong support and ownership of the project.

USAID provided \$120 million for energy infrastructure expansion. Out of this amount, (i) \$31 million will be used for rehabilitation of critical power transmission infrastructure, including the Senaki –I (Menji-Tskaltubo) and Senaki – 2 (Menji – Didi Kutaisi) power lines, which will increase electricity reliability and improve Georgia’s capability to route and export power to Turkey and beyond; (ii) \$81 million is allocated for construction of a new gas pipeline, connecting the Black Sea port of Poti and its free industrial zone to the existing pipeline network, and rehabilitating critical segments of the East-West gas pipeline; and (iii) \$8 million is allocated for facilitating hydro power plant investments through the implementation of technical, economic and environmental studies, as well as investment promotion and marketing activities.

Long-term sector development perspective. The energy sector development is in line with the priorities approved by the Parliament in 2006. Georgia continues to improve energy security by fully replacing thermal generation and import by domestic hydro generation. The government invited private investors for the construction of large and medium size hydropower stations. A number of memoranda of understanding have been signed with potential investors, including for the major projects of Khudoni HPP (700 MW) and Namakvani HPP (450 MW).

The EBRD and IFC have been actively involved in the potential financing of the medium sized power station Paravani (78 MW). The government has also advanced with the negotiations to construct Tekhuri HPP cascade (105 MW).

The conflict had limited direct impact on the energy sector and any indirect effects of the conflict and the global financial crisis have yet to be observed, particularly with regards to attracting private capital in hydropower development. The government has invited investor participation in the development of 92 *small and medium size HPPs* with total capacity of 1.4 GW and has progressed with an additional 13 HPPs (combined capacity of 1.5 GW, generation of 5 TWh). There are signs of interest from the private sector to construct HPPs. Development of HPPs will enable Georgia to benefit from power exports. The transit potential for electricity will be tested after the completion of the Black Sea transmission line.

Municipal. Commitments in the period to end-March 2010 (\$207 million) significantly exceeded *JNA* recommendations (\$138 million), largely because of efficient project preparation and demonstrated capacity to implement quickly and effectively. Strong leadership by the government, keen donor interest, and an efficient Municipal Development Fund were factors behind the timely and striking results. Investments were a part of the fiscal stimulus package and provided work for local contractors during the economic downturn and created thousands of jobs.

Investments were directed at expanding the *water and sewerage networks* or starting new water, sewage and *road projects* in smaller cities and towns throughout the country. The period witnessed heavier amounts of investment in the water and local road sectors than envisaged in the *JNA* in 45 small towns and villages which were not serviced for decades, while fewer investments were made in wastewater treatment and solid waste management, in contrast to the *JNA* recommendations.

The principal providers of funding to the water supply, sewage networks and local roads sectors were the KfW, ADB, EBRD, MCC and the World Bank. All these donors financed rehabilitation of

the water supply and sewage, while the rehabilitation of local roads in a large number of cities/towns is financed by the ADB and World Bank. On the other hand, *wastewater treatment*, especially in large and smaller cities, remains a major challenge. None of the wastewater treatment projects envisaged in the JNA investment plan have started implementation.

During the *JNA* reporting period, in *solid waste* only two projects of the JNA investment plan have started. As was recommended in the *JNA*, there is still a need to establish a number of regional sanitary landfills throughout Georgia, and to upgrade the dumpsites of Tbilisi into sanitary landfills.

The *urban transport* project which started during the *JNA* reporting period is the ADB \$30m project in Tbilisi. The project objective is to finance subprojects that will increase efficiency, quality, coverage and reliability of urban transport, water supply, wastewater, solid waste management, roads, street lightening, traffic management, and other municipal services and goods.

The government has been exploring ways to increase *private sector participation* in the water and solid waste management sectors. Tbilisi water is now fully privatized and ADB will be assisting the United Water Supply Company of Georgia explore concrete PPP options in water service delivery, management and/or operation. PPP in the solid waste collection and disposal system in the cities of Rustavi, Gardabani, Batumi, Kobuleti and Chakvi will be also explored.

On *the institutional side*, the government consolidated urban water and waste water utilities into one company, which was also given policy and regulatory powers. The United Water Supply Company of Georgia is now responsible for sector development and coordination, implementation of sector projects financed by the government or donors, day-to-day operations and maintenance, and interface with customers. However, an integrated approach to municipal infrastructure development to include water supply, wastewater treatment, road network and solid waste “as a package,” instead of the traditional piecemeal approach, that was considered to be a key institutional reform by the government was not adopted largely for reasons of capacity shortcomings. Institutional development was also hampered by a relative scarcity of talent and know-how throughout the municipal sector.

On *project implementation*, the Municipal Development Fund (MDF) is responsible for management and implementation of the *JNA* donor/IFI financed infrastructure investments, with the exception of the ADB and EIB new water projects. MDF is technically competent, but has personnel and resource constraints. It has implemented two key *JNA* recommendations to outsource detailed design review and supervision to well-qualified consultancy companies and to upgrade its procurement department with qualified professional consultants. The MDF could usefully be transformed into a sustainable municipal financing institution by refocusing its role into financing municipal infrastructure and managing project implementation.

Lessons. Continued gains in municipal services outcomes require that the *investment scope* cover overall city/town needs from a package-solution perspective, rather than piecemeal efforts. Such an approach would provide the degree of economies of scale required. A further lesson is that for *solid waste*, unsanitary landfills should be upgraded where technically feasible. Sites that cannot be upgraded should be properly closed and new sanitary landfills should be constructed. *Waste collection* improvements need to be carefully reassessed, including collection vehicles and collection points, as well as transfer station construction where required. Adequate capacity should be built at the local level to secure sustainable landfill operations.

For *local roads*¹³, road rehabilitation work should be done in a comprehensive way to bring the drainage, sidewalks, street width, and road signing and marking into European standards. Several road rehabilitation projects carried out by local self-governments in Georgia are implemented in a partial or piecemeal fashion rather than a comprehensive way to upgrade street sections. A national inventory of local roads rehabilitation needs to be prepared in major and secondary cities in Georgia.

Environment. The JNA identified immediate investment needs of \$2 million to salvage damaged timber and weakened trees and to deal with oil spills. Medium term investment needs were estimated at \$5 million for rehabilitation of fire damaged forests and protected area infrastructure, and to protect villages downstream of affected forests from flooding.

No external funding was received for immediate response actions. The urgent actions undertaken with internal resources mobilized in-country were fencing of the areas under burned forests in proximity to settlements to avoid additional erosion from human activity or grazing by domestic animals. No timber was removed at this stage. The oil spill on the railway near the village of Skra was cleaned up by the Georgian Railway company. No measures were undertaken for containing and cleaning marine oil spills from eight sunken boats near the port city of Poti, for military reasons.

Out of the medium term investments, firefighting equipment and training were delivered to the administration of the conflict-affected Borjomi-Kharagauli National Park using proceeds of an emergency grant amounting to euros 80,000 from the EU financed Caucasus Protected Areas Fund (CPAF). The United States also contributed to building fire-fighting capacity in the Borjomi-Kharagauli National Park.

The Bank of Georgia donated up to 500,000 GEL for rehabilitating burned forests in the Borjomi area. This amount was used for the establishment of two local nurseries, production of tree saplings and their planting. Financing of this initiative includes management of the young plantation over a five year period.

The Ministry of Environment and Natural Resources has prepared a project for *mitigating the major impacts of forest fires*. The main objectives of the project are (a) capacity development of decision makers, scientists, technicians and workers in monitoring ecological processes/restoration techniques, (b) the demonstration of restoration techniques within a pilot area of 400 ha in the 1000 ha of damaged forest ecosystems and monitoring of restored ecosystems, (c) increased public awareness of the causes and implications of land degradation, and (d) creation of short term employment opportunities in a poor region. A secondary objective is to disseminate the successful results and experiences of the restoration works for replication. Finland has expressed its readiness to finance this project in the amount of \$2.2 million.

Banking. The banking sector is privately owned. The JNA identified support for banking from donors to be critical to economic stability; it is the only significant (and large) element in direct support to the private sector. Commitments to the banking sector in the period to end-March 2010 amounted to \$636 million, broadly in line with the JNA recommendation of \$700 million.

¹³ The management of local roads is under the responsibility of the municipalities, not the Road Department. As such, donor funding can be provided directly to eligible municipalities through sub sovereign lending based on pre-agreed performance criteria to ensure good follow-up maintenance.

The banking system had been doubly hit by the conflict and concurrent global financial meltdown. Banking sector resilience was secured through appropriate government policies and intervention by the international financial institutions. The ensuing funding to several major banks provided them with a capital cushion in a difficult macro-economic environment during 2008-09, marked by deteriorating portfolios and a decline in credit. It also allowed refinancing of foreign obligations falling due. At the same time, significant challenges remain: bank funding models need to re-adjust to rely less upon external borrowing and more on domestic sources of funding; stronger emphasis is needed to insure recovery of lending in an environment of stricter underwriting rules and a limited number of larger borrowers with good credit; and there is a need to reverse the resurgence of dollarization in the wake of the crisis.¹⁴

The post-conflict shrinking of the sector was reversed from mid-2009, and by end-2009 deposits reached pre-crisis levels. Given extra caution on new lending, liquid assets have risen markedly. Supervisory authority has been returned to the central bank, which also has the task of supervising insurance and capital markets.

International support took the form of *equity and debt participation* from the EBRD, IFC, OPIC-US, ADB, FMO-Netherlands and DEG-Germany, and ensured the stability of the system from rollover risks in external financing. IFC made a disbursement of \$15 million to Bank Republic in September 2008, a \$20 million trade line was approved to Bank of Georgia in October 2008, and another \$100 million financing package for Bank of Georgia was disbursed in January 2009. This package consisted of senior and convertible subordinated loans as part of a multi-agency deal to help the bank meet its capital and funding needs. In early April 2009, IFC committed an investment of \$70 million with TBC Bank in the form of senior and subordinated loans and equity to help the bank attract a strategic investor and maintain liquidity in a difficult market. A trade line with Bank Republic for \$20 million was also signed that month. Other measures to support the banking sector were undertaken by IFIs such as advisory services on the work-out of banks' exposures to real estate development projects, risk management and non-performing loan management.

Over this period, the EBRD has provided \$280 million to the banking sector. A large transaction consisted of a \$100 million financing package (convertible subordinate debt and senior loans) was provided to Bank of Georgia. These funds were fully disbursed in early 2009. A funding package for TBC Bank amounting to \$70 million was also signed and disbursed. It includes equity, convertible subordinate and senior loans. Support to the top two banks and successful completion of these projects was crucial for the stability of the banking sector and represented a key EBRD response to the crisis.

EBRD also approved a \$70 million funding package for Bank Republic consisting of a subordinated loan, mortgage facility, and energy efficiency credit lines. A \$42 million financing package to Cartu Bank including equity, senior loan and medium size companies co-financing facility components was also approved. A senior loan amounting to \$10 million was also signed.

Technical assistance from IFIs has helped bank management begin to focus on re-evaluation of their business models. Formerly, bank lending policies were excessively reliant on external financing, which proved to be vulnerable to changes in the risk appetite of the world financial markets. Following the crisis, banks have adopted stricter lending procedures and focused on attracting domestic deposit financing. IFIs have begun helping the banks implement institution building plans

¹⁴ Details on developments in the banking sector can be found in Annex III.

and otherwise adapt to the new environment, thus helping build longer-term stability in the banking system.

Since the onset of the crisis, EBRD specifically has been involved in six technical assistance programs with all the major Georgian banks. Smaller programs included loan workouts and corporate recovery training as well as treasury risk management operations. More significant programs (over \$500,000 each) have focused on institutional strengthening and institutional building plan support, as well as support for an energy efficiency lending program.

Aid coordination, impact monitoring, and stakeholder consultations. Throughout the post-*JNA* period, the government has taken steps to fortify *donor coordination* and to improve monitoring of programs and projects. The coordination function within the ministry of finance is active and efficient, and focused in the first place on financial tracking. The ministry plays the key role in the coordinated management of Georgia's international investment projects portfolio and serves as the government advisor in implementing the donor mapping exercise, including Georgia's cooperation with all key bilateral and multilateral development partners.

An effort has been made to streamline donor coordination. Sector coordination is driven by relevant sector line ministries with relevant donors. Success has been notable particularly in road rehabilitation and construction, municipal and urban infrastructure, water and sanitation, energy, and IDP housing. The budget support modality (general and targeted budget support) helped to enhance policy dialogue and streamline support procedures. However, further effort is needed to improve sector donor coordination in areas where capacity on the recipient side is weak and donor assistance is provided through multiple support modalities which mainly feature self-management of aid by donors and are channeled through an excessive number of stand-alone assistance schemes with varying timelines, execution structures and delivery methods.

The pooling of donor funds that has been greatly facilitated by the *JNA* process has provided an impetus to proper and well coordinated delivery of assistance. The coordination task is led by the ministry of finance but is further decentralized to line ministries for coordination with donors in their respective sectors. For the range of major projects and budget support operations that account for the overwhelming proportion of donor support, conceptual design and project planning is led by the ministry of finance and the relevant line ministry. As examples, in transport, municipal and urban, and energy, coordination is exemplary with no duplication; on IDPs, coordination has improved rapidly throughout 2009 and is now considered by the government and by donors to be on a good track, despite the multitude of stakeholders; and in private sector operations (largely banking), the ministry of finance works with the IFIs in strategy formulation and the approval of individual operations by their boards, but these operations are inherently commercial in nature, with the terms of particular transactions being decided between private sector entities and the lending IFI.

Monitoring and results measurement are still works-in-progress. The ministry of finance concludes the legal agreements, and monitors co-financing and project implementation at all stages. Overall fiduciary responsibility for implementation (including observing of covenants) is devolved to execution agencies under control and scrutiny of relevant line ministries. This joint participation of the ministry of finance and of line ministries in major infrastructure loans or budget support operations provides for a holistic monitoring effort that ensures addressing of financial and programmatic aspects through the participation of all stakeholders. At the sector level, line ministries' involvement in policy dialogue has improved yet remains uneven. Reinforcement of

sector policy dialogue is driven by and contingent upon two factors: (a) continuous capacity development in respective line ministries and (b) further harmonization of work on the donor side, especially when sector-specific support is provided by a large number of smaller donors employing different implementation modalities, time perspectives and administrative requirements and thus tending to overstretch capacities on the recipient side.

Consultations with parliament are close, with parliament ratifying all loan agreements and relevant grant agreements after scrutiny by parliamentary committees. The ministry of finance has developed an informative and up-to-date website that provides detailed information on JNA-supported activities, including amounts committed and disbursed, sources and projects, covenants and financial terms, projections over the near term, as well as periodic reporting on implementation and results. The ministry engages the media in the dissemination of information.

Periodic consultations with civil society take place, with the ministry of finance organising regular meetings with key non-governmental players that deal with donor aid delivery. This includes de-briefing NGO representatives on key technical and financial terms of transactions and on how they impact public external debt. NGOs are able to approach project implementing agencies and obtain more detailed information on technical, environmental or procurement aspects of transactions. The ministry has steadily expanded the range of information provided to the public. The ministry's message to the NGO community has been "*You Know What We Know*," which has proven helpful in the context of building trust and ensuring transparency in the aid delivery process.

In regard to *monitoring of the impact on beneficiaries*, EC, UNHCR, UNICEF, the US, WFP and other donors are working closely with the government and with the IDP communities to ensure that aid is reaching them sufficiently and that gaps which are outlined in the JNA progress report are filled as effectively and quickly as possible.

UN Secretary General issued his report on "Status of internally displaced persons and refugees from Abkhazia, Georgia", August 2009, covering the period 16 May 2008 to 15 July 2009, which focuses on (a) the right of return of all refugees, IDPs and their descendants, regardless of ethnicity; (b) the importance of preserving their property rights; and (c) the development of a timetable to ensure the prompt voluntary return of all refugees and IDPs to their homes. Meanwhile a resolution presented to the General Assembly by the Government Georgia entitled "Status of internally displaced persons and refugees from Abkhazia, Georgia and the Tskhinvali region/South Ossetia, Georgia" was formally adopted (September 2009). The resolution recognizes the right of return of all IDPs and refugees and stresses the need to respect their property rights.

The Outlook for 2010

Overall. The JNA identified the funding requirement of the third post-conflict phase (the eighteen months from April 2010 to September 2011) to be \$1.5 billion, with social sector needs being placed at \$506 million, infrastructure at \$874 million, and municipal at \$119 million. In the remainder of 2010, donor commitments of around \$1 billion have already been identified, with \$248 million for budget support (excluding IMF budget support), \$200 million for infrastructure and \$290 million for municipal. No separate, precise identification for social needs can be made, but with funding from the budget, specific IDP and humanitarian programs, the JNA recommendations are expected to be met.

Table 8: Georgia: Donor Funding - Pipeline for 2010¹⁵

	Sectors	\$ (million)	Donor Organization & Anticipated Amounts USD/Euro millions
1	IDP	106.2	EC – 54 (EURO 41.5 million)
			US – 47
			KfW- 5.2 (EURO 4.0 million)
2	Transport Infrastructure	150.0	WB – TBC
			ADB – 150
			EBRD/EIB – TBC
3	Energy Infrastructure	52.0	EBRD/EIB 52.0 (EURO 40.0 million)
4	Urban and Municipal Infrastructure	282.0	WB – 45
			ADB – 185
			EIB – 52.0 (EURO 40.0 million)
			KfW – TBC
5	Other	99.1	US Agencies – 75.0
			WB – 16.0
			IFAD – 8.1
6	General Budget Support 1/	247.6	WB – 50.0
			ADB - up to 100
			EC – 95.0 (EURO 73.0 million)
			Dutch - 2.6 (EURO 2.0 million)
	Total	936.9	

Source: Ministry of Finance of Georgia and Bank staff estimates.

1/ Excluding IMF Budget Support under the Stand-by Arrangement (SBA)

Economic and budget support. As noted,¹⁶ the economic outlook for 2010 reflects the international recovery under way and the country's improved prospects. Output is projected to expand by 4.5 per cent in 2010 and a medium term fiscal consolidation effort will be put into effect. Thus, the fiscal deficit is estimated at 6.8 per cent of GDP in 2010, compared to 9.2 per cent of GDP a year earlier. The macroeconomic program is being supported by a standby arrangement with the IMF and an augmentation of the initial size of the arrangement was agreed in August 2009; the fifth review of the program was concluded in March 2010. The 2009 fiscal deficit (9.2 percent) was below the IMF program ceiling. The 2010 fiscal deficit is estimated at 6.8 per cent of GDP. The IMF paper on the fifth review underlines Georgia's strong public debt management capacity.

The authorities have managed policies throughout 2009 with skill and determination, maintaining a prudent fiscal stimulus within the constraints of donor budgets and balance of payments support. The gradual withdrawal of the stimulus in 2010 as the private sector recovers and as international

¹⁵ Corresponds to commitments for the year and hence differs from Table 3, which is based on disbursements.

¹⁶ All estimates are as of end-May 2010. See Chapter V for details

demand rises is appropriate. The budget support requirement for 2010 is projected at \$551 million (Table 3) of which the IMF standby arrangement will provide \$390 million. Preliminary estimates show that the EC is projected to provide around Euros 47 million (\$61 million), the ADB up to \$100 million and the World Bank \$50 million. These amounts would be sufficient to meet the budget support requirement for 2010. However, the government is keen to minimize IMF budget support, as IMF funding is short-term (maturity of five years) and is not concessional. The authorities have reached an understanding with the IMF that budget support from the Fund will be reduced *pari passu* with the provision of budget support from donors beyond amounts already programmed. The support from donors is likely on terms that are concessional compared to those of the standby arrangement. *Therefore, the government places particular importance on higher budget support commitments from those donors that have agreed to provide budget support already, as well as willingness to provide budget support from other donors.*

Internally displaced persons. There are still over 233,000 IDPs in protracted displacement¹⁷ and over 30,000 IDP returnees to areas adjacent to South Ossetia continuing to need additional assistance to fully reintegrate. The living conditions of many of the first IDP cohort fall far short of acceptable standards. As highlighted in the *JNA*, addressing the previous IDP case load, concomitantly with addressing the most recent displacements is an important element of ensuring equity and addressing the needs of the most vulnerable. Sustained support to implementing this process of reintegration is thus crucial. Moreover, many new settlements, even one year later, are yet to represent thriving communities, especially in remote areas, and, thus, the developmental task of securing integration and livelihoods is still to be accomplished.

For both IDPs and returned IDPs, current programs designed to provide adequate shelter and information on durable housing alternatives ought to be further rethought by also including tailor-made assistance to facilitate the (re)integration of IDPs by strengthening their capacity to become self-reliant through vocational training and income generating activities and, where necessary, with psychological rehabilitation.

WFP is seeking new funds to continue to provide essential food commodities to IDPs, while implementing livelihood-support programs with FAO to provide agriculture inputs and infrastructure with EC funding. The focus of the programs is on improving potable water supply and establishment of sustainable irrigation solutions through innovative approaches in the newly built settlements and villages of the adjacent area.

The government will continue to focus on the provision of durable housing for IDPs in protracted displacement, with uninterrupted effort in this area being contingent upon predictability of donor support. The approach involves the rehabilitation of existing collective centers, the transfer of the residential units in collective centers into private ownership by IDPs, and the allocation of additional housing where required (from the conversion of public buildings and the construction of more housing units)¹⁸. This plan will continue to be implemented mainly with funding from the EC and US. The rehabilitation of collective centers will take place prior to their privatization. With the assistance of UNHCR, the government has adopted an accountability framework for the integration of IDPs in line with the UN Guiding Principles on internal displacement and rights-based approach

¹⁷ This does not include those internally displaced within South Ossetia (estimated at 10,000).

¹⁸ Indications are that because of structural inadequacies in buildings, rehabilitation will not be possible for IDPs residing in all collective centers. The ministry of refugees and accommodations estimates that alternative shelter and accommodation solutions may be required for about 25,000 IDPs.

and is a major step towards resolving the situation of long-term IDPs. Furthermore an agreement was reached with the ministry of refugees and accommodation and the civil registry agency to undertake a comprehensive re-registration and social profiling of all people in protracted displacement.

The process of privatization needs to be coupled with clear well structured standards and criteria (as indicated in the JNA), and implemented in a transparent way with the participation of IDPs. In this regard, the ministry for refugees and accommodation with its partner organizations developed the Rehabilitation Standards and Guiding Principles of Durable Housing Solution that provides clear standards and criteria. Information about privatization will be provided to IDPs through the regional network of the ministry of refugees and accommodation and NGO/UN offices, recognizing the importance of ensuring that IDPs take well grounded decisions about the durable solutions available and the alternatives to self-privatization of collective centers.

Infrastructure. As noted in the previous chapter, the outlook for the infrastructure sectors is encouraging with donors having made a firm start to investments. In transport and energy, IFIs are active and well coordinated. The impressive implementation record in **transport** is expected to be maintained in the course of the year. With the energetic involvement of a number of donors working to a unified plan, the deficiencies in transport institutions particularly on maintenance planning and resourcing as well as on attention to environmental covenants to loan agreements are expected to be addressed. The commitment of the authorities to these goals is commendable.

Energy. The Black Sea regional high voltage power transmission line project is nearing the implementation phase. An Assistance Agreement signed with USAID in Q1 2010 will result in gas transit infrastructure construction, replacement and rehabilitation, as well as a high voltage electricity transmission upgrade. Works will start in 2010. *Looking ahead, it would be important to secure further donor financing for developing regional power transmission infrastructure of cross-border significance, as well as to procure funds for the gas storage project.* More attention should be placed on obtaining private sector participation in projects and on supporting hydropower projects. Specifically, priority projects are: (a) interconnection expansion projects to Armenia and Azerbaijan, (b) Enguri HPP rehabilitation project (2 remaining units and Vardnili channel), (c) underground gas storage project, (d) LNG plant on the Black Sea, (e) pre-feasibility and feasibility studies for renewable energy projects (hydro and wind), (f) Shale Gas production development.

Municipal/urban. There is strong government and donor confirmation of *JNA* initial priorities for the coming phase in the urban and municipal sector. The government continues to see increasing investment in the municipal and urban infrastructure sector as part of the fiscal stimulus package, providing the physical environment for private sector growth and employment generation, and the means for an even regional development in the country. As for donors, full commitment to providing funds to expand and improve municipal and urban infrastructure is evident.

Support for municipal investments is well planned. IFIs and bilateral donors remain active. Municipal and urban investments benefit from generally strong local implementation and execution capacity. The pipeline for 2010 will be bolstered significantly by two new operations scheduled to be signed in 2010 with the World Bank (Regional and Municipal Infrastructure Project II) and ADB (multi-tranche financing facility “Georgia Sustainable Urban Transport Investment Program). Donor support is being considered in further water projects, notably in Kutaisi. Solid waste management support will be explored with relevant donors, in view of needs in the area.

With the recent creation of the United Water Supply Company of Georgia, the government seeks economies of scale and scope, rationalization of tariff structure and uniformity of accounting and managerial practices, all this to foster prospective PPPs and private sector-driven delivery solutions in the water supply and sanitation area. This effort is expected to be buoyed significantly by the two operations planned for signature in 2010: EIB's Water Infrastructure Modernization Project and ADB's multi-tranche financing facility (Georgia Urban Services Improvement Program). These new operations would combine extensive capital expenditure measures implemented throughout the territory of Georgia with concerted institutional capacity building and technical assistance to entities dealing with water supply and sanitation policy formulation and implementation. Furthermore, work is underway with Germany/KfW on phase III of the Municipal Infrastructure Batumi project, which aims at improving access to quality drinking water and improving the sanitary situation for the local population.

Banking. The reform agenda for strengthening the banking sector has been noted earlier in this report and is discussed more fully in Annex III. The IFIs would continue to play an important role in helping improve resilience of the financial system, strengthening its intermediation function and broadening access to financial services. The IFIs intend to help mobilize private financing to support the infrastructure program. Specifically, the EBRD and IFC are exploring projects in renewable energy and IFC is discussing advisory work with the government on private participation in infrastructure. EBRD and IFC will continue to seek to support their banking clients in order to support the renewal of prudent lending. ADB's Private Sector Operations Department (PSOD) is exploring deals in both banking and real sectors and is expected to step up its private sector operations in 2010. While the banking sector is now stabilized and has overcome initial refinancing risks, lending is depressed compared to the pre-crisis level.

In the policy area, *IFIs are expected to focus, inter alia, on supporting further financial deepening of the economy through investments and targeted TA to foster the development of the local non-bank sector* (pensions, micro-finance and the insurance industries), which can help reduce excessive reliance on foreign savings and capital inflows. It would be important to focus IFI efforts on re-building trust in the financial system through supporting improvements to the consumer protection regime and the central bank's proposed scheme to provide banks with long-term local currency funding. This would in turn encourage banks to increase the share of their local currency lending. Continuing and expanding technical assistance efforts to strengthen bank models and risk management are of importance. In helping banks to re-start lending to small and microenterprises, which were cut off from access to credit during the crisis, IFIs could provide additional support to banks that would focus on lending to SMEs and micro-enterprises. Together with the mentioned continuous and multi-faceted support to the banking and non-bank sectors, IFIs' support in the form of direct lending to and investment into real sector enterprises, especially in high growth potential areas and industries, would be important from the viewpoint of improving enterprise management, employment generation and the competitiveness and export potential of the economy.

Annex 1: Financing Requirements for the Recovery Program

	1 Immediate (to March 2009) */	2 Core Investment (to March 2010)	3 Core Investment (to Sept. 2011)	4=(1+2+3) Total: Immediate plus Core	5 Already included in Budget/ Budget Support **/	6=(4-5) Total Funding Needs
I. BUDGET SUPPORT (# 98)	480	450		930		930
II. SOCIAL SECTOR	294	448	506	1,248	251	996
RETURN, RELOCATION & RESETTLEMENT (# 111)	169	268	359	796	220	576
Housing construction/rehabilitation	157	260	349	766	220	546
NFI for 12,000 HHs	7			7		7
Supporting arrangement costs	5	8	10	23		23
SOCIAL PROTECTION (# 115)	45	42	35	122	31	91
Temporary emergency support (in-kind and cash)	24.4	18		42	10	32
Emergency supplementary feeding (children 0-2, pregnant women)	2			2		2
Refurbish damaged TSA offices	2			2		2
One-time cash assistance to resettled IDPs	4			4	1	3
Targeted social assistance for newly poor	12	23	35	70	20	50
Training 24 new-hired social workers, information campaigns among IDPs, victims shelter	1.6	0.6		2.2		
EDUCATION (# 117)	19	16	18	53		53
Restore Infrastructure & Equipment	3	11	13	27		27
Provision of goods and services	13	5	5	23		23
Emergency activities	3.4	0.04	0.04	3.5		3.5
HEALTH (# 120)	29	59	87	175		174.6
Health insurance program for the poor - incremental costs	28.0	56	84	168		168
Rehabilitation of health infrastructure (Gori emergency center and ambulatories)	0.4	2	3	5		5
Provision of health care services	0.5	0.7		1		1
AGRICULTURE & LIVELIHOOD (# 123)	28	53		80		80
Restoration/improvement of food security, rehabilitation of irrigation	28	53		80		80
EMPLOYMENT (# 126)	5	11	7	22		22
Micro finance	4	10	6	20		20
Local capacity building	0.5	1	0.5	2		2

	1 Immediate (to March 2009) */	2 Core Investment (to March 2010)	3 Core Investment (to Sept. 2011)	4=(1+2+3) Total: Immediate plus Core	5 Already included in Budget/ Budget Support **/	6=(4-5) Total Funding Needs
III. INFRASTRUCTURE	99	300	874	1,273	315	958
TRANSPORT	61	262	707	1,030	295	735
Roads (# 130)	18	244	707	969	295^{1/}	674
Damage to several roads	18			18	5	13
Completion of Main Road Network		200	622	822	230	592
Development of secondary network of roads		44	85	129	36	93
Rail (# 135)	4	18		22		22
Damage to Grekali-Metekhi bridge & other	4			4		4
Bridge repairs to increase speed of traffic		18		18		18
Ports (# 137)	1.0			1.0		1.0
Damage to Poti port	1.0			1.0		1.0
Aviation (# 140)	38		0	38		38
Replacement of Sakaeronavigatsia radar in Tbilisi	8			8		8
Rehabilitate Tbilisi airport runway	30			30		30
ENERGY (# 141)	38	38	167	243	20	223
Gas and power equipment, connection, and repair of distribution lines	12			12	1	11
Natural Gas storage		10	167	177		177
Strategic reserve of Mazut as back-up fuel for gas plants	26			26	19	7
220 KV Senaki Power Transmission Line Rehabilitation		28		28		28

IV. URBAN AND MUNICIPAL SERVICES (# 149)	20	118	119	257		257
Water Supply and Wastewater	1	7		9		9
Gori : Replace 3 damaged chlorination units (0.24 mil GEL)	0.2			0.2		0.2
Gori: Rebuild damaged fence around water treatment plant (0.3 mil GEL)	0.2			0.2		0.2
Zugdidi: Rehab water supply systems damaged in 1st Abkhaz war (10 mil GEL)		7		7		7
Zugdidi: Rehab pipes and waste treatment plant damaged (1.5 mil GEL)	1			1		1
Urban and Municipal Roads	17	18	72	107		107
Gori: Resurface 5 km city (2 mil GEL) and 75 km villages (15.8 mil GEL)	13			13		13
Senaki: Resurface 1.5 km and 3 small bridges (0.4 mil GEL)	0.3			0.3		0.3
Zugdidi: Resurface 17 km rural and 20 km urban (6 mil GEL)	4			4		4
Tbilisi: Urban Transport System (traffic control & mgmnt, public transport, road wk)		9	27	36		36
Kutaisi: Urban Transport System (traffic control & mgmnt, public transport, road wk)		9	27	36		36
Batumi: Urban Transport System (traffic control & mgmnt, public transport, road wk)			18	18		18
Urban Infrastructure Development, Housing and Public Buildings	1	81	35	117		117
Kutaisi Infrastructure Development (water pipes, treatment facility, utility, roads)		28	8	36		36
Poti Infrastructure Development (wastewater/treatment network, utility, roads)		23	13	36		36
Zugdidi Infrastructure Improvement (urban and municipal infrastructure)		22		22		22
Senaki Infrastructure Improvement (urban and municipal infrastructure)		8	14	22		22
Housing and Commercial Buildings in Gori	0.9			0.9		1
Housing, Commercial , and public Buildings in Senaki	0.5			0.5		0.5
Management contract related expenses		12	12	24		24

V. ENVIRONMENT (# 157)	2	2	3	7		7
Protection and Production of Forests	1	1	3	5		5
Invest in low-impact logging technologies & training	1	0.2		1		1
Begin salvage operations and provide firewood to IDPs.	0.5	0.2		1		1
Pest management measures, forest rehabilitation, develop fire ecology studies	0.1	0.6	2	2.4		2.4
Relocate flooding affected residents from Daba village			1	1		1
Natural Habitats and Protected Areas	0	1		1		1
Return park administration in Kolkheti to effectiveness	0.3			0.3		0.3
Repair damaged infrastructure in Kolkheti		0.5		0.5		0.5
Coastal and Marine Pollution		0		0		0
Monitoring program and assess impact on marine environment		0.1		0.1		0.1
Terrestrial Oil Pollution	0	0	0	1		1
Secure sites; Remove oil from and replace soil; Install monitoring wells at the train site	0.2			0.2		0.2
Monitor the groundwater at the train site	0.1	0.1		0.2		0.2
Remediate the groundwater		0.1	0.1	0.2		0.2
Other infrastructure: Buildings south west of Gori	0	0		0		0
Assess presence of asbestos	0.1			0.1		0.1
Properly remove and dispose asbestos		0.1		0.1		0.1
TOTAL	895	1,317	1,502	3,715	566	3,148
BANKING SECTOR FUNDING ^{2/} (# 110)	500	200		700		700
<p>Source: JNA Staff Calculations. Memo: Exchange rate of 1.405 Lari per US dollar used in converting estimates that were provided in Lari. * / Post-conflict damage related needs. ** /Corresponds to those items in columns 1 to 4 that have been identified as already funded through the regular budget or as included in donor budget support. # Refers to paragraph number of JNA report where explanations can be found. 1/ Corresponds to the amount of taxes included in the roads sector cost estimates. 2/ It is important to note that the needs assessment relating to the banking system are in the nature of contingent costs. Unlike donor financing of budget support operations or infrastructure investments which are expenditures, banking sector support takes the form of provision of liquidity or of guarantees; and it would be expected that such funds would be ultimately re-paid. Such support will turn into actual expenditures only if banks were to fail.</p>						

Annex 2: The Return, Relocation and Resettlement of Internally Displaced Persons

Developments in 2009

The overarching priorities under this sector remained: supporting a housing response strategy that combined temporary shelter (pending solutions) and durable housing; providing IDPs with information on various prospects available to ensure informed decision making; promoting clear selection criteria and assistance as an integral part of a resettlement / relocation process; monitoring government led privatization and rehabilitation of Collective Centers (CC) and assignment of shelter solution processes; and more generally ensuring IDP protection and human rights. The main impact of activities undertaken by the government, with the assistance of EU, USAID, Germany, UNHCR, OHCHR and IOM, together with their implementing partners, was the provision of durable housing options for IDPs based on agreed standards; respect to and application of IDP Guiding Principles throughout the process; and supporting social integration through the type of activities implemented; and targeting people with specific needs for humanitarian assistance.

During the first stage of the response (until March 2009) activities focused on repair of damaged homes of returnees, on winterization and further repair of buildings serving as collective centers, and on monitoring government led relocation of the population displaced as a result of the August 2008 conflict to the newly constructed settlements. Subsequently, activities turned towards the search for durable shelter solutions for the first cohort of IDPs.

Progress made in relation to IDPs from the August 2008 conflict (the second cohort)

Of the 138,000 people displaced by the August 2008 conflict (so called 'new' IDPs) an estimated 106,000 returned to the Shida Kartli region (including areas adjacent to South Ossetia, Georgia). While the majority of these returnees were able to re-integrate well, in particular in areas where damage was limited, returnees to villages close to the administrative boundary line (ABL) continue to face particular challenges, deriving *inter alia* from an ongoing volatile security situation, together with a loss of access to fields, grazing grounds and forests which used to contribute to their livelihood, causing a number of families from villages in particularly difficult areas e.g. Ergneti, Gugutiankari, Zardiantkari, etc. to continue staying in Collective Centers. Damage to the irrigation system, lack of irrigation water, difficult access to markets and lack of proper storage facilities all aggravate the problem. These challenges in the reintegration process meant that WFP continued its food assistance in the most affected villages close to the ABL and UNHCR postponed the closure of its Gori Field Office, originally foreseen for early 2010, and instead will gradually phase down its operation throughout 2010.

Following the August 2008 conflict the government (with the assistance of IFI and EC funding as well as some bilateral partners, such as Turkish development TIKA and German GTZ) constructed 38 settlements (including buildings rehabilitated to provide apartments to IDPs) containing some 6,000 housing units currently serving about 19,000 IDPs originating from South Ossetia, Akhgori and Upper Kodori Valley, Abkhazia who were displaced in this

conflict and are unable to return. During 2009 multiple efforts have been taken to improve the infrastructure in these settlements (improve roads, secure access to public transport and markets, build or expand schools and kindergartens) and address the challenge of IDPs being able to secure independent livelihoods. In nine settlements, UNHCR constructed and put into operation nine community centers offering a wide range of services including vocational training, and six communal washing facilities were constructed. 1,716 IDP families received one time monetary assistance (so called compensation instead of direct housing solution) of 10,000 USD equivalent in GEL.

Kitchen gardens have been established in most village-like settlements and many IDPs received additional agricultural land, though the size and quality of land distributed differs significantly across the settlements. About 9% of IDP families residing in the settlements do not possess any plots of land; this mainly pertains to IDPs living in “corpus- like” settlements

Due to these efforts as well as those made by people living in these settlements, living conditions have stabilized and life is slowly normalizing, with shops, schools police stations, medical and other facilities beginning to function. Under a UNHCR-sponsored protection monitoring project as well as an information project, Norwegian Refugee Council (an implementing partner of UNHCR) has collected from community leaders (Mamasakhlisi) and IDP parents information that on average 93% of school-age children attend school. However, with only kindergartens in eight settlements, the percentage of children attending kindergarten is considerably lower.

Apart from a few exceptional cases, IDPs living in these settlements have received official IDP status under national legislation together with related documentation. However, granting IDP status has been delayed for newly displaced living in the private sector or remaining in collective centers or other provisional shelter. As of 1 January 2010 out of approximately 22,000 individuals who remain displaced due to the August 2008 conflict, over 19,641 have formally received IDP status, but the process continues. Under a UNHCR project implemented by NGO LDCG, a total of 1,095 IDPs from the 2008 conflict who had lost their ID cards during flight or who never had possessed proper documentation were assisted civil registration issuance of proper documentation. This has also given them access to a number of social and other services.

However, significant infrastructure shortcomings and humanitarian needs still exist in the new settlements. The physical condition of some cottages, often built very quickly, is deteriorating and damages (such as cracks in walls) need to be addressed urgently to prevent further problems. In about 30% of the settlements (mainly cottage type settlements) there is an acute need for improvements in the water and sanitation sector and, in some locations, access roads to the new settlements are still in bad condition.

The key challenge remains the lack of employment facilities and other deficits in securing a sustainable integration and livelihood. Given the lack of income, many IDPs also complain about insufficient access to medical services and medication.

Progress made in relation to IDPs from pre-2008 conflicts (the first cohort)

In May 2010 the government adopted an updated IDP action plan to implement the *State Strategy on Internally Displaced Persons* (February 2007). The Action Plan, covering an implementation period of three years, focuses on the provision of durable shelter solutions for IDPs as a form of local integration and includes activities serving livelihood and income generation developed with the assistance of the international community, including donors, and coordinated by UNHCR.

In its first phase the government's efforts to address shelter needs of pre-2008 IDPs concentrated on rehabilitation and privatization, and privatization without rehabilitation, of more than 500 collective centers and idle buildings to IDP inhabitants and IDPs in need. Based on UNHCR advice, the government improved the terms of the privatization contract with a view to securing better protection of all members of IDP families and introduced legal safeguards and advocating for clear standards and a transparent process. Together with some other measures, provision of houses purchased by the government and cash assistance, so far housing needs of about 15,000 IDP families from pre-August 2008 caseload have been addressed. (equivalent to 43% of IDP families living in collective centers and 18% of the total caseload).

MRA developed an IDP Housing Plan, which elaborates on the envisaged multidimensional approach entailing some additional rehabilitation and privatization of existing or abandoned buildings, construction of new houses (in particular in Poti, Tskaltubo, with further plans on other sites) and purchase of privately owned CCs and idle buildings for durable housing solutions and related infrastructural and funding needs.

Coordination mechanisms

Coordination of a variety of initiatives undertaken by a broad range of governmental, UN agency, NGO and other actors, including key donors has been crucial. Responding to challenges faced and lessons learned during the emergency phase since March 2009, a Steering Committee has been organized under the ministry of refugees and accommodation (MRA) which regularly brings together key actors, serves as a forum for ongoing coordination needs, and also discusses longer term vision and project design. Temporary Expert Groups (TEGs) operating under the Steering Committee continue to address specific issues, such as legal and protection issues, including privatization, the development of shelter standards, development of guiding principles and criteria for allocation of alternative durable housing, multi faceted information campaigns, and livelihood strategies.

These formal coordination mechanisms are complemented by specific informal working groups such as capacity building of the MRA, in which several actors (USAID/Forecast, EC/DRC, UNDP, WB and UNHCR) are involved.

Remaining challenges and ways to move forward.

Improved information policy, based on consistent strategies and transparent approaches

While the dimension of the challenges, and in particular meeting the needs of the protracted caseload, requires a step by step approach and a multi-year effort, it remains important that government commitment and engagement remains stable. Consistency of approaches needs to

be secured, and IDPs not among the first group of beneficiaries should feel assured that their time will come. A carefully thought through finalization of the IDP housing plan, and follow up on the implementation of alternative housing allocation criteria including *inter alia* a rights based approach, is now crucial. This should involve increased prioritization of beneficiary selection based on vulnerability and acute needs (giving increased attention to IDPs who live in collective centers that are so rundown that rehabilitation is not possible).

A strong, systematic and comprehensive information campaign is needed on all available options and applicable standards including the selection criteria. This is important to overcome perceptions of *ad hoc* approaches and fears among IDPs that sooner or later they will again be forgotten and that shelter and other integration assistance projects will discontinue before the government fully completes the job.

Transparent, flexible and sensitive approaches will also be needed to balance the legitimate efforts of the government to optimize the use of existing collective centers, *inter alia* through privatization whilst taking into consideration the rights of various parties involved including private owners / investors of collective centers and IDP residents of privately owned collective centers should be adequately compensated..

Further engagement of international agencies and NGOs in shelter construction

The government has implemented effectively and efficiently large scale shelter projects for IDPs, but nevertheless believes that further international engagement remains crucial to addressing the remaining needs and ensuring adequate housing solutions for all still affected by displacement. UNHCR has indicated its future concentration on those areas of shelter construction where gaps exist, e.g. in construction of shelter for IDPs in the returning process in the Gali region of Abkhazia, construction of homes for elderly or other vulnerable IDPs, and the provision of shelter kits for shelter rehabilitation in self help for returnees in the adjacent areas and possibly some IDPs living in the private sector. UNHCR will continue to monitor and promote transparent approaches and fair procedures throughout the process.

Livelihoods.

While the IDP Action Plan introduced a small chapter on livelihood and agencies and NGOs have engaged in this area, present government activities are still focused on provision of housing. Although the EC and some other donors have already funded a large number of activities, more attention still needs to be given on supporting the social and economic integration of IDPs together with continued robust effort to improve housing conditions for both old and new IDP caseloads.

Building on its earlier Shelter Plus approach, in 2010 UNHCR will concentrate its assistance efforts on the area of livelihood, income generation and related vocational training efforts in areas close to the ABL, where access to traditional sources of livelihood has been interrupted.

Legal advice, legal protection and access to services and targeted social assistance

The remaining gaps in assessing eligibility of displaced population for granting formal IDP status under national legislation needs to be finished as a matter of priority. Individuals denied IDPs status will have to receive legal advice and the opportunity to have the decision reviewed by a court. Public information efforts and legal advice projects should also allow IDPs to be well informed about their rights as well as on criteria and procedures governing eligibility for targeted social and other forms of assistance.

Legal advice will also continue to be needed in the context of evictions, negotiations of fair indemnification payments in case of privatization of collective centers to private investors, and to make informed choices when considering different housing solution options.

Moreover, following the privatization exercise, which has made many IDPs property owners of their apartments in former collective centers, it is important that effected IDPs are properly and systematically informed about their rights and obligations as owners, and assisted in the creation of mechanisms serving the administration of condominiums. UNHCR and partner projects will assist the government in systematically addressing this challenge by offering training in condominium legislation and management and technical support in setting up condominium committees and housing maintenance funds.

Annex 3: The Recovery in the Banking Sector

The Georgian banking system was doubly hit by an armed conflict with Russia and the concurrent global financial meltdown. Bank crisis was averted by appropriate government policies and IFI intervention in the context of the \$4.5 billion multiyear donor pledge to Georgia in October 2008. The ensuing funding to several major banks provided them with a capital cushion in a difficult macro-economic environment during 2008-09, marked by deteriorating portfolios and a decline in credit. It also allowed them to refinance foreign obligations falling due and continue their operations. At the same time, challenges remain: bank funding models need to re-adjust to rely less heavily on external borrowing and more on domestic sources of funding; a tight focus on recovery of lending is needed in an environment of stricter underwriting rules and a limited number of larger borrowers with good credit; and the resurgence of dollarization in the wake of the crisis needs to be reversed.

Banking system in post-conflict crisis

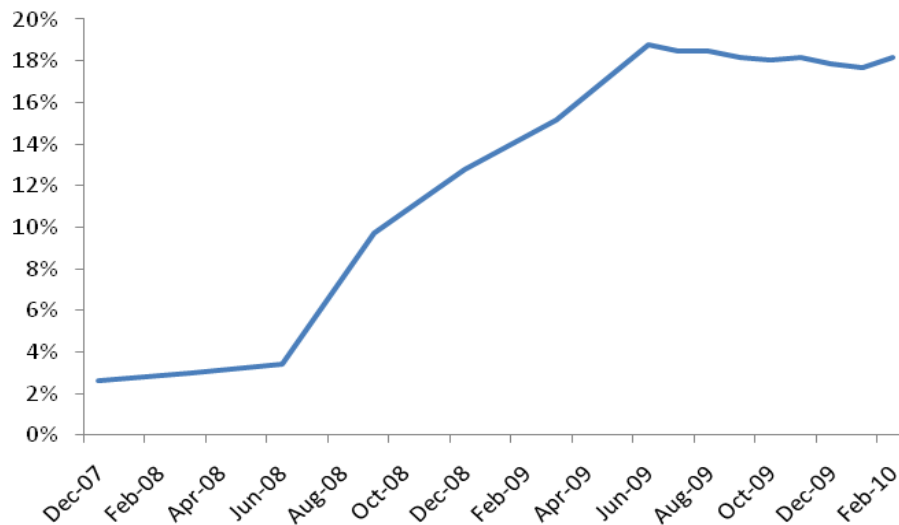
The conflict in August 2008 and the global financial crisis threatened the banking sector, but a systemic crisis has been averted. At the onset of the crisis, the banking system faced significant refinancing needs, with over \$500 million of foreign loans (4 percent of GDP) expected to be repaid between January and June 2009. As the crisis hit, the external capital market virtually closed, thus making it impossible for banks to roll over their external obligations. Moreover, in the first three months of the crisis, one fifth of all deposits left the banking system.

Despite the considerable initial pressures, no bank failed. The banks' stability was helped by a combination of tight prudential requirements, significant international support and central bank measures. The latter included temporary suspension of reserve requirements and lending over GEL 130 million (about 0.7 per cent of GDP) to banks via a 6-month facility. After a decline to 14 per cent at end-2008, capital adequacy of the system recovered to around 20 per cent by August 2009 and at end-February 2010 stood at 18.7 percent. The system's liquidity has also recovered to above pre-crisis levels, with liquid assets at 26 percent of all assets at end February-2010. Deposits have now attained their pre-crisis levels.

Non-performing loans increased since the onset of the crisis. As economic activity contracted, non-performing loans as a share of total loans increased from around 3 percent in July 2008 to 18-19 percent in June 2009.¹⁹ They have remained at the same level of about 18.2 percent at end-February 2010. Facing large non-performing loans, the banks have focused their activities on loan recovery, restructuring, and significantly cut back in their lending activities. The central bank has required banks to assess on a conservative basis loan loss provisions (accounting for about 13 percent of total loans at end-February 2010), – reducing profitability in 2009 and likely in 2010 as well.

¹⁹ Using stricter central bank methodology. Under the IMF methodology, NPLs rose to 7 per cent in mid-2009..

NPLs have become a major issue since the onset of the crisis
(NPLs as a share of total loans)



IFI involvement

International financial institutions provided significant resources to help stabilize the Georgian banking system during the crisis. Against an overall multiyear pledge of US\$850 million for the financial sector, the donors have thus far approved \$636 million in support to the banking sector during the period immediately following the conflict. The EBRD provided a total of \$280 million, the IFC \$225 million, with further resources provided by FMO, DEG and OPIC. Main recipients of the IFI support were the two systemic Georgian banks, totaling \$380 million. The IFI funds were provided in the form of equity, subordinated and senior loans. IFI resources were critical for the ability of the banking sector to cope with the simultaneous outflow of deposits, drying up of sources of external funding, and rapid deterioration of asset quality.

Technical assistance from IFIs has helped banks' management begin to focus on re-evaluation of their business models. Like in other transition countries, during the boom years, banks' lending policies were often lax and perhaps too expansionary. They also relied heavily on external financing, which has proven to be very vulnerable to changes in the risk appetite of the world financial markets. Following the crisis, the banks have adopted stricter lending procedures and focused on attracting deposit financing. IFIs have begun helping the banks implement institution building plans and otherwise adapt to the new environment, thus helping build longer-term stability in the banking system.

Since the onset of the crisis, EBRD specifically has been involved in six technical assistance programs with all the major Georgian banks. Smaller programs included loan workouts and corporate recovery training as well as treasury risk management operations. More significant programs (over \$500,000 each) have focused on institutional strengthening and institutional building plan support, as well as support for an energy efficiency lending program.

Future challenges

Although the banking system has stabilized, challenges remain.

Funding

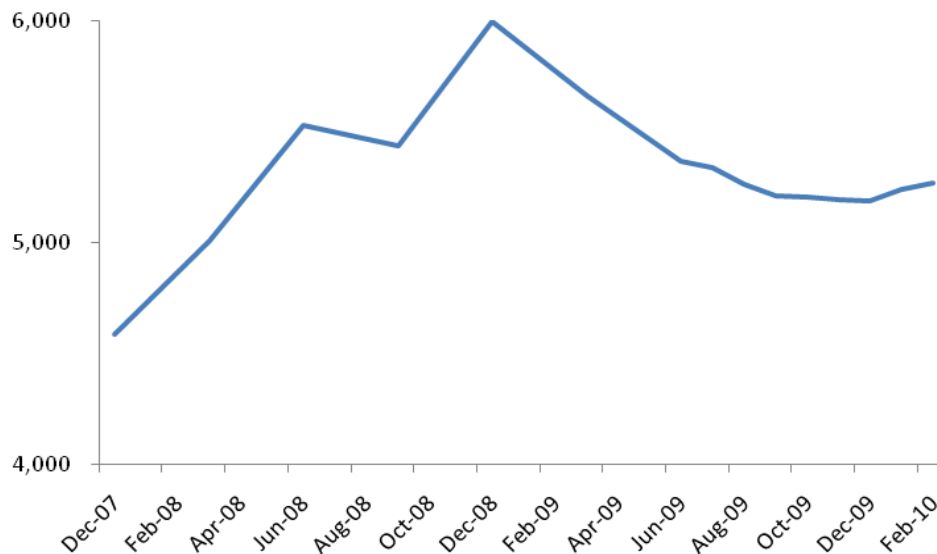
Like other transition countries, Georgia faces the need to adjust its growth model to rely more on domestic savings. As the international capital markets are likely to continue to require premiums on emerging market assets, return to the pre-crisis availability of external capital is unlikely in the nearest future. Therefore, the authorities have to focus on prudential and other measures to foster local sources of savings (including through pensions, micro-finance providers, life insurance and other instruments).

The bank deposit base was small and volatile during the crisis. Before the crisis, Georgia had one of the lowest deposit-to-GDP ratios in the Central Europe and Caucasus (CEE) region. Although the level of deposits increased by around 25 percent in the year preceding the crisis, at its peak in mid-2008 the deposit to GDP ratio only reached around 20 percent. Deposits declined following the crisis onset but recovered subsequently to pre-crisis levels. To attract back lost deposits in the crisis aftermath, banks were forced to further increase deposit interest rates, thus exerting pressure on their profitability.

Lending

After a period of rapid growth credit expansion stopped, though there are recent positive signs. Net lending to the private sector declined by 20 per cent between August 2008 and November 2009 if the devaluation of lari is taken into account. While lending recovered from the worst period following the crisis, net monthly flows remain below their pre-crisis levels. The construction sector, which previously attracted unsustainable lending, was most affected by this net credit withdrawal. Lending to some sectors has recovered, especially to industry (16 percent relative to the pre-crisis level). The trade sector is also receiving 3 percent more loans than in July 2008, but 16 percent below the average for August 2007 – July 2008. Very importantly, however, loan flow decreased for smaller retail or personal loans, pointing to banks' focus on larger clients. In November '09, loans below GEL 1 million were down 39 percent relative to pre-crisis levels, compared to an 18 percent decline for those over GEL 1 million.

After rapid pre-crisis rise, loan stock dropped since Aug'08
 (Loan stock in millions of Lari)



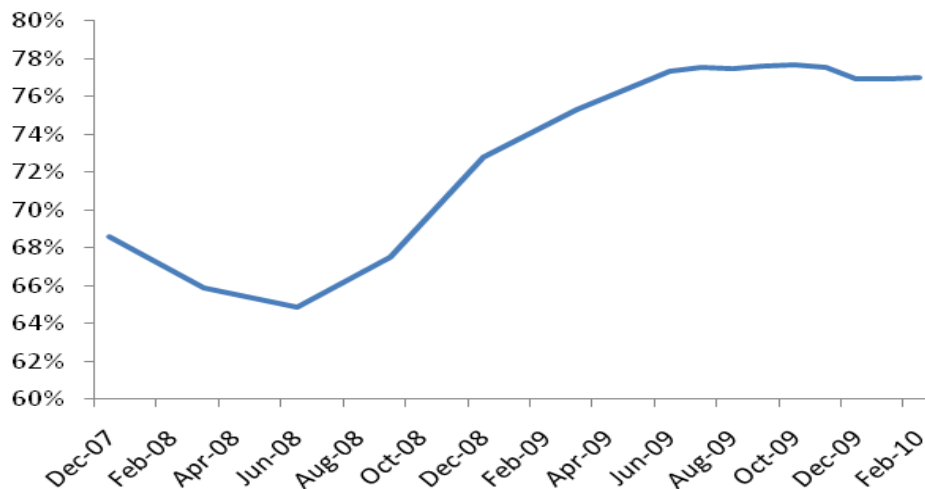
Banks face difficulties in generating sufficient new loan business. They intend to focus on the more reliable smaller and retail business as well as lending to a limited group of larger customers with good credit. However, intense competition for the latter may also force them to look for new sources of business, such as agriculture, a sector that accounts for around 10 percent of GDP, but only under 2 percent of bank credit. It should be noted that the SME sector performed quite well during recession, however banks are unable to ensure full-scale refocusing of their funding on the sector because they have had to focus their resources (including management time) on restructuring loans to larger corporate lenders.

Government institutions may consider developing schemes to provide loan guarantees in order to stimulate lending, especially in the hardest-hit sectors of the economy. A scheme is already in place to support completion of construction begun before the crisis. Similar plans may be contemplated to ensure lending across the economy, not merely to the few larger borrowers for whose business commercial banks are currently competing.

Dollarization

The financial system has been re-dollarized during the crisis. In the year preceding the crisis, the share of foreign currency loans gradually decreased from 74 to 66 percent. However, this trend was rapidly reversed after August '08, and, in particular, following the devaluation of lari. By the summer of 2009, the share of foreign currency loans in total loans increased to 77 percent and it has remained at the same level through end-February 2010. It has stabilized at that level since then. The reversal has been particularly pronounced in the mortgage segment, with foreign currency loans increasing from 75 percent before the crisis to 88 percent in late fall of 2009.

Pre-crisis advances in local lending have been more than erased since Aug'08
(Share of FX-denominated loans in total loan stock)



On the deposit side, re-dollarization followed the loss of confidence in lari after the one-off 16 percent depreciation in November 2008. The foreign currency share of deposits was largely unaffected by the crisis until the depreciation, remaining at around 61 percent, a level achieved after years of steady decline. Following the depreciation, the share of foreign currency deposits jumped to 74 percent in a matter of one month, although it started stabilizing in late spring 2009 and stood at around 69 percent at end-2009 well above the pre-depreciation level, though in line with that of neighboring countries.

Dollarization remains a source of risk for the Georgian banking system. Heavy dollarization represents a source of indirect credit risk for the banks, as income of borrowers is mostly denominated in GEL and their obligations are denominated in a foreign currency.

The central bank can help shift to the use of local currency. Stable monetary policy can help re-build individuals' and businesses' confidence in the local currency and encourage local currency lending. Over time, this could help lead to de-dollarization of bank deposits, thus allowing for an increase in local currency lending by the banks. The central bank can also continue its efforts to devise a scheme that would provide banks with longer-term lari funding and in turn induce them to lend in GEL.

Future IFI involvement

The IFIs would continue to play an important role in helping improve the resilience of the banking system and help encourage banks to continue to intermediate savings and reach all main segments of the market. In particular, the IFIs could help to:

- **Support further financial deepening of the economy through various investment activities.** This can, in turn, contribute to the authorities' efforts to further strengthen confidence in the banking system.
- **Help develop further non-bank institutions such as pensions, micro-finance providers and insurance industries.**
- **Help consider a deposit insurance scheme.**
- **Support the development of local currency swap instruments to reduce excessive reliance on foreign savings/capital inflows.** In the short run, IFIs can focus their efforts on the central bank's scheme under consideration that would provide banks with long-term GEL funding. This would in turn help the banks to increase the share of their local currency lending.
- **Continue and expand technical assistance efforts to refocus bank models and risk management.** The banks would need to adjust their operating models and strategies to address issues that arose in the months after August 2008. IFIs can help the banks' work to develop sustainable business plans that would help ensure long-run stability of the system.
- **Help re-start lending to small and microenterprises, which were cut off from access to credit during the crisis.** IFIs could provide additional support to Georgian banks that would support lending to SMEs, in order to encourage banks to continue lending to this segment of the market. Support will also be needed to help strengthen financial sector infrastructure.



THE UNITED NATIONS



THE WORLD BANK



This document provides a second progress report on the funding extended by a group of donors to Georgia to address its post-conflict recovery and reconstruction needs. It also reports on the main achievements of the recovery and reconstruction program. The paper utilizes the framework of the *Georgia: Joint Needs Assessment* report that provided the background for the donor conference held in Brussels in October 2008. It updates and extends the scope of the first *Progress Report* which was issued in June 2009.

This paper finds that the recovery and reconstruction program continues to maintain an impressive pace of implementation. Donors have followed through with financing in the amounts corresponding to their pledges and to the requirements as assessed by the *Joint Needs Assessment*. The activities on the ground supported by the funding also show promising results.

