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Ex-ante evaluation statement

Accompanying the document

Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

providing further macro-financial assistance to Georgia

{COM(2017) 559 final}

Ex-ante evaluation statement

EU Macro-Financial Assistance to Georgia

TABLE OF CONTENTS

1. PROBLEM ANALYSIS AND NEEDS ASSESSMENT

1.1 Introduction

Georgia continues to face a weak external environment which, through reduced exports and remittances, has contributed to relatively subdued GDP growth of 2.7% in 2016 (compared to 2.9% in 2015 and 4.6% in 2014). GDP growth is projected to increase gradually to 3.5% in 2017, supported by consumption and investment. Regional and global growth is also expected to pick up in 2017, but will remain subject to downside risks of geopolitical instability, protectionism and volatility in the financial markets.

Georgia's fiscal deficit remains significant (4.1% of GDP in both 2016 and, as expected by the International Monetary Fund (IMF), in 2017). The public debt-to-GDP ratio has increased from 35.6% in 2014 to 44.6% in 2016, mainly due to the fact that around 80% of public debt is denominated in foreign currency, and the national currency (the Georgian lari, GEL) has depreciated sharply during that period. Moreover, Georgia's balance-of-payments position remains vulnerable due to a very large current account deficit (12.4% of GDP in 2016) and high external debt (111.8% of GDP in 2016). Georgia's foreign exchange reserves have been broadly stable in absolute terms since 2011, totalling USD 2.8 billion at end-2016, but reserve needs have been increasing according to the composite IMF metric. Therefore, reserves are currently below the level estimated by the IMF to be adequate.[1] Georgia also continues to face the impacts of the ongoing adaptation to the requirements of the Deep and Comprehensive Free Trade Area (DCFTA) with the EU, which, along with opportunities, also entail adjustment costs.

In this context, on 12 April 2017 Georgia and the IMF agreed a three-year (2017-2020) extended arrangement under the Extended Fund Facility (EFF). The EFF represents 100% of Georgia's quota in the Fund (SDR 210.4 million, or about USD 285 million). The aim of the EFF programme is to support an economic reform programme which will help Georgia reduce economic vulnerabilities, and promote higher and more inclusive economic growth.

The government of Georgia also requested Macro-Financial Assistance (MFA) from the EU in June 2017.[2] In light of this request and the economic situation in the country, the Commission is submitting to the European Parliament and the Council a proposal for MFA to Georgia, based on Article 212 of the TFEU. The proposal is for an amount of up to EUR 45 million, of which EUR 35 million are in the form of loans and EUR 10 million in the form of grants.

The proposed new MFA operation is the third one after Georgia's military conflict with Russia in August 2008. In October 2008, the EU pledged two MFA operations of EUR 46 million each at the International Donors' Conference in Brussels. The first of those operations (EUR 46 million, fully in the form of grants) was implemented in 2009-2010 and the second (again EUR 46 million, half in grants and half loans) in 2015-2017. The last tranche of the 2015-2017 MFA operation was disbursed in May 2017.

The proposed new MFA will help Georgia cover part of the residual external financing needs for the period of 2017-2020, which are estimated at USD 752 million (EUR 671 million).[3] The operation will reduce the economy's short-term balance of payments and fiscal

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1 As measured by the composite reserve adequacy measure of the IMF.

2 Letter of 16 June 2017 from the acting Finance Minister Giorgi Tabuashvili to Commissioner Moscovici.

3 All conversions in this document are based on a EUR/USD exchange rate of 1.12.

vulnerabilities. It will be designed and implemented in coordination with the adjustment and reform programmes Georgia has agreed with the IMF and the World Bank, as well as with the reforms agreed in the context of the EU's budget support operations and the DCFTA agreement.

The disbursement of the assistance is envisaged to take place in two tranches. This could take place in 2018, or possibly in 2019, depending on when the legislative process is concluded; the pace of negotiations and ratification of the Memorandum of Understanding and, thereafter, its implementation; as well as progress made with the IMF programme.

The present note first assesses Georgia's macroeconomic situation and policies as well as key structural reform challenges. It then describes the current IMF programme (for 2017-2020), as well as other support provided by foreign donors, and assesses Georgia's external financing needs for the period 2017-2020. Finally, the note presents the main features of the envisaged MFA operation and its consistency with the criteria applicable to MFA operations.

1.2 Georgia's macroeconomic situation

The macroeconomic outlook for Georgia remains vulnerable. The ongoing fiscal consolidation could weaken domestic demand and lower economic growth in Georgia. In addition, the Georgian economy faces broader risks due to an uncertain regional and global economic outlook, external imbalances (notably, a large and still increasing current account deficit and significant external debt) as well international reserves that are below the adequate level.

The economic slowdown in the region and the fact that the currencies of major trading partners have depreciated sharply since late 2014 have weighed on Georgia's exports and remittances. This contributed to a deceleration of economic growth to 2.7% in 2016, from 2.9% in 2015 and 4.6% in 2014. Georgia's **GDP growth** in 2016 was mainly driven by investment, while private consumption remained subdued, reflecting the reduction in disposable income induced by the increase in the domestic-currency value of households' repayment obligations on US dollar-denominated loans in a context of sharp depreciation of the lari. GDP growth is projected to increase gradually, to 3.5% in 2017, supported by consumption and investment, and to 5.0% in 2020 (the end of the recently-agreed arrangement with the IMF).[4]

The **exchange rate** (USD/GEL period-average) moved from 1.77 in 2014 to 2.27 in 2016, meaning around 22% depreciation of the Georgian lari. The effects of this volatility are amplified by the still high **dollarisation** of the Georgian economy, where 70% of deposits and 65% of loans were denominated in US dollars in 2016. Despite this, the banking sector – which is dominated by two institutions controlling around two-thirds of total banking assets – has generally remained resilient, reporting sufficient capital and liquidity. The non-banking sector is growing fast, albeit from a low base.

Although the **unemployment rate** in Georgia (11.8% at end-2016) has been on a downward trend since 2009 (16.9%), it remains an important challenge. While employment opportunities have been created in new growth sectors, especially in tourism and other services, high unemployment persists due to challenges associated with skills mismatch and large regional disparities. Georgia also lacks an unemployment benefit scheme.

In terms of the external sector, Georgia's **current account deficit** further deteriorated in 2016 to 12.4% of GDP (from 12.0% of GDP in 2015 and 10.6% in 2014) and, as noted, remains a major source of vulnerability. The current account deficit widened in 2014-2016, despite the slowdown in economic growth, as the weakness of exports more than compensated for the weak domestic demand for imports, resulting in a larger trade in goods deficit. The current

[4] For selected macroeconomic data here and below in the section, please also refer to Table 1.

account deficit is expected to worsen further to 12.9% in 2017, before decreasing modestly to 11% in 2020, according to IMF programme projections. The very large current account deficit is mainly driven by the trade in goods deficit which is only partly offset by the trade in services surplus and income and transfers from abroad, including remittances.

Although the current account deficit has mainly been financed by inflows of **foreign direct investment** (FDI), the latter is expected to decrease slightly from 11% of GDP in 2016 to 10.3% of GDP in 2017 and remain at a similar level until 2020. Moreover, debt-creating financial inflows have also contributed to the financing of the current account deficit. Hence, Georgia's **external debt**, which hovered around 80% of GDP in 2008-2014, has increased significantly in the following years, to 111.8% of GDP at end-2016. The external debt is projected to increase further, to 120.2% in 2020. As most foreign debt is denominated in US dollar, the lari depreciation has played an important role in this increase.

The National Bank of Georgia (NBG) has generally refrained from large interventions in the foreign exchange market and allowed the lari to depreciate. This has allowed **gross international reserves** to remain stable overall, totalling USD 2.7 billion at end-February 2017 (about 3 months of next year's imports). The recently-agreed IMF programme targets a 54% increase in reserves, from USD 2.8 billion at end-2016 to USD 4.2 billion in 2020 (about 4 months of import cover).

Table 1: Georgia – Selected macroeconomic indicators, 2015-2020

	2015	2016	2017 Proj.	2018 Proj.	2019 Proj.	2020 Proj.
	(Annual percentage change, unless otherwise indicated)					
National Accounts						
Real GDP growth	2.9	2.7	3.5	4.0	4.5	5.0
Consumer price index, period average	4.0	2.1	5.7	2.4	3.0	3.0
GDP per capita (in USD)	3,800	3,800	3,700	4,000	4,300	4,700
Unemployment rate (in per cent)	12.0	11.8				
	(In per cent of GDP, unless otherwise indicated)					
Consolidated government operations						
Revenue and grants	28.1	28.6	29.3	28.6	28.5	28.6
Expenses	31.9	32.7	33.4	32.4	32.4	32.2
Overall fiscal balance*	-3.8	-4.1	-4.1	-3.8	-3.9	-3.6
Public debt	41.4	44.9	45.5	46.7	47.2	46.9
o/w foreign-currency denominated	32.5	35.5	35.9	37.3	37.8	37.8
External sector						
Current account balance	-12.0	-12.4	-12.9	-12.5	-11.5	-11.0
Gross international reserves, end of period (in billion	2.5	2.8	3.1	3.4	3.8	4.2
- In months of next year's imports of	2.7	3.0	3.3	3.5	3.7	4.1
Foreign direct investment, net	9.0	11.0	10.3	10.1	9.9	10.4
Nominal exchange rate (period average, USD/GEL)	1.77	2.27	2.37			

Sources: IMF and Commission staff estimates, Geostat

* *The overall fiscal balance will be further adjusted by 0.4 percentage points to 3.5% of GDP in 2019 and by 0.5 percentage points to 3.1% of GDP in 2020. However, it is not yet clear whether these adjustments will come from the revenue or the expenditure side.*

Regarding **monetary policy**, the NBG remains committed to price stability (inflation targeting regime, with a target for headline consumer price inflation of 5% in 2016, 4% in 2017 and 3% from 2018 onwards, and a flexible exchange rate). In order to limit inflation, mainly as a result of the lari depreciation and increases in electricity tariffs, the NBG

increased its main policy rate (the refinancing rate) eight times in 2015, up to 8%. In 2016, in line with the economic slowdown and abating inflationary pressures (and even a brief period of falling prices), the NBG gradually reduced the key policy rate to 6.5%. However, in 2017, with an increase in inflationary pressures (mainly due to increases in excise taxes and a pick-up in global commodity prices), the NBG raised the refinancing rate two times: from 6.5% to 6.75% (in January 2017) and to 7% (in May 2017).

The period-average **inflation** (consumer price index, CPI) decelerated to 2.1% in 2016, compared to 4.0% in 2015. CPI is projected to increase to 5.7% in 2017, in line with the increase of excise duties which entered into force in January 2017, but should decrease to 3.0% in 2018 and remain at a similar level in 2019 and 2020. The planned reduction of inflation is key, in order to avoid the need to further increase interest rates that would negatively affect consumption and investment, raising doubts about the growth outlook.

Following a long period of fiscal consolidation since 2009, the **fiscal deficit** of the general government started to widen in 2015 (3.8% of GDP), partly as a result of an increase in social spending, which, according to preliminary analysis by the World Bank,[5] has had a broadly positive impact on poverty and inequality, but also reflecting the negative impact of the economic slowdown on tax revenues. The budgetary position further deteriorated in 2016, with the government deficit estimated by the IMF at 4.1% of GDP, as a result of both weaker-than-expected revenues and spending increases ahead of the October parliamentary elections (mainly in defence, public transport, infrastructure and healthcare). The fiscal deficit (which was projected to increase further, to around 6% of GDP this year, before the new IMF programme was agreed) is now forecast to remain at the same level (4.1%) in 2017 and to decrease gradually afterwards, reaching 3.1% in 2020.

The country has been financing its deficits mainly through external borrowing (roughly half of the total – much of it from official creditors on below-market terms), followed by privatisation proceeds and domestic borrowing (in what remains a shallow market). **Public debt** increased to an estimated 44.6% of GDP in 2016 (from 35.6% in 2014) and is expected to rise further, peaking at around 47% in 2019, before decreasing gradually afterwards.

The fiscal strategy of the Georgian authorities is based on further consolidation. Notably, the Georgian authorities plan to reduce current spending (a reduction in the wage bill and administrative expenses, efficiency gains in healthcare spending, and new spending controls on local governments), whilst increasing capital spending, mainly in infrastructure, and introducing a second (funded) pillar of the pension system.[6] On the revenue side, the Georgian authorities have increased taxes (notably, excise duties on tobacco products, vehicles and fuel) to compensate for revenue losses due to the corporate income tax reform[7] and are ready to take additional measures if needed.

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5 World Bank Group: Georgia: Recent Trends and Drivers of Poverty Reduction, August 2016.

6 In the current one-pillar system, pension benefits consist of a lump sum paid to all citizens aged over 60 (women) and 65 (men), regardless of the number of years worked. The reform which should be proposed to the Parliament in June 2017 would introduce a second, earnings-related pillar beside the basic lump sum and would be financed through social security contributions by the government, the employee, and his/her employer, amounting to 2% of the employee's salary for each of the three contributors. The reform is foreseen to take effect in January 2018, bringing the cost of the pension system to 21-22% of the budget, up from around 18% of the budget in 2016. In addition, the government is considering a possibility to introduce a third (privately funded) pillar.

7 As of January 2017, the corporate income tax only applies to distributed profits, while reinvested or retained profits are exempted from taxation. To cover the cost of the reform, estimated at cumulative 1.7% of GDP over 2017 and 2018, excise taxes on tobacco, imported cars and oil products were also raised in January 2017. These increases in taxes and other adjustment measures should compensate the cost of the corporate income tax reform.

1.3 Structural reform challenges

The key element of Georgia's structural reform agenda is the so-called Four Point Reform Plan which focuses on improving business environment, education and public administration as well as investment in infrastructure. The Georgian authorities intend to complement these structural reforms with fiscal reforms and strengthening of the financial sector. An additional challenge is the ongoing adaptation to the requirements of the DCFTA with the EU.

The first leg of the Four Point Reform Plan aims at **improving the business environment**. Notably, the Georgian authorities plan to reform the insolvency law, to ensure an adequate restructuring framework for viable businesses, and to introduce International Financial Reporting Standards (IFRS) for financial reporting by corporations. In addition, the Georgian authorities plan to continue the land reform by extending the application of a special rule which simplifies the land registration process. The land reform should contribute to rural development through increased efficiency in agricultural production, by simplifying land transactions and facilitating the use of land as collateral for borrowing.

The second leg of the Reform Plan concerns **education reform**. The Georgian authorities plan to improve the education system, by setting curriculum standards, and introducing vocational training and adult learning. This reform should help to address the skills mismatch which is one of the main structural weaknesses of the Georgian economy and contributes to high unemployment.

As part of the third leg of the Reform Plan, the Georgian authorities plan to make the **public administration more efficient**. This will notably involve containing the wage bill and administrative expenses, improving the targeting of subsidies and of social assistance programmes, and introducing a one-stop shop for all government services. These changes are expected to improve the business environment further (aside from the measures under the dedicated first leg of the Reform Plan) and create fiscal space for investment.

The fourth leg of the Reform Plan covers **investment in infrastructure** (highways, ports, airports and railways). Additional and better infrastructure is expected to help Georgia utilise its potential of a transit country between Europe and Asia, support the development of the growing tourism sector, and in this way create new economic opportunities for all citizens.

The Georgian authorities intend to complement structural reforms with **fiscal reforms**. Notably, the Georgian authorities plan to improve the management of fiscal risks stemming from public-private partnerships (PPPs) and state-owned enterprises (SOEs). Regarding PPPs, the Georgian authorities will submit a law by end-2017, which will establish reporting and monitoring government exposure on PPPs as well as cap such government exposure. Regarding SOEs, the Georgian authorities will expand the analysis of contingent liabilities associated to such enterprises, as part of the Fiscal Risk Statement accompanying the 2018 budget. The Georgian authorities also plan to tighten budget lending, e.g. to SOEs, by requiring a reasonable expectation of commercial returns on new operations.

In the **financial sector**, the Georgian authorities plan to introduce a deposit guarantee scheme and to improve regulatory, supervisory and resolution frameworks for banks. In April 2017, the Georgian Parliament approved legislative amendments that invalidate the effects of a 2014 law establishing a new financial supervision agency. In this way, the Georgian authorities have reaffirmed the independence of the NBG, reverting to the original legal framework whereby the responsibility for financial supervision is assigned to the NBG, as recommended by the international financial institutions and the EU.

The issue of high dollarisation will continue to be addressed by introducing liquidity coverage ratio limits, with preferential treatment of liabilities denominated in the national currency. On the supply side, the Georgian authorities also plan to develop the capital markets, notably by starting to publish the calendar of government bond issuances to develop a benchmark,

upgrading the trading infrastructure of the Georgian Stock Exchange and introducing derivatives. On the demand side, the Georgian authorities plan to introduce a second (funded) pillar of the pension system, which is also intended to create demand for long-term financial instruments denominated in the national currency. In addition, the Georgian authorities plan to introduce mandatory third-party vehicle insurance, to support the development of the insurance sector.

Another set of structural reform challenges stems from **DCFTA implementation**, in particular the removal of non-tariff barriers and the approximation of rules and standards to the EU that come with it. In the long term, this should have a positive impact on the Georgian economy, by increasing competition, creating a more predictable and transparent legal setting, and improving the business climate. However, recent analysis[8] suggests that the net benefits of the DCFTA are highly asymmetric along the time dimension, with high costs in the short and medium term, and benefits accruing mostly in the longer term. Also, the effects of DCFTA implementation are likely to be uneven across regions and economic sectors, with less competitive regions and sectors facing higher adjustment costs and/or smaller benefits. In order to address these challenges, the Georgian authorities and the EU will continue supporting private sector competitiveness, for instance, as part of a project financed by the EU4Business initiative and the EBRD, aimed at strengthening Georgian SMEs and their ability to export in high potential areas, such as agriculture and the hospitality sector.

1.4 IMF and other donor support

Since 1994, Georgia has benefited from several arrangements with the **IMF** in support of its economic adjustment programmes. The last one, a three-year Stand-By Arrangement (SBA) with a total access of SDR 100 million (about USD 154 million, or 67% of Georgia's quota), was approved by the IMF Executive Board in July 2014. 80% of the funds under this SBA were released in two tranches that same year, following the first programme review. No further reviews were completed under this programme, for several reasons, notably disagreements between the IMF and the Georgian authorities on: (i) the transfer of responsibility for banking supervision from the central bank to the new financial supervision agency (which was seen as a politically motivated assault on central bank independence at the time); (ii) the fiscal strategy in the context of a growing fiscal deficit; and (iii) the failure by the Georgian authorities to put in place a clear legal framework for the granting of state guarantees, including for PPPs. As noted in the previous section, issue (i) regarding the role of the central bank has since been resolved. Likewise, a new government, which took office after the elections in October 2016, has committed to tackling issues (ii) and (iii), as part of its reform programme.

In this context, in April 2017, the IMF Executive Board approved a three-year EFF programme of SDR 210.4 million (about USD 285 million, or 100% of the quota), which will support the reform programme of the Georgian authorities, aimed at promoting higher and more inclusive growth while maintaining macroeconomic stability. In terms of fiscal consolidation, the IMF notably insisted on the need for measures to offset the loss in fiscal revenues due to the corporate income tax reform as well as the government's ambitious public investment programme. The programme is underpinned by an agreement on a deficit reduction path from 4.1% of GDP in 2016 to 3.1% of GDP in 2020, which is projected to help to put public debt on a downward path from end-2019.

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[8] See, for instance, Amat Adarov and Peter Havlik, 'Benefits and Costs of DCFTA: Evaluation of the Impact on Georgia, Moldova and Ukraine', The Vienna Institute for International Economic Studies (wiiw), 20 January 2017, available at: https://wiiw.ac.at/benefits-and-costs-of-dcfta-evaluation-of-the-impact-on-georgia-moldova-and-ukraine-dlp-4111.pdf.

In terms of structural reforms, the benchmarks attached to the new EFF programme notably include the submission to Parliament of legislation establishing a second pillar of the pension system, deposit insurance as well as reporting and a ceiling of exposure on PPPs. Structural reform benchmarks also include measures aimed at strengthening financial supervision and at developing capital markets. In addition to fiscal consolidation and structural reforms, the programme is also expected to unlock additional multilateral and bilateral financing for Georgia over the programme period (2017-2020).

The **World Bank** has been a key development partner for Georgia since 1992, supporting investment projects and the reform agenda in various sectors. In 2014, Georgia graduated from the International Development Association (IDA), which offers concessional loans and grants to the poorest countries, to become an International Bank for Reconstruction and Development (IBRD)-only borrower.

As of April 2017, the World Bank has a portfolio of 13 active projects under implementation in Georgia, with a total commitment of USD 739 million. Although the World Bank's investment portfolio is mainly in infrastructure, its overall partnership with Georgia is broader. Activities in other areas reflect the two active Development Policy Operations (DPOs). The Second Programmatic Inclusive Growth DPO – of EUR 47.2 million approved in April 2017 – targets improvements in the public sector (oversight of public institutions, improved budgeting, a framework for civil service reform, improved coverage and quality of social services, and strengthened monitoring of outcomes). The Second Private Sector Competitiveness DPO – of EUR 44.6 million approved in July 2017 – aims to increase private sector competitiveness (through business environment reforms, financial sector deepening and diversification, and increasing firms' capacity to innovate and export). The World Bank is also active in Georgia through the International Finance Corporation (IFC) which finances and provides advice for private sector projects. Since 1995, the IFC has provided around USD 1.6 billion in long-term financing for the private sector in Georgia.

The **Asian Development Bank** (ADB) has been supporting Georgia's development since 2007. Approved sovereign loans to Georgia total around USD 1.8 billion: USD 900 million from the concessional Asian Development Fund (ADF) and USD 885 million from ordinary capital resources (OCR). In January 2017, Georgia graduated from concessional ADF resources, as it is now classified as a middle-income country. However, Georgia is still eligible for the regular OCR lending, of which the indicative resources available for 2017-2019 amount to USD 600 million. The ADB also provides direct financial assistance to the non-sovereign public sector and the private sector in Georgia. Non-sovereign ADB loans to Georgia total USD 330 million.

The **European Bank for Reconstruction and Development** (EBRD) has invested close to EUR 3 billion in Georgia since 1994. As of August 2017, the EBRD had an outstanding portfolio of EUR 719 million, with 74 active operations. According to its new strategy in Georgia for 2017-2021, the EBRD will continue supporting private sector development through innovation, enhanced value added and convergence with DCFTA standards and obligations; financial sector development through deepening of financial intermediation as well as local currency and capital markets; inter-regional connectivity, notably through investments under PPPs; and renewable energy, resource efficiency and climate change adaptation.

The **European Investment Bank** (EIB) has been active in Georgia since 2010 and has provided to the country EUR 700 million of loans. For instance, the EIB is funding several sections of an East-West highway that will connect Georgia's border with Azerbaijan in the east with Batumi on the Black Sea. The latest section of the highway is funded with a EUR 49.5 million loan signed in February 2016. The EIB also finalised a EUR 100 million deal in October 2015 to rehabilitate the waste-water network and construct a new waste-water treatment plant in Kutaisi.

In addition to multilateral financing, Georgia also benefits from **bilateral official loans**. As of June 2017, the outstanding stock of Georgia's external bilateral government debt was around USD 785 million, the main sources of financing being Germany (with an outstanding stock of loans of around USD 275 million), Japan (USD 205 million), France (USD 110 million, notably through the French development agency, Agence Française de Développement (AFD)) and Russia (USD 75 million).

The **European Neighbourhood Instrument** (ENI) funds the EU's regular cooperation assistance to Georgia, covering budget support, technical assistance, project implementation and policy advice. The total indicative ENI allocation to Georgia for 2014-2020 is EUR 610-746 million. The EU Single Support Framework (SSF) identifies the priority sectors of ENI-funded cooperation with Georgia. Future support, from 2017, will focus on (i) economic development and market opportunities (including smart, sustainable and inclusive economic growth); (ii) strengthening institutions and good governance (including the rule of law and security); (iii) connectivity, energy efficiency, environment and climate change; and (iv) mobility and people-to-people contacts (including support to the continuous implementation of the visa liberalisation benchmarks and to vocational education and training).

Georgia also benefits from the **Neighbourhood Investment Facility** (NIF) which pools grant resources from the EU budget and the EU Member States and, in this way, helps to leverage loans from European financial institutions as well as contributions from partner countries themselves. During the period of 2008-2017, the NIF contributed around EUR 86 million to ten projects in Georgia, mainly in energy, transport and water/ sanitation sectors.

As further discussed in section 4 below, the proposed MFA will support efforts to establish a stable macroeconomic framework and improve economic governance in Georgia. In this way, the proposed MFA will complement the standard EU aid packages mobilised under the ENI and NIF, and will enhance the added value and effectiveness of the EU's involvement through those standard financial instruments.

1.5 Georgia's external financing needs

The projections produced by the IMF in March 2017, in the run up to the agreement on the new EFF programme, point towards significant external financing requirements for the programme period (2017-2020). The **total external financing gap** for this period **is estimated at USD 752 million** (see Table 2). This financing gap can broadly be attributed to three factors: a relatively large current account deficit, the need to increase foreign exchange reserves, and significant expected debt amortisation requirements.

As explained in the section describing the macroeconomic situation, Georgia's **current account deficit** further deteriorated in 2016 to 12.4% of GDP (from 12.0% of GDP in 2015 and 10.6% in 2014) and remains a major source of vulnerability. The current account deficit is expected to worsen further to 12.9% in 2017, before decreasing gradually to 11% in 2020. The very large current account deficit is mainly driven by the trade in goods deficit which is only partly offset by surplus in trade in services, as well as primary and secondary income (transfers from abroad, including remittances).

The second factor contributing to the estimated external financing gap is the significant **external debt amortisation**. In particular, the repayments of public external debt are expected to accelerate from 1.2% of GDP in 2017 to the average of 1.7% of GDP per year during the period of 2018-2020 and peak at 4.2% of GDP in 2021, one year after the end of the recently agreed IMF programme. While other components of the capital and financial account, notably FDI and loans, cover the current account deficit, they are not enough to finance the necessary increase in Georgia's foreign exchange reserves.

Georgia's foreign exchange reserves have been stable in absolute terms in the past few years, totalling USD 2.8 billion at end-2016 (about 3 months of import cover). However, reserve needs have been rising. Therefore, reserves currently represent only 88% of the IMF's composite reserve adequacy measure. In fact, one of the main aims of the recently agreed EFF programme is to help Georgia **increase reserves** to an adequate level. Compared to 2016, the reserves should increase by 54% to USD 4.2 billion in 2020 (about 4 months of import cover). This is projected to be equivalent to 110% of the IMF composite reserve adequacy measure for countries with a floating exchange rate regime. The IMF deems exceeding 100% of its measure to be warranted by the additional risks stemming in particular from high dollarisation.

The targeted increase in foreign exchange reserves and the combined balance of the current account and the capital and financial account produce an overall external financing gap of USD 752 million for the period 2017-2020.

As noted above, the IMF programme approved in April 2017 makes USD 285 million available to Georgia. However, the net disbursements of IMF funds will amount to only USD 171 million over the programme period of 2017-2020. The difference between gross and net flows reflects repurchases from previous IMF arrangements falling due during this period. The World Bank, in turn, is expected to make new disbursements of USD 350 million to Georgia over the period of 2017-2020.

Table 2: Georgia's External Financing Gap and Potential Financing Sources

USD million	2017	2018	2019	2020	Total 2017-2020
1. Current account balance	-1,775	-1,849	-1,836	-1,905	**-7,365**
2. Capital and financial account balance	1,823	1,942	2,076	2,264	**8,105**
3. Overall balance (1+2)	48	93	240	359	**740**
4. Reserves ("-" indicates increase)	-304	-315	-423	-450	**-1,492**
5. Overall External Financing Gap	**-256**	**-222**	**-183**	**-91**	**-752**
6. Exceptional Financing by the IMF and the World Bank					
Net IMF disbursements	69	27	34	41	**171**
Disbursements by the World Bank	100	100	100	50	**350**
7. Residual Financing Gap	**-87**	**-95**	**-49**	**0**	**-231**
Financing of the gap					
EU MFA	26*	50**			**76**
Agence Française de Développement	62				**62**
Asian Development Bank		50	50		**100**
Total identified sources	**88**	**100**	**50**	**0**	**238**

Total MFA as % of the residual gap for 2017-2020	**32.9**

Sources: Latest IMF staff estimates and projections (March 2017) and Commission staff calculations

* *Disbursement of the last tranche of the 2015-2017 MFA operation.*

** *Depending on the pace of the legislative process and, thereafter, the implementation of the MFA operation, the disbursement of the proposed assistance may also be split between 2018 and 2019.*

In total, contributions from the Bretton Woods institutions (the IMF and the World Bank) are expected to reduce the external financing gap by around 70%, leaving a **residual external financing gap of USD 231 million** for the period 2017-2020. Therefore, the proposed MFA operation of EUR 45 million (USD 50 million), in addition to EUR 23 million (USD 26 million) disbursed under the previous MFA operation in May 2017, would cover **32.9%** of the estimated residual financing gap. Such proportion would be consistent with the principles of fair burden-sharing among donors and value added of the EU's MFA, as required in the

Joint Declaration of 12 August 2013 of the Parliament and the Council on Macro-Financial Assistance. Specifically, covering almost one-third of the residual financing gap seems consistent with the "more for more" principle of the European Neighbourhood Policy, considering that Georgia is among the EU's associated countries and arguably a long-standing and consistent reform performer in the Eastern neighbourhood.

Other key contributions to covering the residual financing gap include budget support grants from the French development agency, AFD (of USD 62 million in 2017), and the Asian Development Bank (expected to amount to USD 100 million in 2018-2019). Looking at the total identified financing gap, the proposed MFA amount would cover only 10% of the gap for 2017-2020, with other donors – including those mentioned in the preceding sentence, as well as the IMF and World Bank – covering 90%.

2. OBJECTIVES AND MONITORING INDICATORS OF THE MACRO-FINANCIAL ASSISTANCE

2.1 Objectives

The objectives of the proposed MFA operation are to:

(i) contribute to covering the external financing needs of Georgia in the context of a sizeable external financing gap brought about by a relatively large current account deficit, significant external debt amortisation, and the need to build up foreign exchange reserves;

(ii) support the fiscal consolidation and external stabilisation efforts in the context of the recently agreed IMF programme;

(iii) support structural reform efforts aimed at improving the overall macroeconomic management, strengthening economic governance and transparency, and improving conditions for sustainable growth;

(iv) facilitate and encourage efforts by the Georgian authorities to implement measures identified under the EU-Georgia Association Agreement and in the context of the bilateral cooperation programmes, support regulatory convergence and economic integration with the EU and strengthen the EU's economic policy dialogue with the authorities.

2.2 Monitoring indicators

The fulfilment of the objectives of the assistance will be assessed by the Commission, including in the context of the ex-post evaluation (see below), on the basis of the following indicators:

(i) progress with macroeconomic and financial stabilisation, notably by assessing the degree of adherence to the IMF programme; and

(ii) progress with the implementation of structural reforms, notably the specific policy actions identified as conditions for disbursement of the assistance, which will be included in a Memorandum of Understanding to be negotiated between the Commission and the Georgian authorities.

3. DELIVERY MECHANISMS AND RISK ASSESSMENT

3.1 Delivery mechanisms

The MFA operation under consideration would **amount to a maximum of EUR 45 million** (about USD 50 million). The Commission proposes to provide the amount of the assistance in the form of a **medium-term loan of up to EUR 35 million and grants of up to EUR 10 million**. Given the proposed size of the operation, the Commission is considering releasing the assistance in two instalments.[9] The first tranche would be composed of a loan element of EUR 15 million and a grant element of EUR 5 million, and the second tranche of a loan element of 20 million and a grant element of EUR 5 million.

While the proposed amount is significant in terms of its share in the coverage of the residual financing (32.9%, as noted in the section describing Georgia's external financing needs), it is important to ensure its value added, notably by providing the EU with sufficient leverage to promote progress with reforms. At the same time, disbursements under the MFA programme will be conditional on good progress with both the IMF programme and the specific policy conditionality that will be agreed with the EU in the Memorandum of Understanding in the context of the proposed MFA operation.

The inclusion of a grant element is consistent with the methodology for determining the use of grants and loans in EU MFA, as endorsed by the Economic and Financial Committee in January 2011.[10] These criteria cover the level of economic and social development (as measured by the Gross National Income (GNI) per capita and the poverty ratio) and debt sustainability, and have to be cross-checked against the classification of a country by other multilateral donors, notably the Bretton Woods institutions.

In terms of **economic and social development**, Georgia is a lower middle-income country, with the GNI per capita of USD 3,810 in 2016.[11] In addition, the incidence of poverty remains high in Georgia by regional standards, with 25.3% of population living below the World Bank's relative poverty line,[12] compared to the average of 7.3% in the EU Eastern Partnership countries.

In terms of **debt sustainability**, Georgia's level of public debt is considered as sustainable by the IMF (based on its latest Debt Sustainability Analysis, produced in the context of the recently agreed EFF programme). However, Georgia's public debt ratios have increased significantly, partly due to the depreciation of the lari. The public debt-to-GDP ratio increased from 35.6% at end-2014 to 44.6% at end-2016 and is expected to further rise to about 48% in 2018 before gradually decreasing again. The same is true for Georgia's external debt which hovered around 80% of GDP in 2008-2014 but increased significantly in the following years, to 111.8% of GDP at end-2016, and is projected to increase further, to 120.2% by 2020. The high and increasing level of external debt, together with high dollarisation, remains a major source of vulnerability of the Georgian economy, and thus argues in favour of maintaining the grant element in the proposed MFA operation.

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9 Depending on the pace of the legislative process and, thereafter, the implementation of the MFA operation, the disbursement of the proposed assistance may take place in 2018 or be split between 2018 and 2019.

10 Commission Staff Working Document accompanying the report from the Commission on the implementation of Macro-Financial Assistance to third countries in 2010: Criteria for determining the use of loans and grants in EU Macro-Financial Assistance, SEC(2011) 874 final.

11 Based on the World Bank's Atlas 2016 figures (GNI per capita is the gross national income, converted to US dollars using the World Bank Atlas method, divided by the population). However, Georgia's GNI per capita remains close to the threshold of USD 3,955 separating lower and upper middle-income countries, and Georgia was classified as an upper middle-income country for a single year in 2015.

12 Latest available (2014) data on the poverty headcount ratio at USD 3.10 a day (at purchasing power parity in 2011), as a percentage of population.

In terms of **classification by the Bretton Woods institutions**, Georgia is no longer eligible for concessional financing from either the Poverty Reduction and Growth Trust (PRGT, the concessional arm of the IMF) or the IDA (the concessional arm of the World Bank). However, Georgia's graduation from concessional financing by these multilateral donors is relatively recent, and this is reflected by the fact that IDA credits still represent 63% of the outstanding World Bank lending to Georgia.

Overall, Georgia meets the criteria for receiving MFA grants, notably due to the combination of relatively modest GNI per capita and high indebtedness (both public debt and external debt). This conclusion is also supported by the high incidence of poverty, in particular in rural areas, and the fact that Georgia has graduated from concessional lending by the Bretton Woods institutions only recently. However, this graduation argues in favour of prioritising the loan element.

Therefore, the Commission proposes to provide the bulk (78%) of the proposed MFA in the form of loans. As usual, these loans will have favourable conditions in terms of long maturities (of up to 15 years) and a low interest rate (the rate at which the EU, benefiting from its AAA rating, borrows the funds in the international capital markets). Also, the proposal is consistent with a gradual decrease of the grant element in MFA operations to Georgia (the grant element constituted 100% of the MFA amount in 2009-2010, 50% in 2014-2016, and would constitute around 22% of the proposed MFA operation).

3.2 Risk assessment

There are fiduciary, credit, policy and political risks related to the proposed MFA operation.

There is a risk that the MFA could be *used in a fraudulent way*. As MFA is not designated to specific expenses by Georgia (contrary to project financing, for example), this risk is related to factors such as the general quality of management systems in the central bank and the ministry of finance, administrative procedures, control and oversight functions, the security of IT systems and the appropriateness of internal and external audit capabilities.

To mitigate the risks of fraudulent use several measures will be taken. First, the Loan Agreement and the MFA Grant Agreement will comprise a set of provisions on inspection, fraud prevention, audits, and recovery of funds in case of fraud or corruption. Also, the assistance will be paid to a specific account of the National Bank of Georgia.

Moreover, in line with the requirements of the Financial Regulation, the Commission services have carried out an Operational Assessment of the financial and administrative circuits of Georgia to ascertain that the procedures in place for the management of programme assistance, including MFA, provide adequate guarantees. The preliminary findings from a mission conducted by a consultancy company for the purposes of this Operational Assessment were received in September 2017. They indicate that the current status of the administrative and financial circuits of Georgia is adequate for managing a new MFA operation although some weaknesses remain. The draft final report on this Operational Assessment is expected to be received in November 2017. Developments in that area will continue to be closely monitored also through the regular progress reports on public finance management (PFM) reforms produced by the EU Delegation in Tbilisi.

The Commission is also using budget support assistance to help the Georgian authorities improve their PFM systems, and these efforts are strongly supported by other donors.

Finally, the assistance will be liable to verification, control and auditing procedures under the responsibility of the Commission, including the European Antifraud Office (OLAF), and the European Court of Auditors.

A second risk stems from the possibility that Georgia will fail to service the financial liabilities towards the EU stemming from the proposed MFA loans (*default or credit risk*),

which could be caused for example by a significant additional deterioration of the balance of payments and fiscal position of the country. This risk is mitigated, however, by the fact that the EU's MFA would be part of an international package of official assistance led by the IMF that is supporting an adjustment and reform programme aimed at restoring fiscal and balance of payments sustainability through the implementation of a series of policy measures, included those to be agreed in the Memorandum of Understanding between the EU and the Georgian authorities. Moreover, the risks for the EU budget are cushioned by the EU's Guarantee Fund for external actions.

Another key risk to the operation stems from the *regional geopolitical situation*, in particular due to Georgia's still difficult relations with Russia and the breakaway regions of Abkhazia and South Ossetia. A worsening of this regional geopolitical situation could have a negative impact on Georgia's macroeconomic stability, affecting the IMF programme performance and the disbursement and/or repayment of the proposed MFA.

Finally, the Georgian economy faces *other broader risks* due to an uncertain regional and global economic outlook. Regional and global growth is expected to pick up in 2017, but will remain subdued and subject to downside risks of protectionism, volatile financial markets and potential appreciation of the US dollar. If these risks materialise, they could result in lower economic growth in Georgia which, coupled with persistently high inequality and a relatively limited social safety net, could weigh on the budget and reduce domestic support for structural reforms.

Having made a thorough assessment of the risks, the Commission services consider that there are sufficient grounds and guarantees to proceed with the proposed MFA to Georgia.

The Commission services will maintain close contacts with the Georgian authorities during the implementation of the MFA in order to address quickly any concerns that may arise.

4. ADDED VALUE OF EU INVOLVEMENT

The Union's financial support to Georgia reflects the country's strategic importance to the EU in the context of the ENP. The MFA instrument is a policy-based instrument that aims to alleviate short- and medium-term external financial needs. As a part of the overall EU package of assistance, it would contribute to support the Union's objectives of economic stability and economic development in Georgia. By supporting the authorities' efforts to establish a stable macroeconomic framework and improve economic governance, the proposed assistance would help improve the effectiveness of other EU financial assistance to the country, including budgetary support operations.

The EU's MFA would also complement the standard EU aid packages mobilised under the ENI. By supporting the adoption, by the Georgian authorities, of an appropriate framework for macroeconomic policy and structural reforms, the EU's MFA would enhance the added value and effectiveness of the EU's involvement through other financial instruments.

5. ASSESSMENT OF CRITERIA APPLICABLE TO MACRO-FINANCIAL ASSISTANCE[13]

5.1 Exceptional Character and Limited Time-frame

The proposed MFA operation would be exceptional, aiming to support the restoration of a sustainable external finance situation of Georgia. It would run in parallel to the recently

[13] Established Commission practice in line with the Joint Declaration by the European Parliament and the Council adopted together with Decision No 778/2013/EU of the European Parliament and of the Council of 12 August 2013 providing further macro-financial assistance to Georgia, OJ L 218, 14.8.2013, p. 15.

agreed IMF programme covering the period of 2017-2020. The proposed MFA would have an availability period of 2.5 years from the entry into force of a Memorandum of Understanding, as part of conditionality requirements described below. Such a timeframe is expected to cover part of the IMF programme period.

Against this background, the proposed MFA is expected to be implemented in 2018, with the disbursement of the two instalments in, respectively, the first and the second half of that year.[14] While in the short-term Georgia faces substantial external financing needs, the macroeconomic and structural adjustment programme agreed with the IMF and supported by the proposed MFA is expected to gradually strengthen Georgia's balance of payments position.

5.2 Political preconditions and EU-Georgia relations

MFA is available to geographically close third countries that respect effective democratic mechanisms (including a multi-party parliamentary system) and the rule of law and that guarantee human rights, and with which the EU maintains close political and economic links. Countries that are covered by the European Neighbourhood Policy (ENP), like Georgia, are in principle eligible for MFA.

Political preconditions: A pre-condition for granting MFA is that the eligible country respects effective democratic mechanisms, including a multi-party parliamentary system and the rule of law, and guarantees respect for human rights.

Georgia has consolidated its democracy and the rule of law, as well as further reinforced respect for human rights. The latest parliamentary elections in October 2016 were competitive and well-administered. Regarding the judiciary, Georgia's reforms have promoted judicial independence, professionalism and accountability.

EU-Georgia relations: The EU and Georgia have developed close political and economic relations over the years, leading to the conclusion of the Association Agreement, including the DCFTA, which was signed in 2014 and entered into force in July 2016. This Association Agreement, which has replaced the previous Partnership and Cooperation Agreement, will allow for political association and economic integration of Georgia with the EU. The Single Support Framework (SSF) identifies the priority sectors of EU cooperation with Georgia under the ENI. The SSF for 2017-2020 is currently being finalised.

Georgia's economic ties with the EU are already well developed. In 2016, the EU was the main trading partner of Georgia, with a 32.6% share of trade, well ahead of other main trading partners (Turkey and Russia, with, respectively, 17.2% and 8.1% shares of trade). The EU is also Georgia's main investment partner and donor.

In view of the above, the political preconditions for an MFA to Georgia, including the aspect of political and economic closeness to the EU, may be considered to be satisfied.[15]

5.3 Complementarity

The proposed MFA would complement the assistance provided by other multilateral and bilateral donors in the context of the new IMF-sponsored economic programme. Based on the currently available information, multilateral and other donors than the EU are expected to cover around 90% of the estimated external financing gap for the period of 2017-2020,

[14] Depending on the pace of the legislative process and, thereafter, the implementation of the MFA operation, the disbursement of the proposed assistance may take place in 2018 or be split between 2018 and 2019.

[15] A more comprehensive assessment of the satisfaction of the political preconditions for MFA, provided by the European External Action Service, is annexed to this document.

ensuring reasonable burden-sharing. The EU's MFA would also complement the standard EU aid packages mobilised under the ENI. The proposed MFA would contribute to the EU's leverage on policy making in Georgia, helping the country reduce economic vulnerabilities, and promote higher and more inclusive economic growth.

5.4 Conditionality

Disbursements under the proposed MFA operation would be conditional on successful reviews under the IMF programme and on the effective drawing by Georgia on IMF funds. In addition, the Commission – on behalf of the EU – and the Georgian authorities would agree on a specific set of structural reform measures, to be defined in a Memorandum of Understanding. These reform measures would support the authorities' reform agenda and complement the programmes agreed with the IMF, the World Bank and other donors, as well as the policy programmes associated with the EU's budget support operations. They would be consistent with the main economic reform priorities agreed between the EU and Georgia in the context of the Association Agreement, including the DCFTA and the Association Agenda.

The Commission will seek a broad consensus with the Georgian authorities, so as to ensure ownership and smooth implementation of the agreed conditionality. The policy conditions should address some of the weaknesses shown over the years by the Georgian economy and economic governance system. Possible areas of conditionality could, in principle, include reforms aimed at reinforcing social safety nets, PFM, strengthening the investment climate and supporting the implementation of the DCFTA. Any conditionality will be coordinated with the relevant international financial institutions, as well as the EU's regular policy-based assistance instruments, notably budget support operations.

5.5 Financial discipline

The planned assistance will be provided in the form of loans and grants. The loan part will be financed through a borrowing operation that the Commission will conduct on behalf of the EU. The budgetary impact of the loan assistance will correspond to the provisioning of the EU's Guarantee Fund for external actions, at a rate of 9% of the amounts disbursed, from budget line 01 03 06 (Provisioning of the Guarantee Fund). Assuming that the two loan disbursements (of EUR 15 million for the first tranche and EUR 20 million for the second tranche) will be made in 2018, the provisioning will take place in the 2020 budget, in accordance with the rules governing the guarantee fund mechanism, for an amount of EUR 3.15 million.

The grant element of the assistance (EUR 10 million in total, i.e. EUR 5 million for each of the two tranches) will be financed from commitment appropriations of the 2018 budget, under the budget line 01 03 02 (Macro-Financial Assistance), with payments also taking place in 2018.[16]

Based on current projections on the utilisation of the budget lines 01 03 02 and 01 03 06, the Commission assesses that the budgetary impact of the proposed MFA operation for Georgia can be accommodated.

In line with the requirements of the Financial Regulation, the European Commission services are currently carrying out, as noted, an Operational Assessment of the financial and administrative circuits of Georgia. Developments in this area will continue to be closely

[16] As already indicated, depending on the pace of the legislative process and, thereafter, the implementation of the MFA operation, the disbursement of the proposed assistance may take place in 2018 or be split between 2018 and 2019.

monitored also through the regular progress reports on PFM reforms produced by the EU Delegation in Tbilisi.

6. EVALUATION AND COST-EFFECTIVENESS

This assistance is of exceptional and macroeconomic nature and its evaluation will be undertaken in line with the standard Commission procedures.

6.1 Evaluation

Ex-post evaluations of MFA operations are foreseen in the Multi-Annual Evaluation Programme of the Commission's Directorate-General for Economic and Financial Affairs. An ex-post evaluation of the proposed MFA to Georgia will be launched within a period of two years after the availability period has expired. A provision for the ex-post evaluation is included in the proposed Decision for the assistance and will also be included in the Memorandum of Understanding. Budget appropriations from the budget line for macro-financial assistance grants will be used for this evaluation.

6.2 Achieving cost-effectiveness

The proposed assistance would entail a high degree of cost effectiveness for several reasons:

(i) Since the assistance would be closely coordinated with the international financial institutions, which, as noted, are making their own financial contributions, its ultimate impact could be very significant compared to its cost. Moreover, in negotiating specific policy conditions, the Commission will be able to draw on the expertise of those institutions, including the IMF and the World Bank, and to influence their conditionality as well in ways that will take into account the EU's views.

(ii) Providing coordinated macroeconomic support to Georgia on behalf of the EU, the MFA would be more cost efficient than the provision of a similar total amount of financial support by EU Member States individually.

(iii) A substantial part of the proposed assistance would be provided in the form of loans, through which scarce budgetary funds are effectively leveraged, thus enhancing the impact of the EU budget.

(iv) Finally, the Commission will aim at achieving synergies with other EU policies and instruments used to support the implementation by the beneficiary of the relevant measures (notably in the area of PFM).

ANNEX

EUROPEAN EXTERNAL ACTION SERVICE

Head of Division
Eastern Partnership - Bilateral

Brussels, 16 August 2017
EURCA EAST 2 (2017) 4424462 (s)

ASSESSMENT OF DEMOCRACY, HUMAN RIGHTS, RULE OF LAW AND POLITICAL REFORMS IN GEORGIA

Georgia's current constitution provides for a semi-presidential democracy based on the rule of law, division of powers including independence of the judiciary, and respect for human rights. The ongoing revision of the constitution should introduce in the years to come a fully proportional electoral system and reinforce pluralist multi-party democracy in the country. The constitution, together with ordinary law, guarantees the freedom of the press/media, speech, religion, association and assembly. There is also a well-developed legal framework providing for free establishment and functioning of civil society organisations.

An EU-Georgia Association Agreement, including a Deep and Comprehensive Free Trade Area (AA/DCFTA), was signed in 2014, provisionally applied from 1 September 2014 and entered into force on 1 July 2016. The Association Agenda coupled with the Agreement includes numerous commitments of human rights, with concrete chapters of justice; democratic institutions (including elections, constitutional reform and decentralisation); law enforcement bodies; anti-torture and ill-treatment; support to the Public Defender Office; gender equality and children's rights.

The government's reform agenda is ambitious and has recently been formalised in an agreement with the IMF. In the region Georgia is a frontrunner in most chapters of EU cooperation. However, the super majority of the Georgian Dream party in the legislature and the weak position of opposition parties increase the risk of a lack of consensus on some future reforms.

Recent developments

The October 2016 ***elections*** resulted in a landslide victory of the Georgian Dream, which secured a constitutional majority in parliament (115 out of 150 seats). They once again brought up the question of proportional gender and ethnic minorities representation. Currently, only 15% of Parliamentary seats are occupied by women and 7% by national minorities (according to the 2014 census, ethnic minorities make up 13.2%). Current financial incentives for political parties to include more women appear to be ineffective which is also reflected in the limited number of women in the ministerial positions (2 out of 18).

In January 2017, the main opposition party, United National Movement (UNM), split following tensions between the faction supportive of former President Mikheil Saakashvili (which kept the

UNM denomination and has 6 seats in Parliament) and the moderate faction ("The Movement for Liberty - European Georgia" with 21 seats in parliament), which further weakened the opposition.

The rules for local elections have been reviewed, reducing the number of cities with direct mayoral elections. The next local elections (scheduled for October 2017) will be a test for European Georgia's capacity to attract the UNM's electorate.

The parliamentary commission tasked with the preparation of the constitutional reform finalised its draft on 21 April 2017. The main changes proposed in the draft constitution include: introduction of a fully proportional system with a 5% threshold (without the possibility of electoral blocs and all votes for parties not crossing the 5% threshold to be allocated to the winning party); weakening of the President (election by an assembly, reduced veto power, suppression of the National Security Council he chairs and of his right to appoint Supreme Court judges); introduction of a no-confidence procedure against the government (either by one-third of MPs or by the Prime Minister); no second term for the Ombudsman; stronger independence guarantees for the Public Broadcaster and the Prosecutor's Office; and marriage defined as a voluntary union between a man and a woman.

The draft was submitted to the Venice Commission of the Council of Europe (VC) whose preliminary opinion welcomed the general direction of the changes but went against some specific proposals concerning the rules regulating elections (e.g. the combination of three mechanisms: the "bonus" for the winning party, the 5% threshold and the prohibition of electoral blocs). The indirect election of the President was not criticised, but mentioned as another factor strengthening the need for high standards in the parliamentary electoral system. The VC preliminary opinion also sent a strong message on the need for recognition of same-sex partnership in the lower level legislation.

The government partially followed its commitment to follow VC recommendations, limiting the scope of the vote bonus to 9% and agreeing that the President be elected by direct vote in 2018. But, facing the resistance of a large group of Georgian Dream (GD) parliamentarians, it had to take a last-minute, unilateral decision to postpone the introduction of full proportionality to 2024. The opposition and civil society perceive this as a move fully discrediting all previous GD declarations about working for consensus in an inclusive manner. This also prompted a negative reaction of the VC about the whole process and the apparent lack of consensus behind the major legislative project. The Parliament adopted constitutional amendments in a second reading on 23 June 2017 with 115 votes. Opposition parties boycotted the session. Subsequently, the leaders of the ruling party made public commitments showing openness to try to reach a consensus with the opposition. Opposition parties have expressed their readiness to cooperate, as long as the ruling party agreed to introduce for the next 2020 parliamentary elections the fully proportional model of elections.

Regarding ***human rights and good governance***, Georgia has seen some positive developments in 2016 and 2017. Examples include implementation of the Juvenile Justice Code or increased awareness on discrimination and domestic violence. A national Human Rights Strategy and Action Plan were adopted in 2014. The Action Plan 2016-2017 was adopted with a delay in June 2016. The anti-discrimination bill adopted in May 2014 needs to be more effectively implemented. Concerns remain in various fields, in particular regarding the rights of persons belonging to minorities. Other areas of concern are gender equality, domestic violence, and lack of accountability with regards to alleged crimes of law enforcement officials. The Public Defender's Office has continued to be very active in monitoring the human rights situation, issuing an increased number of recommendations and special reports on specific topics. The Government institutions are reporting back on those

recommendations which can be seen as evidence that the PDO is increasingly accepted in its role. The mandate of the PDO is expiring and a new one should be appointed by the end of 2017.

A series of radical reforms from the 2000s led to the de-facto elimination of petty corruption and violent crime. Georgia has also made progress in other areas of human rights and good governance, such as penitentiary reform. On a less positive tone, though, growing consolidation of media ownership in few hands, together with low media revenues, resulted in an only 'partly free' rating for Georgia by Freedom House in 2016.

The ***challenges stemming from the conflicts of the 90s and the 2008 conflict*** in Georgia remain high. The Georgian government is increasingly concerned by what it perceives as the slow but continuous annexation by Russia of the Georgian breakaway regions of Abkhazia and South Ossetia (closure of two crossing points along the administrative boundary lines with Abkhazia in March, "elections" in Abkhazia, "referendum" in South Ossetia to change the name in April, implementation of the 2015 "treaties" with Russia). That said, the 40th round of the Geneva International Discussions took place on 20-21 June 2017 in a constructive atmosphere. With regard to the long-standing project to adopt a statement on non-use of force, parties were very close to an acceptable text, to which finally the Georgians could not agree 'at this stage'. They asked to postpone the issue to the October round.

EU-Georgia relations

Relations between the EU and Georgia are deep and multifaceted, encompassing gradual economic integration and deeper political cooperation. Georgia participates in many EU agreements and programmes, and is among the best performers in approximation and implementation.

With a view to facilitating the implementation of the Association Agreement and its Deep and Comprehensive Free Trade Area, the EU and Georgia agreed in 2014 on an Association Agenda, which provides a list of priorities for joint work through which the overarching objectives of political association and economic integration could be attained. This Agenda is currently being updated for the years 2017-2020.

Visa liberalisation for Georgia entered into force in March 2017, since then, 55,000 citizens of Georgia have travelled visa-free to the EU.

Conclusions

Georgia's constitution and organic legislation enshrine the principle of a multi-party democracy, the rule of law and respect for human rights. Also, the EU and Georgia have developed close institutional and economic ties and the ongoing implementation of the Association Agreement signed in 2014 should help deepen them further.

In consistency with the programme that Georgia recently signed with the IMF, the EU remains fully committed to supporting Georgia in its reform efforts together with other international donors. The envisaged financial assistance should help keep the current reform momentum. In this context, the European External Action Service stands ready to provide a further detailed assessment of the situation of democracy, human rights, rule of law and political reforms in Georgia throughout the lifecycle of the proposed Macro-Financial Assistance operation, whose political preconditions may be considered as being fulfilled.