

CHAPTER III. THE STRATEGY FOR RECOVERY AND SUSTAINED GROWTH

46. The over-arching objective of donor assistance is to help Georgia attain its pre-conflict economic growth and social development trajectory. This would require addressing the immediate effects of the conflict on economy, society and infrastructure as well as strengthening the capital base through public and donor-funded investments thereby bridging to the period when full confidence returns and private investment flows are resumed. It would also create the room in the budget for higher social spending.

47. The strategy for recovery and sustained growth is based on the recognition that the sharp knock to business confidence will undermine private sector investment, bank lending and private consumption and, thus, economic growth. Falling domestic demand will affect fiscal revenues, reducing the capacity of the state to undertake vital expenditures, including additional social spending (related to internally displaced and conflict-affected populations). Therefore, the need arises for public expenditures to bridge to the period when private confidence is substantially restored – perhaps a period of about two years – by:

- a combination of externally provided budget support funds and some counter-cyclical fiscal policy, implying a relaxation of the pre-conflict fiscal deficit targets, to finance current expenditures largely associated with social spending needs; and
- external support for core investments to be undertaken largely by the public sector to substitute for private investment shortfalls and to accelerate planned public investments so as to lay the foundations for the restoration of economic growth as well as for the provision of support to the banking system.

48. Such a macroeconomic policy stance boosting demand and domestic output will help to cushion the reduction in economic growth, although it will nevertheless be lower than projected in the pre-conflict period and fiscal revenue losses will be experienced. Reductions in outlays in certain areas (chiefly non-social spending) will be needed to make room for the additional social spending and to limit the rise in the fiscal deficit to the programmed levels.

49. The implementation of core investment needs through external financing will also address new urgencies that have emerged from the conflict. These include certain new investments to strengthen the economic security of energy, infrastructure and public services by *inter alia* improvements in the reliability of power transmission or storage of gas to deal with possible interruptions in imports and a broadening of choices in road connectivities.

50. The approach to addressing post-conflict needs is rooted in the authorities' overall long term strategy of reliance on the private sector as the engine of growth and hence on the establishment of an environment conducive to business and to foreign investment. The trade and investment regime is highly liberal, thereby fostering integration of the economy

with the rest of the world. The regulatory apparatus is modern in design, light and confined to core areas of safety and prudential behavior. With the introduction of low and flat taxes, the tax burden is regionally competitive so as to attract investment and to fund a small government that focuses on financing the provision of essential public goods and services, with delivery of such services being undertaken by the private sector to the extent feasible.

51. The authorities have adopted a program of fiscal prudence – with requirements for budget surpluses that would be transferred to savings funds – continued reduction of tax rates and abolition of taxation of financial instruments and a steady reduction of the share of the state in the economy eventually to 25 per cent. The privatization of assets will continue, although the asset prices and, consequently, privatization proceeds may be expected to decline in the short- to medium-term. Competition for investment flows has been further enhanced through streamlining of financial regulations and stock exchange demutualization. Finally, monetary policy would be geared towards explicit inflation targeting.

52. This program would now be adjusted in light of post-conflict shocks to the economy, with the emergence of temporary fiscal deficits for example, but the authorities are determined that the reform thrust would be kept up and in certain areas structural reforms efforts will be made to accelerate.. The authorities have stated that there is a new urgency to negotiating free trade agreements with the European Union and the United States; as a first step, a broadening of GSP preference products from the United States is envisaged. It would be helpful to have a relaxation of worker visa requirements from donor countries.

53. Consistent with this approach to ensuring high growth rates over the long run, the authorities intend to continue their long-established privatization programme, which provides for sale, or setting up concessions or developing other instruments for private sector participation in those projects that can be structured to attract such investment. The privatization processes are expected to follow high international standards of transparency. Privatization proceeds are expected to be placed either in the budget or in long term publicly-owned investment vehicles, such as the Fund for Future Generations or the Stabilization Fund.

54. The conflict has greatly affected the civilian population, both the IDPs as well as host communities, and requires a sensitive, human rights based approach. While the specific immediate needs of the newly displaced are being addressed, a harmonized, non-discriminatory approach toward both old and new IDPs is essential. Moreover deceleration of the economy will affect the most vulnerable groups of the population (displaced persons, but also the unemployed, rural population and pensioners). The government strategy respects these considerations and is grounded in reliance on targeting social assistance for the needy and on maximizing the choice of recipients of social benefits, e.g., a menu of choices in resettlement will be offered to IDPs.

55. *Reform strategy:* The government has pursued an ambitious human development reform program sector with an overarching objective of improving access to good quality health and education services for the poor and vulnerable. The underlying principles have been equity, support first for the poorest and most vulnerable, private provision of social services, efficiency and effectiveness, decentralized management, transparency, and fiscal responsibility. The key elements of the strategies employed in implementing the reform are:

56. Health: limit state provision to health public goods; public financing for universal access to primary health care services; private provision of in-patient services (hospital privatization); publicly financed health insurance for the poor for in-patient care; state focus on regulation, monitoring, stewardship role.

57. Education: decentralization; autonomous boards for schools with local choice; per capita-financing; human resources development; performance testing; monitoring and evaluation; participation in international tests, promotion of choice of schools, through the voucher system and aiming at 100 per cent enrollment; student loans from banks for tertiary education. The government aims to stimulate enrollment in private schools from 6 per cent of the student body currently to 20 per cent by 2012.

58. Social protection: target social transfers and other programs to the poorest and most vulnerable; consolidate smaller programs into a bigger, better targeted one; move from status to needs based targeting; ensure sufficient funding to cover the neediest; modernize social protection administration.

59. *Post-conflict strategy*: In the post-conflict period the immediate challenges are to ensure: adequate shelter (including durable housing), access to health and education services and appropriate social protection to the population directly and indirectly affected by the recent conflict, but without compromising the achievements of the reforms to date.

60. The key short term priorities include: providing the repair of the health and education infrastructure damaged during the conflict, timely resumption of academic year, regular flow financing of health and education services, payment of pensions, targeted social assistance and other social transfers, effective provision of basic health services, one-time income support for poor and vulnerable population and appropriate protection of people who have experienced displacement because of the recent conflict. This process should ensure that internally displaced children, and children otherwise directly and indirectly affected by conflict, have equal access to quality mainstream education from kindergarten, through to primary, secondary and tertiary level. The medium-term aim is to fully rehabilitate education infrastructure damaged by the conflict. Over the period of the recovery program, steadily improving the quality of education at all levels and gradually reducing existing inequalities, including rural/urban, IDP/non-IDP and poor/non-poor disparities, are other important objectives.

61. While the immediate concern is to adequately protect people affected by the conflict, it is vital to sustain progress achieved in the reforms of health, education and social protection and to maintain the overall thrust of long term reforms.

62. Key to safeguarding employment will be re-starting agriculture and providing for productive urban livelihoods. It is the policy of the government to pursue these objectives on a nation-wide basis as the impact of the conflict is being felt nation-wide, and poverty is widespread, especially outside Tbilisi. It is notable, however, that agriculture is the basis of the economy of the most conflict-affected region, Shida Kartli, which is also a poor region. The impact of the conflict on agriculture threatens the future of Shida Kartli as a viable

economic region. Moreover, water (both potable and for irrigation) flows to the region from South Ossetia have been largely cut off.

63. Employment of the affected groups will benefit from job opportunities that will be created in the course of the implementation of the priority recovery and investment program. Even if only temporary, such jobs will benefit individual households by mitigating the risks of these groups falling deeper into poverty and increasing their employability as well as, through increased purchasing power, the wider community.

64. The multi-sectoral strategic response consists of:

- Infrastructure rehabilitation: Damaged/looted/destroyed schools, health facilities and targeted social assistance offices will need to be reconstructed/refurbished and made functional again.
- Access to health services: All affected population will have access to health services under the same conditions as other citizens. The poor and vulnerable will be covered by medical assistance program (health insurance program for in-patient services covered by the government), if they test eligible.
- Targeted social assistance: All the newly affected are eligible to apply for targeted social assistance and all will go through an eligibility testing process having chosen to register with the data base on poor and vulnerable population. All household assessed as eligible qualify for regular income support (targeted social assistance). In addition, about 25,000 IDP households will receive a one-off cash assistance and IDPs-92 will still receive IDP allowance until their inclusion in the TSA system.
- Food security: About 110,000 people directly affected by the conflict, including the displaced currently in shelters, are expected to experience food insecurity during the next 6-18 months. Therefore, distribution of food and non-food items will be maintained for this period. Children of age 0-2, pregnant women, and nursing mothers might be in need of a more diversified diet than normally provided through food aid.
- Education: Basic education for all children is compulsory and free of charge. All children affected by the conflict have been enrolled in schools and the academic year has begun in most schools across Georgia.

65. The responses specific to affected groups are:

- Displaced population is currently sheltered in public buildings including kindergartens and schools. The shelters are in need of winterization. At the same time, the government is taking actions to provide permanent housing, restoration of livelihoods and start up assistance for this group of affected population. In addition, programs to foster integration of resettled population into new communities will also be provided.

- The 1992 IDPs: Some of the collective centers housing population displaced since 1992 are in need of winterization. Furthermore, the government is developing options to provide 1992 IDPs with permanent housing in the medium term.

RISKS AND MITIGATION

66. The success of the overall strategy relies upon re-establishment of private sector confidence., which, in turn, depends on regional and internal factors. With regard to external risks, a reduction in tensions along international borders and the administrative boundaries with the regions of Abkhazia and South Ossetia and the implementation of the agreement ending hostilities in all its aspects would contribute to security and confidence.

67. With regard to internal risks, the greater participation of all strands of political opinion in the country in implementation of the recovery and growth strategy would add to the prospects of success of the economic recovery program. In this connection, the decision by the government to provide for significant opposition representation in bodies to monitor the implementation of donor-financed programs is encouraging. Recently announced measures to strengthen democratic processes, including reforms related to freedom of media and parliamentary reforms and measures to bolster the independence of the judiciary would add to social cohesion.⁴ The combination of the decisive steps that the government is taking to address post-conflict needs and the provision of adequate finance by donors is expected to lead to restoration of confidence.

68. In particular, flexibility in its public policy, to redirect public spending to the new high priority needs, to mobilize external resources for budget contingencies, and to obtain a standby arrangement with the IMF to support international reserves as well as the prompt provision of liquidity to the banking system by the central bank are highly encouraging developments.

69. The government has succeeded in stabilizing confidence – bank deposits are beginning to recover, and fiscal revenues are becoming in line with targets. The provision of financing to leading banks by IFIs is helping to address liquidity constraints and raise confidence. Public services and infrastructure services are being provided with no interruptions or loss in quality. The authorities have acted swiftly to repair conflict-related damage. Parliament has passed a supplementary budget for 2008 to recognize the new realities. The early provision of budget support by international financial institutions and key bilaterals for 2008 has mitigated risks significantly.

⁴ These government decisions and measures were outlined in the statement of the President of Georgia to the 63rd UN General Assembly on September 23, 2008.

70. The quick and decisive actions taken by the authorities to provide housing for all displaced and to construct 4,700 of houses and refurbish 2,500 flats before next spring, thereby meeting an estimated 70 per cent of the total requirement – financed entirely through the 2008 budget is commendable. The authorities have also made provision for sustainable livelihoods by allocating arable farm land to those to be resettled in villages.

THE ROLE FOR DONOR FINANCING IN STRATEGY IMPLEMENTATION

71. The major areas where needs for financing arise are:

- the macro-economic and fiscal shocks and hence the case for budget support;
- banking system need to roll over its external liabilities and to resume lending aggressively. This gives rise to the case for refinancing operations and guarantees related to the external liabilities of the major banks;
- social needs associated with conflict-affected people, including housing and related support; education, health and social protection; restoration of agriculture and of livelihoods,
- the investment needs in infrastructure – transport and energy, municipal and urban investments, including water and waste management, and addressing the rehabilitation needs in environment.