

**LETTER OF DEVELOPMENT POLICY OF THE GOVERNMENT OF GEORGIA
FOR THE COMPETITIVENESS AND GROWTH DEVELOPMENT POLICY OPERATION**



**PRIME MINISTER
OF GEORGIA**

Robert B. Zoellick
President of the World Bank
Washington, DC

*Re.: Letter of Development Policy – Georgia First Competitiveness and Growth
Development Policy Operation*

Dear President Zoellick,

Allow me to begin by thanking the World Bank for strong support of Georgia's successful development efforts that have been underway in all the recent years. One of the key objectives of the Government of Georgia, as stated in our Ten-Point Plan for Modernization and Employment (2011-15), is to create the preconditions for successful and prosperous Georgia. To achieve this goal, we have been focused on fostering job creation through establishing best possible investment environment, particularly in the sectors with high export growth potential and capacity to generate high-productivity jobs. We believe this will help make the economy more resilient. At the same time, we continue deploying efforts aimed at improving living conditions of the most vulnerable members of our population.

Georgia has been implementing deep and comprehensive reforms since 2004 with impressive results. We undertook significant reforms to reinforce public finance management, improve business environment and social services, eradicate corruption, liberalize trade and upgrade infrastructure. These efforts, against the background of favourable global economic environment, resulted in growth rate of more than 9 percent per year during 2005-2007. Large inflow of foreign direct investment (FDI) was one of the drivers behind this growth trend. The FDI in Georgia was galvanized by strong investor confidence in the country's development dynamics, large-scale privatization and significantly improved business environment - Georgia's Doing Business rank rose from 112th in 2005 to 16th in 2012. Prudent and pragmatic public debt management helped ensure steady improvement in public debt indicators, with public debt declining from 63.2 percent of GDP in 2003 to 25.5 percent in 2007.

We responded swiftly to the twin shocks of the global economic and financial crisis and the military invasion by Russia in August 2008. Countercyclical fiscal stimulus measures helped usher sustainable economic recovery from 2010 onwards. In 2010, real GDP growth rate was 6.3 percent, up from -3.8 percent in 2009, chiefly driven by robust performance of manufacturing, construction and services. Public expenditures were reprioritized and increased from 33.7 percent of GDP in 2007 to 37.2 percent in 2009. Expenditures on infrastructure, education, health, and social protection were scaled up, with the fiscal space for these increases coming partly from tightening of public sector administration costs and reduction of other non-recurrent expenditures. At the same time,

revenue collection declined. The resulting higher fiscal deficits were financed primarily through increased international donor support provided on concessional and grant terms that allowed us to sustain a favourable public debt situation. In 2011, real GDP grew 7 percent despite challenging external environment, with strong performance across the board. As the economic recovery gained traction, public expenditure to GDP ratio declined to below 31 percent in 2011 and is expected to decline further below 30 percent by 2012-13.

In summary, Georgia's economic performance has been excellent in all the recent years, bolstered by far-reaching institutional reforms, steep fiscal consolidation and firm recognition that a dynamic and vibrant private sector needs to be in the driver's seat with the state playing a facilitating role. Yet, global economic outlook remains uncertain, compounded by lingering Eurozone choppiness. We thus need to continue building safety buffers to make sure that macroeconomic stability, which is one the key objectives of the Ten-point Plan, is preserved unscathed. To this end, we are on the right track with our policy of fiscal consolidation and we continue managing our public debt in a conservative manner. These policies will allow us to maintain adequate fiscal-space with sufficient headroom to react in the event that exogenous risks to economic growth materialize.

We have been complementing horizontal reforms focused on the business environment with reforms aimed at increasing competitiveness of the Georgian economy through modernization of healthcare, education, infrastructure (including the power sector) and agriculture. Active promotion of exports, investment and tourism, with continued emphasis on a market-friendly business environment, efficient management of public finances and a zero-tolerance policy against corruption - are all part of our strategic vision. Along these lines, we suggest including a number of important reform measures in the Competitiveness and Growth Development Policy Operation.

In the area of trade our strategy is three-fold. To secure market access, facilitate investment in tradable sectors, and promote exports. It is in this spirit that the Government is actively working towards a successful conclusion of negotiations of a Deep and Comprehensive Free Trade Agreement with the European Union (DCFTA). The current trade regime with the EU, GSP +, is temporary and covers many but not all products. Our objective is to liberalize trade with the EU on a permanent basis through a free trade agreement that covers widest possible range of products. We also expect that improved market access will attract more foreign direct investment to Georgia, which will in turn support employment. To this end, we have started DCFTA negotiations, while at the same time taking steps towards the relevant legislative approximation with the EU. In this context, shortly after the first round of negotiations in the middle of March 2012, Georgia's parliament approved a legislative package including new laws on competition, food safety, and technical barriers to trade.

We have achieved significant strides in transforming Georgia into a regional hub for trade, transit, logistics and manufacturing. Customs administration has been streamlined, both in terms of infrastructure at the points of service delivery and simplification of processes. We have been successfully upgrading infrastructure of cross-border significance including trade corridors and railways to achieve better efficiency and higher transportation speed. As a result, our transport and transit sectors have been growing apace, with the number of loaded truck entries into Georgia increasing by 18.4 percent y-o-y in 2011 and 22.6 percent y-o-y in the first 5 months of 2012. To further improve the delivery of our services, we have been implementing several measures. In particular, the Government has

authorized the Revenue Service of the Ministry of Finance of Georgia to issue certificates of origin and permits related to exports and imports in accordance with best international practice. Actions are also being taken to improve efficiency of coordination among various departments through improved IT systems, and to introduce automated selectivity in risk assessment for transit traffic.

To boost employment generation, we have embarked on the implementation of broad reforms agenda in general and vocational education systems, aiming to better prepare young people for entry into the job market. In particular, we are working to increase private sector participation in our vocational education system. We have strengthened the relevance of general education by upgrading and modernizing the curriculum. Introduction of the new curriculum in the schools has already started, and over the next three years, the new curriculum will be implemented for all grades. Over the same period, teachers in all disciplines will be certified. The Government is also supporting teacher certification through professional development services, including better pre-service and in-service training. The physical infrastructure of schools is undergoing improvements as well, through the provision of new computers, laboratories, and other equipment. Efforts are underway to improve school management through the launch of principals' certification and modification of the funding formula that is used to support efficiency of school spending.

Over the last decade, the Government has successfully transformed a loss-making, heavily indebted state-owned national power sector into a fast-growing sector with significant upward potential. Building on these highly successful reforms, our government is pursuing two strategic objectives: to ensure continued reliable domestic energy supply, and to facilitate Georgia's hydropower plants' participation in regional electricity trade. In particular, our efforts are currently focused on implementing two parallel and mutually reinforcing priority tasks: (1) bringing responsible investors to develop hydropower plants and other renewables following best international environmental and social safeguards practices; and (2) continuing implementation over the next three to five years a program of approximation of the legal and regulatory framework of the power market in Georgia to relevant EU market regulations to promote private investment and regional power trading as well as facilitate market integration.

We stand ready to cooperate with the World Bank, the EU, and other development partners in the implementation of the tasks outlined above. The Government has already signed the Cross-Border Electricity Trading Agreement with Turkey, which is an initial step towards the establishment of a framework for regional power trade. In addition, we initiated regulatory reforms by preparing amendments to the market rules aiming at ensuring transparent and non-discriminatory access to interconnection transmission lines by new investors. We plan to enact the relevant decree within the next three months after a process of public hearings and consultation with all stakeholders, and incorporating their comments as appropriate.

We will continue our efforts to establish an efficient regulatory and institutional framework for the electricity sector. In particular, we are preparing a transmission grid code to ensure that technical specifications are established that will help improve system reliability. We are also reviewing other aspects of the legislative framework, such as the law on electricity and gas with a view to revising these as needed over the next 18-24 months. We are also drafting a Law on Renewables in line with EU principles to support the use and development of renewable energy, which we plan to submit to the Parliament.

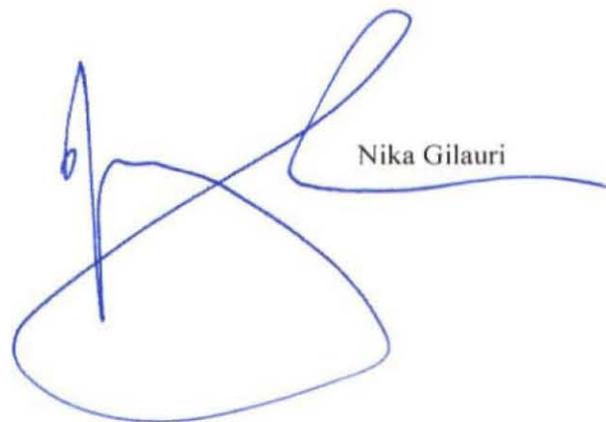
These wide-ranging efforts to facilitate investment and enhance competitiveness are accompanied by measures to further strengthen public financial management through improved accountability, broader coverage, and greater transparency of the Government fiscal accounts. These actions support our ongoing efforts to expand performance budgeting to all levels of the government and will contribute to improving budgetary controls and to enhancing the quality of public spending. An important step in that direction is the publication of the accounts of Legal Entities of Public Law (LEPLs) in the annual budget execution report. Their integration into the budget reporting system will help improve monitoring of public expenditures and will support our overall results-oriented approach.

Georgia has developed strong and well-targeted social safety nets, including both the targeted social assistance program (TSA) and the medical insurance plan (MIP). While advancing on the fiscal consolidation front, we have been able to maintain at the adequate levels spending on health, social protection and education to ensure that our objectives of protecting vulnerable demographic groups are not compromised. As part of these efforts, we are increasing the coverage of the medical insurance plan (MIP) to include children under six years of age and pensioners, and will also extend insurance to university students and persons with disabilities. We thus expect coverage to increase by more than 600,000 persons over the next two years. We are also improving further the efficiency of administration of our targeted program through the development and roll-out of a Social Information Management System that is expected to reduce significantly the time taken to issue benefits for both the TSA and the MIP. We are focussing both on access and quality. In this context, the Government has introduced mechanisms to enforce upgraded standards in hospitals, including the development of a detailed reporting system to monitor quality that will complement physical inspections.

We would appreciate support of the World Bank in the implementation of the strategic actions outlined above. We are looking forward to our continued successful partnership with the World Bank, including in the context of the proposed development policy operation.

Allow me, Mr. President, to take this opportunity to extend my regards and esteem.

Sincerely,



Nika Gilauri