Michael Borish & Company, Inc.

REVIEW OF THE BUSINESS AND FINANCIAL ENVIRONMENT FOR SMALL AND MEDIUM-SIZED ENTERPRISES IN GEORGIA

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ACRONYMS

CAMEL	Capital, Assets, Management, Earnings, Liquidity
CAR	Capital Adequacy Ratio
CIS	Commonwealth of Independent States
CPI	Consumer Price Index
DCA	Development Credit Authority
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FIAS	Foreign Investment Advisory Service
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GEGI	Georgia Enterprise Growth Initiative
GEL	Georgian Lari
GOG	Government of Georgia
GSE	Georgian Stock Exchange
IAS	International Accounting Standards
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IFS	International Financial Statistics
IMF	International Monetary Fund
IPO	Initial Public Offering
IR	Intermediate Result
IT	Information Technologies
MFI	Micro-finance Institution
NBG	National Bank of Georgia
NGO	Non-governmental Organization
NPL	Non-performing Loan
OECD	Organization of Economic Cooperation and Development
R&D	Research and Development
ROA	Return on (Average) Assets
ROE	Return on (Average) Equity
SDS	State Department of Statistics
SME	Small and Medium-sized Enterprise(s)
TACIS	Technical Assistance to the Commonwealth of Independent States (EU)
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VAT	Value Added Tax
WBG	World Bank Group
WTO	World Trade Organization

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EXECUTIVE SUMMARY

Purpose of the Assignment

The purpose of this assignment has been to review SME finance and development issues in Georgia with the intention of producing concepts for a new SME activity to be supported by USAID. The SME activity is focused on financial product design, business support services, and/or other activities that could help to increase SME access to finance and enhance their competitiveness.

Summary of Problems Faced

Many of the problems Georgia faces are related to the business environment and capacity limitations with regard to the policy, legal, regulatory and institutional framework. As such, SMEs and financial institutions face an environment that is inadequate for sustained market development. (These issues are being addressed by a separate USAID project focusing on an improved business environment regarding registration, licensing, permits, standards-setting and enforcement, and development and use of property and collateral registries for secured transactions. As such, recommendations deal with other initiatives that USAID could potentially support to reinforce efforts to improve the business environment.)

A summary of key problems includes:

Firm-Level Constraints

- *Scale*: Most private sector companies are very small, usually informal or unregistered, with fewer than 10 employees and well below $100,000-equivalent in *reported* annual revenues. While revenues or turnover may be under-reported for tax avoidance/evasion purposes, most of Georgia's enterprises remain exceedingly small in scale and cash flow. The small size of firms in Georgia limits prospects for export competitiveness and investment, although growth should provide opportunities for employment generation on the condition that tax and regulatory processes are not burdensome.

- *Firm Productivity*: Average output levels confirm that most enterprises in Georgia record low levels of output, and fall well within the "small" designation for companies if these data are used as a proxy for average turnover. The average across all firms in 2003 was less than $60,000. Such limited turnover with associated costs points to severe limitations on the borrowing capacity of most companies. Under such circumstances, cash flow is limited, and asset values are low. Thus, there is a limit to how much banks will be able to lend to such companies, whether secured or unsecured.

- *Employee Productivity*: As for employee output per capita, the highest figures were in more capital-intensive sub-sectors, namely industries, construction, and transport and communications. Employees in these areas of the economy were responsible for $10,000-$20,000 per employee in 2003, well above the average of about $3,500.The lowest levels are in agriculture, education, public administration and trade. This particularly points to the need for increased investment in machinery and equipment in the agricultural sector to boost output and labor productivity. The industrial sector also experienced declining investment from 1998-2002, and needs new capital investment to increase productivity.

- *Governance*: Most Georgian firms are very basic and fundamental in terms of governance standards and management structure. In the case of governance, few firms have outside ownership, and as such are not subjected to external scrutiny. As most Georgian firms do not have bank loans, there is no real external scrutiny from financial institutions. As such, due to the lack of incentives, Georgian enterprises rarely have qualified, independent boards that exercise scrutiny over management. Annual shareholder meetings, when held, are generally formalities to ratify decisions made by one or a handful of controlling interests. Modern financial management systems are uncommon. Internal audit is underdeveloped as an autonomous function within the company to report to the board on the effectiveness of internal controls and efficiency of operations. Other building blocks that would otherwise make it more feasible for enterprises to access loans and possibly go to the capital markets for additional financing (e.g., bonds, equities) do not exist.

- *Management*: Management tends to be concentrated, with most firms run by one person. With some of the larger and medium-sized companies, there is periodic evidence of management teams in which various specializations are present and combined to forge consensus on financial and operational decisions (e.g., wine sector). However, this is not usually the case, and one person is ordinarily responsible for most major decision-making. The behavior of most firms is often disinclined towards disclosure, resulting in insufficient information provided to financial institutions for them to decide on the credit worthiness of a firm. This represents a business culture constraint in the system, and one that needs to be addressed for SMEs to increase access to bank loans and other sources of formal finance.

SME Access to Finance: Supply Side Issues

- *Bank Penetration*: As of year end 2004, Georgia had 19 licensed banks. Total assets were about $950 million, or about 19 percent of GDP. As a penetration ratio, this is low by global standards, although fairly standard for the bottom half of the CIS and representative of a continuous increase. By contrast, bank assets to GDP averaged 16 percent in 2002-03, indicating that the system is growing.

- *Banking System Concentration and Solvency*: The banking system has been consolidating in recent years. The top six banks accounted for 83 percent of assets, 86 percent of loans, 85 percent of deposits, and 69 percent of capital. All of these banks had CAMEL ratings of “2” or better, with one exception. On the other hand, 14 banks had CAMEL ratings of “3” or less, reflecting weaknesses, of which three were fairly severe. While all the banks met minimum capital requirements as of year end 2004, several of the lower rated banks are likely to face difficulties meeting the minimum capital requirements of about $6.5 million targeted for 2008. This portends the likely merger, acquisition, re-licensing (possibly as a non-bank financial institution) or collapse of most of the smaller institutions.

- *Scale*: On average, the banks are small. Notwithstanding favorable trends, the small size of the banks limits their capacity to make loans above relatively low values on an individual project/loan basis, as well as collectively in terms of overall exposure to a borrowing entity. Banks also cite the limited availability of term funding, which shortens the maturities they can provide on loans.

- *Earnings*: Banks’ earnings are poor, with returns on average assets and equity less than 1 percent. Data from NBG in 2003-04 indicate that the average for banks’ total after-tax earnings were only $1 million in 2003 and $0.8 million in 2004. The largest profit of any bank was only about $8 million, an exceedingly low figure by international standards. Yet this was 56 percent of total after-tax earnings for the system as a whole in 2004. Thus, earnings opportunities are constrained in Georgia, which also limits the amount of earnings that can be retained to boost capital for expanded operations.

- *Lack of Syndication*: Banks have not engaged in the practice of syndicating loans, possibly because they are unfamiliar with how to syndicate, and partly because of competitive instincts that preclude cooperation with rival banks. Changing this practice would effectively constitute a change in commercial bank lending cultures in which they share information on the prospective borrower and project to be financed, and then co-finance. This is a common technique in functioning markets, and is used to spread risk and free up capital for other loans. Originators also frequently sell these loans to other banks for fees as well, again freeing up capital for new loans while generating fee income that contributes to banks’ ROA and ROE targets. However, in Georgia, this has been a rare occurrence.

- *Maturity Mismatches*: Banks have attracted greater deposits in recent years, but most of these are either demand deposits that can be withdrawn at any time, or term deposits in which maturities are usually for less than one year. The lack of long-term funding makes it difficult for banks to lend on a long-term basis due to asset-liability matching practices. The absence of hedging mechanisms in the market pushes banks to pursue excessively conservative asset-liability management practices, with very little willingness to take on open loan positions (where loans exceed deposits on a maturity basis). However, in the case of most manufacturing firms and many SMEs, their financing needs are for machinery and equipment or premise expansion that take years to cover. These investments require long-term loans (three to five years, sometimes longer) given the high up-front cost and time required to generate cash flow to help service the loan and ultimately repay.

- *Enterprise Deposits*: While banks have increased deposit collection in recent years, most of this has been from individuals and households. Enterprise deposits remain low, at no more than about 15 percent of total. Many banks are wary of lending to enterprises that are unable or unwilling to place deposits with the banks. This not only reduces the total value of the relationship, but also deprives bankers of an opportunity to monitor company cash movements for needs, seasonality, etc.

- *Lack of International Ratings*: The broad absence of ratings in the banking system precludes opportunities for Georgian banks to participate in the international syndicated loan market. As such, Georgian banks miss out on one of the most fundamental ways to extend maturities for lending. However, given banks' surplus liquidity, there has been little incentive to take action to increase term funding for long-term loans.

- *Non-Bank Financial Institutions*: There is little activity apart from the banks in terms of meaningful financial data, reflecting underdevelopment of the non-bank financial sector. MFIs and credit unions had about $15 million in loans in early 2005. Lease contracts were valued at about $3 million. The securities market is generally inactive.

SME Access to Finance: Demand-Side Issues

- *SME Non-Compliance with Underwriting Standards*: In many cases, the SMEs themselves are unwilling or unable to meet banks' underwriting standards and requirements. Key among these (according to the banks) are the lack of assets SMEs have or are willing to pledge as collateral for loans, and difficulties verifying information presented. As such, many enterprises and their financing proposals present credit risk that banks need to manage or are unwilling to underwrite.

- *Insufficiency of Collateral Due to the Legal Environment*: While there is credit risk, the traditional response is that secured loans can offset risks associated with SME inability to service and repay loans from cash flow. However, in Georgia, property rights are poorly defined and enforced, the legal environment for secured transactions is weak, institutional mechanisms for credit risk evaluation are underdeveloped, and dispute resolution mechanisms are notoriously slow or unreliable. As such, banks themselves are not automatically secured, even when collateral levels are two to three times loan values. Techniques that banks can pursue to offset this risk include broader value chain relationships that are more cash-based and provide banks with greater opportunities to monitor SME cash flows. However, if SMEs are unwilling to make these commitments or comply with requirements, they are unable to access needed financing.

- *Inadequate Equity Levels*: Many SMEs expect banks to finance most or all of their investment needs with loans, which represents a highly exposed position for the banks. As such, many SMEs themselves do not have sufficient equity reported in their companies, reducing the amount of loans banks are willing to make.

- *Inadequate Working Capital Levels*: Enterprises also make mistakes with regard to needed working capital once financing for property, plant and equipment is obtained. In some cases, enterprises in the past have managed to obtain needed financing for fixed assets, only to find their operations constrained by the lack of working capital. This has resulted in capacity underutilization, which has translated into insufficient cash flow for debt servicing.

- *Market Intelligence*: Market information and research is weak in Georgia. This makes it difficult for SMEs to more accurately ascertain what their market prospects are, and to plan out investment strategies and needs accordingly. The inability to do so raises doubts about the accuracy of plans submitted to banks for financing, and certainly raises the risk of taking on such exposures. Even loans made against contracts are not necessarily safe, given that contracts can be easily breached.

- *Interest Rates*: When SMEs do obtain financing, interest rates are often high. This is partly due to risks associated with the firms and/or the project, but mainly due to weak protection for creditors. Difficulties and costs related to loan recovery have substantially added to the risk premium banks assign to such exposures. In a worst case, the high interest rate burden can jeopardize credit quality, and lead to losses for both borrowers and lenders.

Financing Supplied

- *Credit Supplied*: At year end 2004, total *loans* by banks to households, enterprises and other banks approximated $530 million on a gross basis, and $494 million on a net basis after subtracting loan loss reserves. Given that other non-bank credit institutions had less than $20 million in outstanding credit as of year end 2004, banks are the main source of formal lending in the system.

- *Enterprise Distribution*: Bank loan data specific to SMEs are not comprehensively recorded. At a minimum, dedicated bank loans from non-resident (donor) sources accounted for $46 million at year end 2004, or about 9 percent of net loans. However, the figure is higher as banks have also provided some loans to SMEs from their own mobilized resources (mainly from deposits). Likewise, loans to households now account for about 31 percent of total loans, and these are sometimes for productive purposes (small businesses) as opposed to pure consumption. As for the dedicated SME loans provided, almost all are in the services (construction, trade and other services like hotels, restaurants, transportation, etc.). Very little is utilized for agriculture ($2.3 million), industry (zero beginning 2005) or fixed asset purchases (only $3.4 million outstanding as of year end 2004).

- *Loan Maturities*: NBG data indicate that long-term loans actually accounted for 58 percent of total loans as of year end 2004, and 64 percent of loans to resident legal entities. Long-term loans are primarily made available to commercial trade ($101 million) and industry ($62 million), the former reflecting increasing sales of appliances, cars and other consumer items. Households likewise have benefited, obtaining more than $64 million in long-term loans, slightly higher than Georgian industrial enterprises. (Interestingly, donor credit for SME development has stagnated in dollar terms and declined in GEL terms since the beginning of 2003. Thus, donor programs do not appear responsible for the increase in long-term funding by banks.) Long-term loans have also been reported for housing, and many construction-related exposures and other loans have been collateralized with real estate. However, there is also a catch, as most long-term loans are barely for longer than one year. Moreover, there is some industrial concentration in bank lending to the larger enterprise sector, meaning that SMEs have little access to long-term credit. Much of this problem stems from the limited amount of deposits with terms exceeding one year, pushing banks to keep the maturities of their loans relatively short (up to 18 months) for asset-liability management purposes. However, this also points to a shortcoming of the banks, namely the inability or unwillingness to manage maturity mismatches, which are fairly common in developed markets.

- *Fixed-Variable (Pricing) Mismatches and Liquidity Issues*: Banks are reported to lend primarily at fixed rates, while paying out interest on deposits at variable rates. Under current circumstances, this is beneficial to the banks, given the declining interest rate environment. However, the reverse could also occur, which would result in an unfavorable turn for net interest margins. Likewise, as 55 percent of real sector deposits are demand deposits and could be withdrawn on short notice, banks need to manage their liquidity for such potential risks. All of these risks actually drive up costs of loans for SMEs.

- *Currency Denomination*: Most loans are in foreign currency, accounting for 84 percent (or more) of total. This is consistent with general dollarization trends in the economy, and very closely match the 73 percent of deposits that are foreign currency-denominated in value ($437 million in foreign currency-denominated loans, and $394 million in foreign currency-denominated deposits). However, this puts the onus on companies to manage their foreign exchange risk, and there is little capacity to do so apart from hedging via dollarization.

- *Interest Rates*: In 2004, the effective interest income on average for the banks on loans was 16 percent. Loans to individuals and households were higher, at nearly 24 percent, and include most SMEs. If so, this explains the complaints about high interest charges, particularly when GEL loans are needed. On the other hand, 16 percent is not extremely high in risky environments like that in Georgia, which is just slightly lower than rates charged to legal entities. Thus, larger enterprises appear able to access credit at somewhat affordable rates (16.5 percent in foreign currency or less as the interest rate environment improves for borrowers), and banks are able to access inter-bank loans at lower rates.

- *Collateral*: Banks are accused of "over-collateralizing" their loans, usually with assets valued at two to three times loan value. However, this is largely due to the risks associated with credit exposures in Georgia, given the weak framework for secured transactions.

- *Size of Loans*: Banks provide about $3,000-$3,500 on average per registered enterprise in Georgia, although this likely increased to about $4,000 in 2004 given increases in total lending to enterprises. The larger the firm, the more likely the prospect for obtaining a loan from a bank, particularly if there are close personal relationships involved. Thus, SMEs tend to have smaller loans if they have loans at all. A rough estimate of credit to enterprises (medium-sized) and households (small-scale) based on value of actual loans outstanding and number of registered firms suggests that average SME loans are for less than $3,000 in size. These would suffice for small inventories, but not for the purchase of needed equipment and machinery to raise productivity levels.

- *New Credit*: A broad flow of credit analysis shows that incremental (net) loans to the enterprise sector were only $244 million from 1999-2003, for a yearly average increase of only $49 million. However, the increment was $153 million in 2004, reflecting a sharper increase than in previous years. Since 1999, per enterprise averages have increased by the hundreds of dollars each year from 1999-2003, and by about $1,300 in 2004. Thus, while trends are favorable, it still appears that enterprises are only accessing minimal increases in loans on average. Given that these are averages, most small enterprises are likely not receiving loans at all (if they have not applied), or are receiving only small amounts when they do obtain loans.

- *Non-Bank Sources*: Because formal sources of financing have been difficult to access, most SMEs (and other enterprises) rely on "informal" or personal sources of financing to run their enterprises. Based on 2002 data, about 60 percent of working capital and 75 percent of investment capital is derived from internal funds and retained earnings, loans from family and friends, and other informal sources.

Macroeconomic Considerations

- *Monetary and Fiscal*: Macroeconomic fundamentals are increasingly sound. This is pushing banks to lend more, as they are unable to generate sufficient earnings from investments in government securities. Limited fiscal deficits and high levels of concessional external assistance have reduced government issues of Treasury securities. Likewise, the inflation rate has declined, bringing down interest rates.

Consultation and Coordination

Many of the issues affecting SMEs are cross-cutting, and cannot be easily segmented into neatly defined categories without recognizing the linkage to other factors. As such, the approach taken by USAID should be comprehensive, involving public and private sector activities, and involving financial sector and enterprise sector reforms.

The approach also requires strategic vision and coordination, which is not currently as developed as it should be. This includes better coordination among government, private sector institutions and donors. Thus, it is recommended that the soon-to-be established Investment Council actually take the lead in serving as a vehicle for strategy development on a number of different areas of focus. This can and should be done by establishing Working Groups with key government officials to map out strategy in critical areas of importance (e.g., tax and customs administration, non-bank financial sector development, facilitation of regulatory compliance) that can foster SME growth and development.

USAID's proposed role (along with other donors) would be to lend support to these Working Groups focused on policy, laws and regulations, institutional capacity building, information flows and infrastructure development. An appropriate role for USAID would be to work with the government and World Bank to provide support to the Investment Council, with direct assistance (to be defined) at the Working Group level.

Summary of Recommendations

Recommendations have been evaluated based on the following criteria:

- Counterpart "buy-in"
- Prospects for sustained long-term impact
- Major results from budgetary resources
- Whether the proposed intervention(s) fill(s) major gaps
- Consistency with USAID strategic objectives
- Confidence of success

Recommendations recognize the importance of sound financial institutions as a basis for sustained SME access to finance, and this influenced proposed interventions.

- **#1: Support establishment of a viable secured transactions framework**. This is already under way with USAID's One-Stop Shop project to improve the business environment. As USAID (and others) have already begun work in this regard, the main recommendation is to implement a comprehensive and integrated approach, intensify the effort, and establish the electronic linkages necessary for property and collateral registries to properly function.

- **#2: Build on current efforts to promote leasing market development**. This would include the one direct financial intervention from USAID, the potential use of a DCA guarantee to permit leasing companies to raise term funds for lease contracts of three to five years. Leasing is considered a useful interim approach to equipment and machinery lending on a term basis while work continues on developing a viable secured transactions framework, and in the absence of a viable corporate bond market.

- **#3**: If USAID is committed to further involvement in more fully developing financial institutions, **it should conduct a comprehensive financial sector assessment for the next round of reform**. (If USAID is explicitly not interested in non-bank financial sector development and next-generation issues in banking, this assessment is not needed.) There is a common view that neither Government nor donors have a coherent strategic vision for Georgia with regard to financial sector development, SMEs, and private sector development. Given that the FSAP was concluded several years ago and the system is poised for considerable change and development in the coming years, this initiative would provide USAID with the framework needed to provide it and the Government with the vision needed for systematic reform. As recently shown in Armenia, this could be done in close coordination with the IMF and World Bank should the Government of Georgia seek an updated FSAP.

- **#4**: As an extension of #3, **USAID should consider another round of assistance for the National Bank of Georgia, in this case tied to commercial bank training to support modern credit practices and related risk management features**. While this initiative would be particularly focused on exposing lenders to market-based practices to stimulate increased lending and how to manage risks, it would also tie in with key financial stability needs. This is considered essential as the system consolidates, deposit insurance comes into existence, and banks lend more and diversify (including into non-bank activities) to generate higher earnings in a lower interest rate environment.

- **#5: Support development of mortgage finance markets**. This initiative would be an extension of #1 as well as #3-4. The reason to consider mortgage finance development is that it serves as a convenient framework for other desirable reforms for a sound economy and financial market. Mortgage finance reform may largely benefit households rather than SMEs. Nonetheless, given how small SMEs are in Georgia, home ownership would serve as a useful collateral asset to increase access to credit. Moreover, this initiative would include commercial property development, which would include hotels, warehousing, office space, and other properties needed for SME development. (This also points to the importance of #3, as this effort will require development of the insurance sector to accommodate property and casualty needs.) Reforms under this initiative would also have fiscal benefits (property tax administration), potentially point to ability of governments to float municipal bonds (based on property tax revenues collected and targeted, likely with a guarantee from an IFI), improve the permit and licensing process, shore up building codes, serve as a catalyst for realty association development, serve as a basis for strengthening valuation procedures, and help to meet a critical social objective of increasing the supply of affordable housing.

- **#6: Support development of a credit information bureau**. USAID should consider further assistance to help the market introduce a credit information bureau if other private initiatives falter. The benefit of having a bureau that is comprehensive, up-to-date, and accessible is that it reduces barriers to credit access for credit worthy borrowers, permits better information for the pricing of risk, and provides information that allows for unsecured (non-collateralized) lending to increase. The presence of the bureau is highly desirable. The reason for it being a lower priority than some of the others is related to confidence about prospects for success. Given the obvious benefits, bankers and other creditors should be pushing for this bureau to be established. That progress has been slow suggests possible doubts about the willingness to share information needed to expand markets.

- **#7: Support linkage of academic institutions and think tanks with innovative initiatives and enterprises**. This effort would likely be the highest in terms of risk and cost. However, it is designed to promote a more competitive, innovative SME sector that is knowledge-based, essentially the way much of the global economy is moving. By focusing on increasing linkage between research and thought centers and SMEs, there are opportunities for information flows, improved standards, centers for certification and accreditation, and commercialization of products. Such centers would likely serve as a magnet for support services, including vendors focused on specialized services (e.g., research, information systems and integration, finance). Such an approach also helps to train people, and provides opportunities for market-based business associations to emerge.

I. Background and Acknowledgements

The purpose of this assignment has been to review SME finance and development issues in Georgia with the intention of producing concepts for a new SME activity to be supported by USAID. The SME activity is to be focused on financial product design, business support services, and/or other activities that could help to increase SME access to finance and enhance their competitiveness. The components of the SME support design include interventions consistent with recommendations derived from existing materials/evaluations provided by USAID, as well as from findings from additional interviews and research.

The methodology for carrying out this assignment has been to review background materials and conduct interviews with financial institutions, businesses, project contractors, and government and donor officials. A list of meetings is found in Annex 1. A bibliography of background materials is found in Annex 2.

Recommendations have been evaluated based on the following criteria, with a simple scoring system[1] to differentiate options:

- Counterpart "buy-in"
- Prospects for sustained long-term impact
- Major results from budgetary resources
- Whether the proposed intervention(s) fill(s) major gaps
- Consistency with USAID strategic objectives
- Confidence of success

In the end, recommended interventions deviate slightly from the modified scoring system to take the specific focus of SME access to finance into account. Recommendations also recognize the importance of sound financial institutions as a basis for sustained SME access to finance, and this influenced proposed interventions as well.

This assignment has been carried out by Michael Borish and Company, Inc. under contract to the United States Agency for International Development (USAID). Michael Borish visited Georgia from February 19-March 7, 2005 to conduct meetings related to the assignment. He wishes to thank Denny Robertson (USAID Resident Representative), Jeffrey Lehrer (Director, Office of Economic Growth), Craig Bell (SME Advisor) and Rezo Ormotsadze (Project Development Specialist) of AID/Georgia for their support. Mr. Borish also worked closely with Hugh Haworth (Senior Financial Market Advisor, EE/MT), and wishes to thank him for the productive collaboration. Mr. Borish also wishes to thank all the people and institutions in Georgia that were helpful in providing data, information and time.

[1] "1" = low; "2" = medium; "3" = high.

II. SME Development and Finance Issues

A. Private Sector Structure and System Profile

1. Overview

Georgia's economy is largely private sector in orientation, although a sizeable portion of the economy operates in the informal sector,[2] and Georgia still has several large enterprises in the state sector accounting for a large share of GDP and employees. Most private sector companies are very small, with fewer than 10 employees and well below $100,000-equivalent in *reported* annual revenues. (Recorded turnover approximated $3 billion in 2003, or about $113,000 among 26,871 SMEs and large-scale enterprises. Figures for the additional 83,525 registered firms, mostly individual enterprises with no more than five employees, would add marginally to the gross turnover figure while bringing down the average significantly.) While revenues or turnover may be under-reported for tax avoidance/evasion purposes, most of Georgia's enterprises remain exceedingly small in scale and cash flow. On the other hand, the number of reported employees may be lower than the actual use of contracted employees due to the burden to firms of hiring permanent employees under official labor contracts. Tax incentives (i.e., exemption from personal income tax) offered to companies with five or fewer employees have been used to reduce constraints to permanent hiring, although this exemption may have been overturned with the recently adopted Tax Code, [3] and other administrative inconveniences such as filing and accounting requirements have reduced the effectiveness of tax incentives for hiring.

Specific to SMEs, the number of firms is estimated to be about 37,000. This is based on legal definitions[4] of small and medium-sized enterprises, and assumes about 300 large-scale enterprises among the 37,280 "commercial legal persons" (2003 data), while excluding individually-owned and -operated enterprises:

- "Small" enterprises have up to 20 employees and GEL 500,000 per year in annual turnover (revenues).
- "Medium" enterprises have up to 100 employees, and annual turnover not exceeding GEL 1.5 million.

Among these firms, almost all are considered small. There is little presence of medium-sized firms in the economy, and only about 10 percent of SMEs were considered to be medium-sized based on the legal definitions. *The small size of firms in Georgia limits prospects for export competitiveness and investment, although growth should provide*

[2] The State Statistical Department estimates this to be 26-35 percent of economic activity. A higher estimate of 67 percent is provided by the World Bank (see *Cost of Doing Business*, 2005). Other estimates are even higher, such as from several business associations and analysts in Georgia.
[3] Exemptions now seem to only apply to single individuals. See "Small entrepreneurs search for benefits", *The Messenger*, February 23, 2005.
[4] See "Law on the Support to Small and Medium Enterprises", 1999.

opportunities for employment generation on the condition that tax and regulatory processes are not burdensome.

2. Sector Profile

Based on SDS data, Georgia had more than 110,000 registered enterprises as of 2003, and an estimated 122,000 firms in 2004.[5] According to 2003 data, the vast majority of firms were active in trade (66,002) and manufacturing (11,204), the latter mainly low-level processing. Thus, these two sectors accounted for 70 percent of total registered firms in Georgia. In general, services accounted for about 86 percent of registered firms, most of these single person or very small-scale operations. Another 10,000 or so firms operate in transport and real estate. The following table highlights the number of firms by economic sector. The table shows steady growth in commercial trade, manufacturing, real estate and hotels/restaurants in recent years.

Table 1: Number of Registered Enterprises by Economic Sub-sector

	2000	2001	2002	2003
Agriculture (incl. forestry + fishing)	3,041	3,172	3,357	3,474
Mining/Quarrying	292	308	324	333
Manufacturing	9,632	10,011	10,540	11,204
Electricity/gas/water	401	449	476	486
Construction	2,497	2,660	2,744	2,820
Trade	35,938	42,649	55,194	66,002
Hotels/restaurants	2,263	2,356	2,659	2,932
Transport and communications	5,199	5,488	5,629	5,862
Financial intermediation	1,213	1,281	1,325	1,370
Real estate	3,734	3,948	4,062	4,280
Public administration/defense	1,570	1,596	1,615	1,686
Education	1,075	1,132	1,163	1,259
Health/social work	2,229	2,331	2,423	2,448
Other	4,893	5,428	5,738	6,240
TOTAL	73,977	82,809	97,249	110,396
Source: State Department for Statistics				

3. Firm-Level Profile

Taking a simple model of sub-sector contribution to GDP (output at basic prices) and dividing by numbers of firms and employees, the distribution indicates that agriculture and agro-processing have the highest output levels per enterprise. (The statistics do not include subsistence agriculture, which would clearly bring down these ratios.) However, as these are reported to be largely exempted from taxation, their figures are correspondingly reported to be more transparent. Output data for other sectors may be influenced by under-reporting given tax evasion and the prevalence of informal transactions. Interestingly, health and social work approximate the same values as construction companies, which raise doubts about the veracity of construction sector data.

[5] Published SDS data only provide for figures through 2003. See "Statistical Yearbook of Georgia—2004", Department for Statistics.

Industry stagnated from 2000-02, but appears to have increased in 2003, as did transport. However, overall, the average output levels confirm that most enterprises in Georgia record low levels of output, and fall well within the "small" designation for companies if these data are used as a proxy for average turnover. The average across all firms in 2003 was less than $60,000. *Such limited turnover with associated costs points to severe limitations on the borrowing capacity of most companies. Under such circumstances, cash flow is limited, and asset values are low. Thus, there is a limit to how much banks will be able to lend to such companies, whether secured or unsecured. Even with changes in the Tax Code and gradual increases in the formalization ("legalization") of enterprises' activities and reporting, scale will remain an issue for banks in terms of whether to lend, and amounts to lend.*

Table 2: Per Firm Output at Basic Prices by Economic Sub-sector

	2000	2001	2002	2003
Agriculture (incl. forestry + fishing)	$302,153.7	$313,842.1	$292,770.4	$345,021.5
Industry	$122,099.1	$125,097.8	$126,473.7	$139,445.9
Construction	$91,053.0	$97,290.3	$132,962.6	$190,912.1
Trade	$15,801.3	$14,014.0	$11,171.8	$11,409.1
Hotels/restaurants	$44,833.9	$58,459.0	$58,509.5	$56,632.5
Transport and communications	$117,139.3	$110,922.7	$122,196.6	$134,893.2
Financial intermediation	$56,401.7	$55,210.5	$57,608.3	$67,017.5
Real estate	$64,859.7	$64,253.2	$58,886.0	$65,996.5
Public administration/defense	$90,182.9	$102,369.5	$114,916.4	$117,079.1
Education	$119,140.7	$122,522.7	$128,015.4	$123,058.2
Health/social work	$185,090.3	$164,512.3	$161,159.9	$193,494.5
Other	$1,737.4	$1,085.8	$801.7	$708.1
TOTAL	$63,351.4	$59,913.2	$54,365.8	$57,321.3
Source: State Department for Statistics; author's calculations				

As for employee output per capita, the highest figures were in more capital-intensive sub-sectors, namely industries, construction, and transport and communications. Employees in these areas of the economy were responsible for $10,000-$20,000 per employee in 2003, well above the average of about $3,500.The lowest levels are in agriculture, education, public administration and trade. *This particularly points to the need for increased investment in machinery and equipment in the agricultural sector to boost output and labor productivity*.[6] Given that agriculture produces comparatively significant overall output per firm, most of these enterprises are presumed to be very labor-intensive. Other figures show that agricultural enterprises employed 287 people on average in 2003, as opposed to only 7-8 in the industrial and services sectors. *The industrial sector also experienced declining investment from 1998-2002,[7] and needs new capital investment to increase productivity*.

[6] Overall labor productivity increased 7.8 percent from 1998-2002, higher than most CIS countries. However, the labor growth rate actually declined, and in areas not receiving adequate investment, overall productivity remains low. For data and findings, see "Analysis of Recent Growth in Low-Income CIS Countries", IMF Working Paper 04/151, August, 2004.

[7] See "Analysis of Recent Growth in Low-Income CIS Countries", IMF Working Paper 04/151, August, 2004.

Table 3: Per Employee Output at Basic Prices by Economic Sub-sector

	2000	2001	2002	2003
Agriculture (incl. forestry + fishing)	$958.9	$1,005.0	$993.8	$1,203.9
Industry	$11,534.1	$13,154.8	$16,813.7	$18,880.2
Construction	$6,746.6	$7,331.2	$10,699.4	$13,425.7
Trade	$3,089.6	$3,293.0	$2,862.6	$3,793.6
Hotels/restaurants	$6,421.5	$8,608.1	$10,303.1	$10,002.8
Transport and communications	$8,055.7	$7,325.4	$8,784.7	$10,282.8
Financial intermediation	$7,201.6	$6,933.8	$9,913.1	$9,368.8
Real estate	$6,115.8	$6,554.8	$11,725.2	$8,745.1
Public administration/defense	$1,272.1	$1,547.2	$1,710.5	$2,159.7
Education	$1,066.4	$1,000.0	$1,147.9	$1,142.6
Health/social work	$4,594.3	$4,495.6	$6,159.2	$9,666.8
Other	$91.8	$65.3	$49.8	$78.2
TOTAL	$2,548.0	$2,642.2	$2,874.6	$3,533.1
Source: State Department for Statistics; author's calculations				

4. Ownership

As noted, based on SDS data, Georgia had about 110,000 registered enterprises as of year-end 2003. Most firms are "individual" enterprises, mainly small-scale trade, contracting or related activities. Other types of ownership and incorporation that prevail include limited liability companies, joint stock companies and other "commercial legal persons". Most firms that are large-scale or medium-sized are joint stock companies, while most of the small firms are limited liability companies. The following table highlights the number of firms by type of ownership.

Table 4: Firms by Type of Ownership or Incorporation

	2000	2001	2002	2003
Joint stock companies	1,424	1,619	1,755	1,791
Limited liability companies	24,051	26,609	29,404	32,128
Cooperatives	895	927	970	1,021
Other Commercial Legal Persons	2,140	2,201	2,256	2,340
Individual enterprises	35,142	39,804	51,417	58,191
Other	10,325	11,649	11,447	14,925
Total	73,977	82,809	97,249	110,396
Source: State Department for Statistics				

5. Governance/Management

Background reports indicate that most Georgian firms are very basic and fundamental in terms of governance standards and management structure. In the case of governance, few firms have outside ownership, and as such are not subjected to external scrutiny. In this regard, such external scrutiny is exercised by banks when lending to enterprises, in the form of regular reporting to determine if enterprise borrowers are adhering to loan covenants. However, as most Georgian firms do not have bank loans,[8] there is no real external scrutiny apart from that of the tax authorities (or other government "inspectors"). However, this is more related to revenue collection, and has little to do with competitiveness or productivity on the part of enterprises.

As such, *due to the lack of incentives, Georgian enterprises rarely have qualified, independent boards that exercise scrutiny over management*. Annual shareholder meetings, when held, are generally formalities to ratify decisions made by one or a handful of controlling interests. Modern financial management systems are uncommon. Internal audit is underdeveloped as an autonomous function within the company to report to the board on the effectiveness of internal controls and efficiency of operations. Other building blocks that would otherwise make it more feasible for enterprises to access loans and possibly go to the capital markets for additional financing (e.g., bonds, equities) do not exist.

Management tends to be concentrated, with most firms run by one person. With some of the larger and medium-sized companies, there is periodic evidence of management teams in which various specializations are present and combined to forge consensus on financial and operational decisions (e.g., wine sector). However, this is not usually the case, and one person is ordinarily responsible for most major decision-making. This is not uncommon around the globe, and many closely held, privately held, family-run, and small-scale businesses operate this way. On the other hand, it often means that such companies are less willing to cede control, and are very protective of information. As such, the behavior of most firms is often disinclined towards disclosure, resulting in insufficient information provided to financial institutions for them to decide on the credit worthiness of a firm. *This represents a business culture constraint in the system, and one that needs to be addressed for SMEs to increase access to bank loans and other sources of formal finance.*

B. Privatization and the Existing State Enterprise Sector

1. Overview

Georgia launched a privatization program in the mid-1990s. Apart from a few large privatizations in 1996-98 which culminated in comparatively high FDI for the period, most of the companies privatized were small or mid-sized, outmoded in terms of productive capacity, lacking in modern management and market links, and lacking the financial resources for effective turnaround. The approach taken by the authorities constituted a mix of auction sales, competitive tenders and other methods. However, there was very little effort or ability to attract strategic investment from abroad, given the condition and scale of the enterprises, limited market size, and degree of instability. As elsewhere in the CIS and many non-CIS transition economies, this often resulted in a transfer of ownership without meaningful restructuring in Georgia. In fairness, most of the enterprises privatized were very small, and would not have attracted external interest.

[8] An IFC survey of 792 companies indicates 70 percent never applied for a bank loan, and another 9 percent were rejected after applying. See "Potential Lease Market in Georgia", IFC, March 2004.

However, among the dozens of large- or medium-scale enterprises privatized each year (369 in total from 1997-2003), there was limited potential to attract strategic investment. As a result, many of the companies that were privatized are still unable to compete in the global (or even domestic) marketplace with newer, more efficient firms. Above all, they are unable to compete without new cash infusions and equity injections needed for new plant, equipment, technologies, systems, data and information, market linkages, and general quality control. Other factors include the small market, low levels of purchasing power, corruption, internal instability and political risk, all of which have made it difficult to attract needed investment. The absence of sovereign ratings has added to the challenge, particularly as international investors have turned away from many emerging markets in recent years. *The absence of investment likewise makes it more difficult for SMEs to identify potential buyers for their output (as regularly contracted suppliers), reducing the prospective market for them. This, in turn, reduces sales and cash flow generation prospects, making it more difficult to obtain formal financing.*

2. Sector Profile

A distribution of state vs. private companies shows that most firms are private. However, many of Georgia's largest companies remain state-owned, and a sizeable portion of formal employment is in the public sector (government plus state enterprises), although this is rapidly changing with privatization and civil service compression. State ownership remains prevalent in many of the key utilities sectors, as well as in telecommunications and transport (e.g., railways, airports). Utilities have been reported to operate as monopolies, resulting in poor service and high prices for SMEs. Otherwise, most of the economy is considered to be in private hands, although corruption has also made it possible for some privatized companies to engage in collusion, price-fixing, and other market-distorting practices that have constrained fair competition and SME growth.

3. Firm-Level Profile

As noted above, in terms of size, many of Georgia's state companies are among the country's largest, although there are also many large-scale private firms. The latter are usually privatized companies, rather than *de novo* firms that have grown since start-up. SMEs are generally private, although many remaining state-owned companies are small, and soon to be privatized as the government continues to accelerate the privatization campaign. Likewise, most intensive agricultural lands will be privatized in the coming months.

4. Ownership

As of year end 2004, about 1,800 enterprises remained state-owned, compared with an estimated 120,000 or so enterprises that are private. About half are considered shell companies, or companies in name only, the assets having been stripped or representing inactive parts of other companies that have since been privatized. Among the 800 or so active state enterprises are those engaged in "natural monopoly" activities, along with many small hotels and similar facilities. Meanwhile, many of the larger companies in Georgia are former state enterprises that have become joint stock companies.

5. Governance/Management

Governance practices and management systems at state firms have improved in some cases in recent years, largely due to recognition of the need to limit quasi-fiscal losses. These enterprises are mainly in the energy sector, and measures taken have included a tightening of expenditure, increased efforts to improve collection performance, and stricter reporting and performance monitoring. As a result, losses in electricity and gas have come down to about 4.5 percent of GDP in 2004, as compared with 6 percent in 2002. (However, actual dollar-denominated losses have actually increased, partly due to the need for capital expenditure to modernize operations, and the rising cost of power generation.) SMEs complain that energy and power supplies are unreliable, inspections are often cumbersome, and service levels are not satisfactory. Moreover, there is substantial diversion of power by illegal or illicit means, adding to inefficiency in the system. Recognizing the adverse effects on the economy and on households, the current government is planning to increase expenditure for more regular power and gas supplies. Other measures include improving management of the electricity company to strengthen its financial and operating condition, requiring customers to pay for service, punishing those engaged in diverting resources (to avoid making payments to service providers), and achieving better and more reliable service.

C. SME Access to Finance

1. Financial Institutions

As of year end 2004, Georgia had 19 licensed **banks**. *Total assets were about $950 million, or about 19 percent of GDP. As a penetration ratio, this is low by global standards, although fairly standard for the bottom half of the CIS and representative of a continuous increase. By contrast, bank assets to GDP averaged 16 percent in 2002-03, indicating that the system is growing*.

The system has been consolidating in recent years, with some banks able to merge and attract foreign investment, while others remain very small. The top six banks—TBC, Bank of Georgia, Cartu, ProCredit, United Georgian Bank, Republic—accounted for 83 percent of assets, 86 percent of loans, 85 percent of deposits, and 69 percent of capital. All of these banks had CAMEL ratings of "2" or better, with one exception. On the other hand, 14 banks had CAMEL ratings of "3" or less, reflecting weaknesses, of which three were fairly severe.[9] While all the banks met minimum capital requirements as of year end 2004, several of the lower rated banks are likely to face difficulties meeting the minimum

[9] In one of the cases, a foreign investor has recently been found to take over and restore the bank to soundness and stability.

capital requirements of about $6.5 million targeted for 2008.[10] This portends the likely merger, acquisition, re-licensing (possibly as a non-bank financial institution) or collapse of most of the smaller institutions.

On average, *the banks are relatively small, averaging $50 million in assets, $26 million in loans to enterprises and households, $27 million in real sector deposits[11], and $11 million in capital. While being small, these averages have increased in recent years as system assets have grown, and as the number of banks has steadily declined.*[12] For instance, banks now have more than two times the capital they had in 2001. Likewise, their loan figures to the enterprise and household sector, deposits from these segments, and general assets have all increased. Thus, banks are small, but growth trends have been favorable in recent years.

The small size of the banks limits their capacity to make loans above relatively low values on an individual project/loan basis, as well as collectively in terms of overall exposure to a borrowing entity. Banks also cite the limited availability of term funding, which shortens the maturities they can provide on loans. As most funding is in dollars, there is also only a small amount of funding available in GEL, although this is not perceived to be a major constraint due to the predominance of dollars and ready convertibility into GEL as needed. On the other hand, it does introduce exchange rate risk, for which counterparties are generally unprepared in the event of a shock (as occurred in 1998 with the ruble crisis). Key figures and ratios include:

- *Assets*: Total assets were $948 million at year end 2004, an increase of 47 percent from 2003 ($644 million). The five largest banks (TBC, Bank of Georgia, Cartu, ProCredit, United Georgian, Republic) accounted for about 83 percent of banking system assets, reflecting reasonable concentration in the system. Claims on (loans to) enterprises and households accounted for about 52 percent of total assets at year end 2004. Cash and related holdings were about 30 percent of assets, mainly reserves. Thus, banks' balance sheets are fairly straightforward on the asset side, with little value reported in terms of credit to government or other banks, securities markets, real estate investments, or other exposures that would reflect a more developed and complex system.

- *Liabilities*: Total liabilities were $744 million in 2004. Deposits accounted for about 57 percent of total funding (liabilities and equity), of which the largest proportion was from households (demand plus term deposits). Enterprise *term* deposits were only 7 percent of total deposits, although this does not account for enterprise demand deposits which likely accounted for another 7 percent of total. (The relatively low level of enterprise deposits, at about 14 percent of total, is

[10] Minimum capital requirements will increase from about $2.7 million (GEL 5 million) to $6.5 million-equivalent by year end 2008 (with increases of GEL 1.4 million each year from 2004-08, bringing the minimum requirement from GEL 5 million to GEL 12 million).
[11] Demand deposits plus term deposits from enterprises and households.
[12] There were 101 banks in 1995. This number declined to 42 by 1998 when the GEL depreciated due to the ruble crisis. Since then, NBG has raised minimum capital, and a net 23 banks have closed or been consolidated with other banks.

both cause and effect with regard to access to credit. There are also term structure issues, and asset-liability management issues that prevent banks from making loans much beyond 18 months.) Other liabilities are minor, although banks' liabilities do show about 17 percent in borrowed funds from other sources, a figure that has increased slightly in recent years. These borrowings are mainly from donors. Georgian banks are not active in the international syndicated loan market, partly due to the absence of ratings at the sovereign as well as institutional level.[13]

- *Capital*: Equity capital was $205 million at year end 2004. This accounts for about 22 percent of total balance sheet funding. This is a reasonably high capital-to-asset ratio, although it has come down in recent years. Given that capital has increased, the trend suggests that asset growth is exceeding capital growth as banks lend more to strengthen earnings. The latter trend is partly driven by the declining interest rate environment and limited volume of government securities, prompting the banks to lend for increased earnings. Among the banks, only eight had capital in excess of GEL 10 million (about $5 million) as of year end 2004.

[13] Anecdotally, KfW offered a 90 percent guarantee on such loans, but there was no reported interest from international banks. TBC had a CCC rating, and this was raised to CCC+ by Fitch Ratings. Bank of Georgia also has a CCC+ rating, and ProCredit received a CCC+ rating from Fitch Ratings in September 2004. This is considered sub-investment grade, mainly due to the country environment.

The following table profiles basic bank balance sheet indicators since 2002.

Table 5: Summary Banking System Balance Sheet

($ millions)	**2002**	**2003**	**2004**
ASSETS			
Cash	$160.2	$187.7	$286.8
Securities	$15.7	$20.2	$36.4
Claims on Government	$3.2	$6.0	$0.1
Claims on Enterprises and Households	**$292.7**	**$362.6**	**$511.8**
Claims on Banks	$5.3	$10.2	$18.2
less Loan Loss Reserves	-$19.7	-$26.3	-$35.6
Accrued Interest/Dividends	$7.2	$7.8	$9.2
Equity Investments	$5.9	$5.8	$18.9
Fixed Assets	$45.4	$51.6	$67.0
Other	$18.3	$18.4	$35.3
Total Assets	**$534.2**	**$644.0**	**$948.3**
Avg. Net Real Sector Loans/Bank	**$11.1**	**$15.1**	**$26.0**
Avg. Assets/Bank	**$21.4**	**$28.0**	**$49.9**
LIABILITIES AND EQUITY			
Bank Deposits	$16.5	$8.2	$6.4
Demand Deposits	**$113.2**	**$146.5**	**$287.7**
Enterprise Term Deposits	**$28.5**	**$28.6**	**$35.9**
Household Term Deposits	**$97.7**	**$138.4**	**$197.3**
Government Deposits	$35.5	$32.2	$12.7
Accrued Interest/Dividends Payable	$3.6	$4.9	$6.5
Borrowed Funds	**$79.8**	**$102.4**	**$163.7**
Other Liabilities (*)	$8.3	$12.4	$33.4
Total Liabilities	$383.1	$473.6	$743.7
Equity Capital	**$151.1**	**$170.5**	**$204.7**
Total Liabilities and Capital	$534.2	$644.0	$948.3
Avg. Real Sector Deposits/Bank	**$9.6**	**$13.6**	**$27.4**
Avg. Capital/Bank	**$6.0**	**$7.4**	**$10.8**
Notes: (*) Small residual in "other liabilities" in 2004			
Source: NBG data; author's calculations			

In general, *banks' earnings are poor, with returns on average assets and equity less than 1 percent*. Data from NBG in 2003-04 indicate that the average for banks' total after-tax earnings were only $1 million in 2003 and $0.8 million in 2004. One of the six largest banks showed after-tax losses, along with four other smaller banks. The largest profit of any bank was only about $8 million, an exceedingly low figure by international standards. Yet this was 56 percent of total after-tax earnings for the system as a whole in 2004. Thus, earnings opportunities are constrained in Georgia.

Total interest earnings were $81 million in 2004, only $4 million per bank. Non-interest income from commissions/fees, currency conversions and related activities was also modest, at $63 million (about $3 million per bank), although this was an increase from 2003. The major reason for low and declining earnings in 2004 relates to non-interest expenses, which were reportedly due to the higher costs of loan administration and rising salaries. All in all, banks' earnings are poor, which also limits the amount of earnings that can be retained to boost capital for expanded operations. The following table highlights the weak income statement of the banking system.

Table 6: Banking System Earnings in 2003-04

($ thousands)	**2003**	**2004**
Interest Income	$73,489	$81,040
Non-interest Income	$43,441	$63,127
Interest Expense	$19,526	$22,474
Non-interest Expense	$60,172	$84,689
Provisions	$9,996	$18,518
Pre-tax Profit	$27,237	$18,485
Taxes	$4,158	$4,123
After-tax Profit	$23,079	$14,362
Average Earnings per Bank (thousands of US$)	$1,003.4	$755.9
Y-o-Y Growth of Average Earnings	n/a	-24.7%
Return on Avg. Assets	0.17%	0.09%
Return on Avg. Equity	0.62%	0.40%
Source: NBG data; author's calculations		

The 19 banks have a total of 164 branches. These are generally concentrated in Tblisi, although most of the major secondary towns have several banks that are operating as well. The branch network declined in 2004 with the closure of four banks. ATMs exist as well throughout the country, but primarily in the capital.

There is little activity apart from the banks in terms of meaningful financial data, reflecting underdevelopment of the non-bank financial sector.

- Georgia had 53 non-bank depository institutions, mainly **credit unions**. These credit cooperatives are much smaller on average than banks, and generally finance agricultural cooperatives or isolated farming communities. Total assets[14] were only $862,637 as of October 1, 2004, or about $16,277 per credit union. (The Credit Union Development Center reported higher figures for 55 credit unions at year end 2004, although these had not yet been posted by the NBG.[15]) Loans are generally very small (less than $600 on average, with maturities of nine to 12 months), and capital is low as well given that minimum capital requirements have only been GEL 50 per member (about $25). (Reported capital was only about $58,242, or $1,099 per credit union.) However, NBG anticipates credit unions playing a larger role in the future, and is encouraging consolidation so that surviving credit unions can operate from a stronger financial position. According to the Credit Union Development Center, there were 5,652 members across 55 credit unions, of which 1,855 were borrowers.

[14] General data on assets and capital are from NBG, as quoted in *Georgian Business Week*, February 21, 2005.
[15] These figures included total assets of GEL 2.2 million ($1.2 million), of which loans were nearly GEL 2.0 million ($1.1 million), with the balance mainly cash and due from banks.

- There are 11 **micro-finance institutions** in Georgia. Total loan volume was about $14.3 million as of year end 2004. Four MFIs—FINCA, Constanta, World Vision and GRDF—accounted for 78 percent of total loan portfolio exposure. Most loans are small, and the average per borrower approximated $420. Micro-finance institutions reported 33,985 clients in very early 2005. Averages for the four major MFIs range from $250 to $2,436. The other seven generally show average loan size of about $400-$500.

- Georgia now has two **leasing** companies. This is a relatively new market, with two banks (TBC, and Tbiluniversal, which was recently acquired by Bank of Georgia) owning the leasing companies—TBC Leasing and Georgia Leasing. According to IFC, total lease contracts approximated $3 million as of early 2005, with the average contract valued at $32,000 and average maturities of about 35-40 months. Leasing is for diverse purposes, including agricultural equipment, industrial equipment, vehicles and other equipment needs. The IFC survey conducted in 2004 estimated leasing demand at $15-$23 million, with more than 60 percent of firms planning to purchase additional machinery, equipment or other fixed assets.[16] Demand is reportedly high among manufacturers, the power sector, in construction, and health and social work. However, *leasing companies face financing constraints, and are currently unable to meet equipment purchase needs in the market*. Basic options for them include long-term borrowings from banks in Georgia and from abroad, corporate bond issues, and equity issues. Leasing companies could also pay the fees for derivative instruments to cover any exchange rate, interest rate or pricing risks, although they would need to manage the credit risk themselves. Many of these options are currently unavailable due to the absence of ratings (precluding syndicated loans from abroad), inactive bond and equities market, and unavailability of hedging mechanisms for market risk.

- There are 412 **exchange bureaus** in Georgia, making it fairly easy to convert GEL, dollars and rubles. This number increased significantly in 2004, from only 325 in 2003. The presence of Western Union in many banks also facilitates remittance transfers, although banks are the only institutions that can participate in the payment system.

- The **postal system** is not widely used for financial services. There was a Post Bank, but it was closed down. To the extent that the postal system does have a role, it is mainly for small pension and disability payments in remote areas where other financial institutions do not have agencies or offices.

- Georgia has only 14 **insurance** companies, down from 22 in 2003. The insurance sector remains small, with premium revenues of only about $18 million (GEL 38.4 million) in 2003. Four companies accounted for about 69 percent of the market. The four main classes of insurance underwritten were property, medical, civil liability and land vehicles, accounting for 64 percent of premium revenues.

[16] See "Potential Lease Market in Georgia", IFC, 2004.

Compulsory insurance includes third party motor vehicle and fire insurance, which accounted for less than 14 percent of total in 2003.

- Georgia has three **pension funds**, although reported assets are miniscule. There has been no real movement to a second and/or third pillar system. There are insurance companies interested in playing a role in a reformed pension system, be it second pillar, occupational or otherwise. Nonetheless, pension reform is only at its nascent stages as of early 2005. As such, pension funds are many years away from playing a meaningful role as institutional investors in Georgia.

- The **Georgian stock market** is inactive due to the unwillingness or inability of firms to divulge needed information to make markets, as well as for prospective purchasers to come forward to make securities purchases in the open. The latter would require large buyers to declare income and assets, exposing them to tax payments. The absence of institutional investors also stymies market development. (The 14 insurance companies are restricted in their investments to Government securities, and up to 20 percent of assets in OECD banks that have received investment-grade ratings. These companies are all too small to have an investment impact in the Georgian capital markets, and restricted by law from investing in equities. Likewise, even in pension funds had sizeable assets, they, too, would have restrictions on equity investment.) General indicators show that government securities are generally held when purchased, and not traded in the markets. Most equities are traded off-market when traded. There is only one listed stock (Bank of Georgia).

2. Financing Supplied

At year end 2004, total *loans* by banks to the economy, namely to households, enterprises and other banks, approximated $530 million on a gross basis, and $494 million on a net basis after subtracting loan loss reserves. Given that other non-bank credit institutions had less than $20 million in outstanding credit as of year end 2004, banks are the main source of formal lending in the system. Bank lending is summarized below.

- *Sector Distribution*: Most lending by banks is to the commercial trade sector, accounting for 43 percent as of year end 2004. A range of industries received 28 percent of bank loans.[17] Construction, hotels and restaurants, financial intermediation (loans to banks and other financial sector entities), and other services account for most of the balance. The data also show that there is very little exposure to transport and communications (less than 3 percent), agriculture or real estate (less than 2 percent), or public services (less than 1 percent). However, with regard to "real estate", 32.5 percent of loans were collateralized by real estate as of September 30, 2004. (This would approximate $170-$175 million in value against year-end 2004 data for gross loan values.)

[17] This includes manufacturing and mining.

- *Ownership Distribution*: As of year-end 2004, banks had virtually no loan exposures to the state sector. Net loan exposures to state enterprises were only $144,000. Thus, virtually all lending in Georgia is now to private sector firms and households. (Banks also hold limited amounts of government securities. In general, banks' exposure to the government is low.)

- *Enterprise Distribution*: Bank loan data specific to SMEs are not comprehensively recorded. At a minimum, dedicated bank loans from non-resident (donor) sources accounted for $46 million at year end 2004, or about 9 percent of net loans. However, the figure is higher as banks have also provided some loans to SMEs from their own mobilized resources (mainly from deposits). Likewise, loans to households now account for about 31 percent of total loans, and these are sometimes for productive purposes (small businesses) as opposed to pure consumption. As for the dedicated SME loans provided, almost all are in the services (construction, trade and other services like hotels, restaurants, transportation, etc.). Very little is utilized for agriculture ($2.3 million), industry (zero beginning 2005) or fixed asset purchases (only $3.4 million outstanding as of year end 2004). Loans for industry may have been too expensive for borrowers, although this is not the only explanation. Fixed asset purchases have consistently had lower interest rates than for loans financing services, yet loans for construction and other services are more widely used than are loans for fixed asset purchases.

- *Loan Maturities*: NBG data indicate that long-term loans actually accounted for 58 percent of total loans as of year end 2004, and 64 percent of loans to resident legal entities. For enterprises and households, the shift in maturities represents a substantial increase in long-term loans (greater than one-year maturities) from about 35 percent of total at the beginning of 2003. This suggests that long-term loans are more accessible for enterprises now than they were two years ago, and that increased borrowings by banks may be filling the gap in funding shortages. Likewise, increases in term deposits have also provided banks with more resources to match fund loans on an extended maturity basis. Long-term loans are primarily made available to commercial trade ($101 million) and industry ($62 million), the former reflecting increasing sales of appliances, cars and other consumer items. Households likewise have benefited, obtaining more than $64 million in long-term loans, slightly higher than Georgian industrial enterprises. (Interestingly, donor credit for SME development has stagnated in dollar terms and declined in GEL terms since the beginning of 2003. Thus, donor programs do not appear responsible for the increase in long-term funding by banks.[18]) Long-term loans have also been reported for housing, and many construction-related exposures and other loans have been collateralized with real estate. However, there is also a catch, as most long-term loans are barely for longer than one year. Moreover, there is some industrial concentration in bank lending to the larger enterprise sector, meaning that *SMEs have little access to long-term credit. Much*

[18] NBG data indicate that SME credit from non-resident sources was GEL 96.7 million ($46.3 million) on January 1, 2003, and GEL 82.8 million ($45.5 million) on January 1, 2005.

of this problem stems from the limited amount of deposits with terms exceeding one year, pushing banks to keep the maturities of their loans relatively short (up to 18 months) for asset-liability management purposes. However, this also points to a shortcoming of the banks, namely the inability or unwillingness to manage maturity mismatches, which are fairly common in developed markets.

- *Fixed-Variable (Pricing) Mismatches and Liquidity Issues*: Banks are reported to lend primarily at fixed rates, while paying out interest on deposits at variable rates. Under current circumstances, this is beneficial to the banks, given the declining interest rate environment. However, the reverse could also occur, which would result in an unfavorable turn for net interest margins. Likewise, as 55 percent of real sector deposits are demand deposits[19] and could be withdrawn on short notice, banks need to manage their liquidity for such potential risks. All of these risks actually drive up costs of loans for SMEs.

- *Currency Denomination*: Most loans are in foreign currency, accounting for 84.4 percent (or more[20]) of total. This is consistent with general dollarization trends in the economy, and very closely match the 73 percent of deposits that are foreign currency-denominated in value ($437 million in foreign currency-denominated loans, and $394 million in foreign currency-denominated deposits). However, this puts the onus on companies to manage their foreign exchange risk, and there is little capacity to do so apart from hedging via dollarization.

- *Interest Rates*: In 2004, the effective interest income on average for the banks on loans was 16 percent,[21] not too different from interest rates reported by NBG for loans to legal entities. In this regard, *loans to individuals and households were higher, at nearly 24 percent,[22] and may include most SMEs. If so, this explains the complaints about high interest charges*, particularly when GEL loans are needed. On the other hand, 16 percent is not extremely high in risky environments like that in Georgia, which is just slightly lower than rates charged to legal entities. Thus, larger enterprises appear able to access credit at somewhat affordable rates (16.5 percent in foreign currency or less as the interest rate environment improves for borrowers), and banks are able to access inter-bank loans at lower rates.[23]

- *Collateral*: Banks are accused of "over-collateralizing" their loans, usually with assets valued at two to three times loan value. However, this is largely due to the risks associated with credit exposures in Georgia, given the weak framework for secured transactions.

[19] The figure is about 53 percent when adding bank and government deposits to the denominator, although most of these could also be withdrawn on short notice.
[20] Differing data sheets show differing distributions. Nonetheless, at least 84 percent of loans are in foreign currency.
[21] Interest income on loans to banks, households and enterprises in 2004 (at $72.3 million) effectively averaged 16 percent for the banks relative to *average* loans made to these entities in 2003-04.
[22] GEL loans were 29.5 percent to individuals, and foreign currency loans were 22.5 percent.
[23] Different from legal entities and individuals/households, banks were able to borrow GEL at lower interest rates than prevailed in foreign currency.

A stock analysis of household and enterprise credit indicates that *banks provide about $3,000-$3,500 on average per registered enterprise in Georgia, although this likely increased to about $4,000 in 2004 given increases in total lending to enterprises*. Data that disaggregate SMEs from other (mainly large-scale) enterprises were not available. As such, it is not possible under such data constraints to quantify exact averages. Nonetheless, the larger the firm, the more likely the prospect for obtaining a loan from a bank, particularly if there are close personal relationships involved. Thus, SMEs tend to have smaller loans if they have loans at all. In general, these figures are very small, and amount to financing sufficient only for modest working capital requirements. Since not all SMEs have access to loans, it is clear that actual loans made by banks are often larger than these averages, and thus are sufficient for some SME needs. However, even a rough estimate of credit to enterprises (medium-sized) and households (small-scale) based on value of actual loans outstanding and number of registered firms suggests that average SME loans are for less than $3,000 in size. These would suffice for small inventories, but not for the purchase of needed equipment and machinery to raise productivity levels.

Table 7: Estimate of Average Loans per Registered Enterprise

	2000	2001	2002	2003	2004
Number of Registered Enterprises (*)	73,977	82,809	97,249	110,396	122,000
Avg. Loan Exposure/Registered Enterprise (**)	$3,059	$3,057	$3,159	$3,418	$4,347
Avg. Loan Exposure/Registered Enterprise (***)			$3,010	$3,285	$4,195
Notes: (*) 2004 data assume 122,000 registered enterprises; (**) IFS credit data; (***) NBG credit data					
Source: State Department for Statistics, NBG, IFS, author's calculations					

A broad flow of credit analysis also shows that incremental (net) loans to the enterprise sector were only $244 million from 1999-2003, for a yearly average increase of only $49 million. However, the increment was $153 million in 2004, reflecting a sharper increase than in previous years. Since 1999, per enterprise averages have increased by the hundreds of dollars each year from 1999-2003, and by about $1,300 in 2004. Thus, *while trends are favorable, it still appears that enterprises are only accessing minimal increases in loans on average. Given that these are averages, most small enterprises are likely not receiving loans at all (if they have not applied), or are receiving only small amounts when they do obtain loans*.

Table 8: Estimate of Increases in Average Loan Size per Registered Enterprise

	2000	2001	2002	2003	2004
Net +/- in Enterprise Loans ($ millions)	$50	$27	$54	$70	$153
Y-o-Y Growth of Bank Lending to Enterprises	31.56%	16.65%	23.15%	21.94%	23.28%
Avg. Net Increase/Avg. # Registered Enterprises	$727.4	$341.8	$601.1	$675.4	$1,317.0
Notes: 2004 data assume 122,000 enterprises; average number of enterprises taken from previous and current year end figures and divided by two					
Source: State Department for Statistics, NBG, IFS, author's calculations					

Net of banks, there is little available credit. Microfinance groups had about $14 million in loans on their books as of year end 2004. Credit cooperatives had loan exposures of about $1 million at year-end 2004. Leasing companies only had $3 million in lease contracts as of early 2005. Thus, these sources combined only had exposures equivalent to about 3-4 percent of loans made by banks.

Banks do offer guarantees, trade finance facilities, and other off-balance sheet financing tools. However, these are regulated by NBG. In general, they are presumed to have been kept in check to avoid financial instability based on excessive build-up of contingent liabilities. However, some of the banks are reported to have large off-balance sheet items relative to capital. As these are not unused lines of credit, there may be some risks associated with these items that would weaken the solvency of certain banks in the event of unforeseen developments. Programs to provide trade finance, risk insurance, and related enhancements have been in place with donor support (see below). However, these facilities have not been widely utilized.

Apart from internal sources and savings, most firms do not have meaningful levels of equity. The GSE has not been used for IPOs, and it is still awaiting flotation of its first corporate bond. Key problems for SMEs in accessing capital from these markets relate to perceptions of complexity and cost (prospectus, due diligence, etc.), the need for a comprehensive financial audit according to international standards of auditing, and general lack of activity in the markets due to lack of trust, problems of tax evasion, etc. The presence of insurance companies and pension funds may help in the long run with institutional investment. However, for now, these institutions are restricted to safe investments in their investment policies, precluding equity investments in Georgia. Moreover, even with some relaxation of investment policy restrictions in the future, their fiduciary responsibilities would require them to subject enterprises seeking equity investment or the purchase of corporate bonds to greater scrutiny than most firms are willing to accept. As such, contractual savings institutions in Georgia are more likely to invest in government securities for the foreseeable future, and to place funds abroad in investment grade banks.

Because formal sources of financing have been difficult to access, most SMEs (and other enterprises) rely on "informal" or personal sources of financing to run their enterprises. Based on 2002 data,[24] about 60 percent of working capital and 75 percent of investment capital is derived from internal funds and retained earnings, loans from family and friends, and other informal sources. (High as this is, it is lower than CIS averages, which put working capital and investment capital at 79 percent and 83 percent, respectively, from these sources.) However, funding for machinery and equipment is often externally financed, or at least partly financed from external sources.[25]

[24] From *Business Environment and Enterprise Survey II*, World Bank and EBRD.
[25] See "Potential Lease Market in Georgia", IFC, 2004.

D. Macroeconomic Factors and Indicators

1. General

Georgia's macroeconomic indicators are fairly stable, although they also point to a small economy in the aggregate. Real GDP growth has been 7.5 percent on average from 2001-04. However, per capita incomes were only about $1,000 (2004), and half the population lives in poverty, with about a quarter living in extreme poverty.

Inflation rates have been largely stabilized by prudent NBG policy focused on price stability. The medium-term outlook is that average CPI will fall below 5 percent in 2005 and then stabilize at 4 percent from 2006-08. The exchange rate has fluctuated a bit in recent years, but shown appreciation against the dollar in nominal terms and real terms since 2003. In either case, exchange rate swings have been fairly gradual since the effects of the 1998 ruble crisis settled, and monetary policy continues to operate as a managed float regime to maintain relatively stable exchange rates.

Fiscal deficits are modest and easily financed. While banks' holdings of government securities have increased, these have been modest in value relative to lending increases to the real sector. As such, fiscal deficits and government borrowings have not adversely affected SME access to credit. However, other issues related to scarce funds (notwithstanding increases in recent years from a small base) in the banking system have made loans costly for enterprises.

The balance of payments reveal relatively high current account deficits, but these are largely driven by pipeline-related imports. Deficits have been partly mitigated by rising remittance flows and other current transfers, as well as by some increases in foreign direct investment. Georgia's debt profile remains modest in principal and interest, and thus does not impose any serious debt servicing burdens on the private sector. Combined external and domestic debt (that is publicly-guaranteed) was equivalent to 48 percent of GDP at year end 2004, with projections of decline from 2005 on. However, the quantum of exported goods and services is fairly limited, reflecting problems of export competitiveness. (For instance, Georgia's exports are lower as a share of GDP than in Armenia, Azerbaijan, the Kyrgyz Republic, Moldova, Tajikistan and Uzbekistan.[26]) On the other hand, exports have increased, including in 2004, and there is cautious optimism that Georgia's agro-processing, scrap metal, transit trade and tourism sectors can sustain rising levels of foreign exchange generation.

2. Monetary Policy and Credit Patterns

The NBG is focused on price stability to ensure a low inflation environment. As such, the inflation rate has stabilized significantly since the tumultuous days when the transition to a market economy began. Average annual CPI approximated 163 percent in 1995 and 39 percent in 1996, settling to single digit rates from 1997 on apart from 1999 (19 percent),

[26] See "Analysis of Recent Growth in Low-Income CIS Countries", IMF Working Paper 04/151, August 2004.

when the effects of GEL depreciation were felt following the ruble crisis of 1998. Since 2000, CPI has been less than 6 percent, with the 2004 rate of 5.8 percent the highest since 1999. This was partly due to higher energy costs resulting from rising oil and gas prices in global markets. Current projections are that the inflation rate will decline to 4.8 percent in 2005, and then stabilize at 4 percent from 2006-08.[27]

While the inflation rate has come down, the level of financial intermediation in the economy remains low. This is typical of the Caucasus and other CIS countries, and has traditionally reflected a number of factors: low levels of trust and confidence in the banks; reluctance to place deposits in banks due to concerns about potential violation of account privacy; cash needs for daily or current transactions; lack of perceived benefit of placing funds in the banks, etc. While this applies less to households, the perception still appears to apply to enterprises, which accounted for only about $60 million in deposits (about 15 percent of total deposits) as of year end 2004.

However, conditions are improving for households, the major source of deposits for the banks. In 2004 alone, deposits grew by 53 percent, or $186 million. Households accounted for almost all of the increase.[28] Households are also now obtaining more loans than in past years, reflecting a symbiotic relationship that should benefit SMEs, or at least very small enterprises, over time (if they are willing to put their funds in the banks).

Based on 2004 data, the broad money-to-GDP ratio was 13.8 percent. In one sense, the trend is favorable, as it has risen since 1999 and is projected to rise again to 15.1 percent in 2005. On the other hand, it places Georgia at the low end of the chart in terms of other transition countries, with only a few CIS countries having lower ratios.

One of the challenges for the banks is how to manage deposits attracted. Many of the banks claim they are unable to lend to SMEs because the latter are unable to comply with banks' underwriting standards, which have become tougher in recent years as the NBG has enforced prudential norms. This has also kept real interest rates paid on deposits (nominal interest rates less the inflation rate) very low, further reducing incentives to enterprises to place funds with the banks.

Meanwhile, the relative scarcity of funding in the banking system (until 2004) and risks associated with lending to the enterprise sector have kept risk premiums fairly high. Although the inflation rate has come down, and with it interest rates on bank deposits and loans, banks' loan interest rates remain high on a real basis, at about 10-20 percent (depending on the client). Individuals have particularly high interest rates on their loans, with consumer credit rates being nearly 27 percent for short-term loans at the beginning of 2005, although they were 19 percent on long-term loans (mainly for housing). This is largely a consequence of the weak legal environment for creditors. Such weaknesses have

[27] See IMF Country Report No. 05/1, January 2005.

[28] Demand deposits are not broken out by household and non-household. However, of the $66.2 million increase in household and enterprise term deposits in 2004, households accounted for $58.9 million. Meanwhile, bank and government deposits decreased. Thus, almost all of the increase in 2004 was due to households.

added to the risk premium, pushing up loan interest rates. This makes access to finance more costly for SMEs. The following table highlights basic monetary and credit trends.

Table 9: Intermediation and Interest Rate Indicators

	2000	2001	2002	2003	2004
Average CPI	4.10%	4.68%	5.55%	4.80%	5.80%
Money and Quasi-Money/GDP	10.36%	11.12%	11.60%	12.38%	13.80%
Nominal Interest Rates on Loans (*)	35.87%	31.25%	29.68%	28.19%	18.82%
Nominal Interest on Loans less Inflation (*)	31.77%	26.57%	24.13%	23.39%	11.27%
Nominal Net Spreads (**)	24.21%	21.33%	19.52%	18.99%	13.02%
Notes: (*) Preliminary calculations based on a mix of nominal interest rates and consistent with GEL and foreign currency loan distributions; (**) Calculations based on net loan-deposit spreads consistent with distribution of GEL and foreign currency loans and deposits. NBG average weighted interest rates tend to be lower than those from the IMF. NBG data used for interest rates and spreads in 2004.					
Sources: IMF and NBG data; author's calculations					

3. Fiscal Deficits and Domestic Borrowing Trends

As elsewhere in the CIS, Georgia's fiscal weakness has traditionally been with revenue collection. This is a circular proposition, as the public has avoided making tax payments due to a lack of trust and confidence in government institutions. At the same time, it has been harder for government institutions to provide meaningful expenditure and services in the absence of adequate revenue flows. This is beginning to change on both fronts, as collections improved in 2004 and supplemental budgets were introduced to help rectify problems derived from earlier suppression of expenditure. This includes faster progress on wage and pension arrears, and increased expenditure on energy needs.

Georgia's fiscal data show that deficits have been brought under control since 2000, partly by keeping expenditure at about 10 percent of total fiscal costs from 2000-04. In 1999, the cash balance fiscal deficit was 5 percent of GDP[29], depending on the measure used. This was equivalent to $140 million in deficit financing needs, almost all of it from borrowings domestically and externally as privatization proceeds were only $25 million. The deficit-to-GDP ratio declined in 2000, to 2.6 percent, and has since continued to fall to a projected 1.8 percent cash balance deficit in 2004. This would bring actual deficit financing needs to $88 million, which is roughly the average projected from 2005-08.

In general, the deficits have been financed primarily from net external borrowings. Cumulative deficits from 2000-04 approximated $355 million, with 56.5 percent of financing coming from external borrowings and another 21.1 percent coming from privatization proceeds. This means that domestic borrowings have not materially diverted potential lending flows from banks to enterprises. In fact, domestic debt declined in 2004, and lending by banks has increased far more than purchases of government securities.

On the other hand, while domestic borrowings in 2000-04 amounted to only $79.5 million in total, almost all of which was in 2000, the banks have shown an increasing

[29] Commitment balance basis showed a 6.6 percent fiscal deficit relative to GDP.

willingness to hold government securities. Banking sector data reveal that their purchase of government securities accounted for only $3 million in 2000, yet has increased steadily since. As such, their stock of government securities purchases has increased their share of total deficit financing. This is partly to recapitalize balance sheets with perceived minimal risk, and partly to generate earnings without assuming the degree of risk taken on other lending activities. Meanwhile, as NBG has pressured banks to reduce bad loans, as evidenced by steadily declining non-performing loan ratios,[30] this has encouraged banks to increase their holdings of government securities. However, banks have actually increased their lending far more than their purchases of government securities, so bank financing of fiscal deficits should not be overstated as a cause of difficulty for SMEs with regard to access to finance. The following table highlights key fiscal and deficit financing data.

Table 10: Fiscal Deficits and Financing, and Banks' Holdings of Government Securities

	2000	2001	2002	2003	2004
Fiscal Deficits/GDP (*)	-2.6%	-1.6%	-1.9%	-1.3%	-1.8%
Fiscal Deficits ($ millions)	-$79.1	-$51.3	-$64.4	-$51.8	-$87.8
Deficit Financing from:					
Privatization Proceeds	$9.1	$3.2	$6.8	$12.0	$43.9
Domestic Borrowings	$66.9	-$12.8	-$3.4	$23.9	$4.9
External (net) Borrowings (**)	$0.0	$60.9	$61.1	$39.8	$39.0
Banks' Financing of Fiscal Deficits:					
Banks' Claims on Governments (***)	$2.9	$8.3	$17.7	$25.6	
Banks' Financing/Fiscal Deficit	3.65%	16.08%	27.39%	49.41%	
Notes: (*) Cash balance data; (**) Imbalance in deficit and financing due to inclusion of debt relief in financing figures; (***) State and local government claims					
Sources: IMF and NBG data; author's calculations					

4. Exchange Rates, Dollarization and Reserves

NBG has long focused on maintaining a stable GEL exchange rate with the US dollar. However, as experienced in 1998 after three straight years in which the exchange rate was stable, the authorities have come to learn that the economy needs to be competitive for the underlying stability of the currency to be preserved. Exposure to the ruble and trade with Russia during its difficulties in 1998 triggered the deteriorating value of the GEL in 1998. Since then, NBG policy has been to permit the GEL to fluctuate relative to the US dollar. The average GEL exchange rate declined to as low as 2.2 to the dollar in 2002, but has since begun to rebound (as have most other currencies around the globe). The average approximated 2.15 in 2003, 2.04 in 2004, and is roughly projected to

[30] Some in the market believe NPL ratios are understated in NBG data, and that loan portfolios are weaker in quality than stated.

average 1.85-1.9 from 2005-08.[31] By end 2004, the GEL had appreciated 15.4 percent against the dollar on a nominal basis, and 9.8 percent in real terms since end 2003.[32]

There is increasing evidence of confidence in the GEL, as the rate of dollarization decreased substantially in 2004. However, dollarization of the economy remains in effect, with 73 percent of deposits in foreign currency (down from 86 percent at year end 2003), most of it dollars. Some of this has to do with the substantial influx of dollars associated with oil and gas pipeline development. However, as remittance flows are considered largely to be in dollars, the proportion of foreign currency in the economy would likely still be high even without such major investment.

Gross international reserves increased in 2001-04 from 2000 levels, with a significant increase in 2004 (partly related to dollar inflows related to oil and gas pipeline investment). This has translated into gross reserves approximating 5-8 percent of GDP, but only about 1.5-2 months' imports of non-pipeline imports. As such, while reserves are fairly stable, they provide limited import cover.

Table 11: Exchange Rates, Dollarization Ratios, and Gross International Reserves

	2000	2001	2002	2003	2004
Average GEL:US$ Exchange Rates	1.98	2.07	2.20	2.15	1.92
Foreign Currency Loans/Total Loans (*)	81.4%	81.4%	83.8%	87.7%	86.7%
Foreign Currency Deposits/Total Deposits (**)			84.9%	86.1%	72.9%
Gross International Reserves ($ millions)	$109	$161	$198	$191	$380
Gross International Reserves/GDP	3.6%	5.0%	5.8%	4.8%	7.8%
Gross Int'l Reserves Months' Import Cover (***)	1.0	1.4	1.8	1.5	>1.9

Notes: (*) 2004 data from September; (**) Figures from year end; (***) Gross International Reserve months' cover for non-pipeline imports estimated at 1.9 months based on a $320 million figure; if imports were unchanged from original calculations, this would bring cover to about 2.2 months

Sources: IMF and NBG data; author's calculations

5. Balance of Payments and Debt Servicing

Georgia's current account deficit has continued to grow in recent years, with a particularly strong increase in imported goods and services associated with pipeline construction. The current account deficit approximated 7.5 percent of GDP in 2004, or about $368 million. This is projected to increase to $473 million in 2005, or 8.1 percent of GDP, after which it will decline.

Exports showed strong growth in 2004, with exports of goods and services increasing from an average $537 million in 2000-02 to $730 million in 2003 and $1,063 in 2004. However, by contrast, imports have grown from 1.8 times' export figures in 2000-02 to nearly $1.8 billion in 2004, roughly the same ratio and pointing to a widening gap in dollar terms. Thus, Georgia already had a consistent deficit in goods and services, and this had widened further since 2003-04. The trends point to a shrinking of the deficit once

[31] Projected average exchange rates from 2005-08 simply take GDP figures in GEL and dollars, and then average out those ratios on a year-to-year basis. For GDP data, see IMF.
[32] See IMF Country Report No. 05/1, January 2005.

work on the oil and gas pipelines is largely concluded, on the condition that Georgia is able to continue to generate foreign exchange from agriculture, agro-processing, scrap metal, transit trade and tourism.

Some of the current account deficit has been mitigated by rising remittance flows, considered the largest portion of overall private transfers. It is conceivable that remittance flows are underestimated, as many CIS economies (along with others around the globe) have substantial inflows that go unrecorded. In this case, as with migrant workers and others abroad (particularly in Russia), cross-border transit involves the physical transport of cash that is often unrecorded by central banks and customs authorities when balance of payments figures are produced. Thus, it is fully conceivable that Georgia's current account deficit is actually less than stated. However, there is also a major problem of smuggled goods in Georgia, and this may offset the net benefit of underestimated remittance inflow. Based on the official figures, the deficits approximate 7.5 percent of GDP (2004), with remittances, other private transfers, and other official transfers reducing the impact.

Georgia's figures for foreign direct investment are also skewed. Apart from 1997-98 when Georgia's privatization campaign intensified, the data have been modest since 1996. However, recent pipeline-related investment has generated FDI in excess of 1997-98 levels, with $335 million recorded in 2003 and $438 million in 2004. As with the current account deficit, this is expected to rise again in 2005, and then begin to decline from 1996 on. Thus, along with remittance flows that help reduce the current account deficit, higher FDI has also helped to finance the deficits that have materialized. However, as with Azerbaijan, there is limited FDI in sectors unrelated to the pipeline and resource exploitation. Thus, Georgia continues to face the challenge of how to sustain needed FDI once the pipeline is built and operating.

Notwithstanding these challenges, Georgia's debt profile remains manageable. External debt approximated $1.8 billion in 2004, and is projected to stay roughly at that level for the foreseeable future. As a share of GDP, these figures are modest, and well within prudent standards of debt management. Debt service was $165 million in 2004, and these servicing requirements are likewise expected to diminish after 2005. Thus, while there is pressure on Georgian enterprises to become more competitive in export markets and for the economy as a whole to be more attractive for foreign investment, the country's balance of payments are benefiting from rising remittances, non-pipeline FDI that exceeded $150 million in 2004, and a manageable debt load largely priced on a concessional basis.

Table 12: Current Account, Remittance Flows, Direct Investment, and Debt Profile

	2000	2001	2002	2003	2004
Current Account Deficit ($ millions)	-$131	-$205	-$197	-$287	-$366
Current Account Deficit/GDP	-4.3%	-6.4%	-5.8%	-7.2%	-7.5%
Remittance Flows ($ millions)	$77	$78	$72	$166	$197
Foreign Direct Investment ($ millions)	$153	$80	$122	$335	$438
o/w pipeline FDI ($ millions)	n/a	n/a	$15	$240	$280
Public External Debt ($ millions) (*)(**)	$1,560	$1,655	$1,776	$1,840	$1,796
External Debt to GDP (**)	51.3%	51.6%	52.4%	46.2%	36.8%
External Debt Service			$228	$114	$165
External Debt Service/Exports			65.6%	25.7%	15.5%
Notes: (*) Public external debt includes publicly-guaranteed; (**) NBG annual reports show lower foreign debt figures due to exclusion of credits guaranteed by Government; these figures do not include domestic debt					
Sources: IMF and NBG data; author's calculations					

6. Vulnerability to External Shocks, Political Instability and Capacity to Adapt

Georgia has a series of macroeconomic, structural and geo-political risks that make it vulnerable to potential shocks. At a minimum, there are several weaknesses that could make the environment more difficult, notwithstanding economic growth in recent years. Any or all of these weaken the environment for SME growth. These include:

- Limited import coverage (as shown in low months' import cover from export earnings)
- Low levels of FDI net of pipeline-related activities (although increases were registered in 2004)
- Anti-corruption efforts that may threaten vested interests or raise questions of due process (notwithstanding broad recognition of past illegalities and tax evasion), possibly having the unintended effect of deterring investment
- Breakaway regions within the country
- Relations with Russia
- Any decline in remittance flows from Russia might be hard to replace, although Georgia also has many workers in EU countries sending back remittances as well
- Commodity price increases and Georgia's high levels of imported energy resources weaken the balance of payments and undermine industrial competitiveness
- Low value-added from most exports, and reliance on low labor costs for international competitiveness, subject Georgia to vulnerability to exogenous factors such as unfavorable weather or changes in commodity prices

E. General Business Environment and Impact on Competitiveness

1. General

There are no reliable statistical indicators by which to measure financial return, operational efficiency, managerial performance, and related reflections of firm-level competitiveness. Moreover, macroeconomic data are less than reliable as an indicator due to the high level of informality in the economy. In general, while progress has been made in many areas, such as actual legislation, registration requirements, and the recently adopted Tax Code, there are many areas in which Georgia's economy are insufficiently developed to support and actively promote SME development. Key areas of needed improvement include government stability and dialogue with the private sector (although this has improved with the new government), legal reforms, property and collateral registration systems, credit information, trade policy, competition policy, and tax/customs administration:

- *Government*: SMEs believe that more systematic and open dialogue with Government is needed to move forward with development of a stable investment climate. Greater certainty in policy is needed to mitigate risk and to stimulate investment.

- *Legal*: Significant changes are needed in legal and judicial infrastructure, as well as shortcomings in numerous laws related to property rights, contract enforcement, and secured transactions.

- *Enterprise, Property and Collateral Registration*: The business environment would benefit significantly from comprehensive, unified, automated business, property and collateral registration systems that easily interface. This would provide needed information to creditors and investors in determining whether to commit financial resources, and how to price risk. An improved system would also introduce new financial products and broaden the fiscal base.

- *Credit Bureau*: The absence of a functioning credit information bureau also adds time and cost to the credit risk evaluation process, translating into smaller loans at higher cost to those SMEs able to obtain loans in the first place.

- *Trade*: A strengthened environment for cross-border trade based on improved customs administration and border-crossing protocols, lower tariffs for needed imports, and increased capacity for prospective exporters to meet certification standards (e.g., phyto-sanitary) in potential export markets.

- *Competition*: More balanced competition, including liberalization of "natural monopolies" which have failed to render better service at lower cost in many areas of critical importance to SMEs (e.g., power, telecommunications).

- *Tax and Customs Administration*: Major improvements are needed to modernize tax and customs administration built on a broad fiscal base, reduced corruption, simplification, greater consistency, and rising compliance based on lower average costs for households and enterprises.

Other weaknesses are also discussed below, including issues of corporate culture, transparency and disclosure, information availability and access, business associations, and physical and academic infrastructure.

2. Political and Governmental

The change in government in 2003-04 has been positive in many ways, not the least of which is a strong desire to reduce corruption, modernize government operations, and invest in institutional capacity for long-term development. However, with regard to SME development, a number of factors remain problematic. Part of this has to do with the long-term nature of many systemic and institutional challenges that cannot be solved in a short period. However, some issues have contributed to ongoing difficulties for SMEs. These include:

- The relatively frequent rotation of government appointees, which has undercut the mandate of appointees to establish a clear program and to forge the working relationships needed with the private sector in support of meaningful SME development. (This may now be changing.)
- The lack of business management experience of many in the government.
- The heretofore unfulfilled task of presenting a comprehensive framework and approach to SME development, and a more certain framework for the investment community by which to determine whether and how much to invest in Georgia.[33]
- Unresolved territorial disputes within Georgia.
- Tense relations with Russia.

3. Legal and Taxation

In general, the legal framework fails to provide adequate protection for property rights and contract enforcement. There are certain pieces of legislation that remain incomplete, ineffective or, in some cases, problematic for all enterprises, including SMEs. Some of the major legal framework problems include:

- *Company law*[34] *and corporate governance*:[35] Minority shareholder rights are insufficiently protected with regard to dividend payments, company auditors, share transfers, conflict of interests involving company officials and the need for

[33] The Federation of Georgian Businessmen, for one, has called for a more certain investment climate, and pointed to frequent policy changes will undermine investment. This is considered more important than certain tax concessions, such as reduced VAT. See *Georgian Business Week*, February 21, 2005.
[34] The Law on Entrepreneurs of 1994 provides the legal framework for company law.
[35] A summary of company law and governance weaknesses is based on an EBRD Legal Assessment. See EBRD 2004 Strategy for Georgia, Annex 7.

transactions to be conducted at fair market value. Boards lack sufficient responsibility and empowerment regarding management oversight, potential misuse of corporate assets, and general independence. (Recent improvements have been made for joint stock companies with regard to their financial reporting requirements, and protection for shareholders.)

- *Business registration and licensing*:[36] Registration is a fairly straightforward process without major costs in terms of procedures, days or financing. However, the laws themselves give rise to the numerous administrative burdens imposed on SMEs. Thus, the legal framework needs streamlining for SMEs to develop in Georgia. Additional problems emerge as a result of limited capacity at local court levels, where registration occurs. This is manual, information is not always complete, and the absence of centralization and automation results in a fragmented system that undermines the collation of information for business and tax purposes. Such a system makes it more difficult for creditors to confirm information is accurate (e.g., precise borrower/company names), resulting in higher costs of credit risk evaluation. Verification requires the submission of requests to local courts, adding time and cost. In some cases, the same name (albeit a different entity) shows up on a security interest, resulting in borrowers being denied credit strictly due to poor records. (Incomplete searches by banks and other creditors also raise the opposite risk that certain individuals or companies with differing names may borrow from different banks at levels that are imprudent once debt levels are consolidated.) The absence of needed information either adds risk to the banks, or prompts them to reject credit applications.

- *Secured transactions, property rights and contract enforcement*:[37] In general, property rights are poorly defined and largely unregistered. Even when registered, there are inadequate provisions for moveable properties for use as collateral. For instance, pledges are recognized, but retention of title upon sale, financial leases, and other forms of security are not recognized.[38] There is no centralized pledge registry, driving up costs of credit and reducing access. The pledge registration system is reported to not function well. Secured creditors gain priority after the payment of auction and court fees, although proceeds are distributed proportionally rather than hierarchically.[39] Out-of-court enforcement fees are 7 percent of sales proceeds, while inadequate provisions for such procedures add to uncertainty with regard to the outcome. While the number of procedures is not high (and is comparable with OECD norms), the process is costly in terms of time (average 375 days) and as a percent of disputed debt amounts (32 percent) for

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[36] Company registration information is mainly derived from GEGI's recent SME Assessment, 14 February 2005, as well as its "Monitoring of Administrative Burden to Small and Medium Enterprises in Georgia".
[37] The Civil Code of 1997 (Articles 254-315) governs the secured transactions framework. A summary of weaknesses in the secured transactions framework is based on a recent GEGI SME assessment (see SME Environment Assessment, 14 February 2005), an EBRD Legal Assessment (see EBRD 2004 Strategy for Georgia, Annex 7), and indicators from the World Bank (see *Cost of Doing Business*, 2005).
[38] See "SME Environment Assessment", GEGI, 14 February 2005.
[39] This is based on 2001 amendments to the Law on Execution Proceedings.

court and attorneys' fees.[40] Thus, in terms of creditor returns, time involved, and clarity of the process, Georgia's framework is cumbersome. This has resulted in reluctance by banks to lend to SMEs, high required levels of collateral when banks issue loans, and high risk premiums as reflected in high loan interest rates.

- *Bankruptcy legislation*[41] *and the insolvency framework*:[42] The definition of insolvent debtors is insufficiently precise as to be vulnerable to misinterpretation. Bankruptcy proceedings occur in non-specialized courts, resulting in procedural and other delays during which debtor asset values are vulnerable to rapid decline. Bankruptcy administrators are not required to return secured assets to secured creditors, resulting in higher costs of credit and reluctance of creditors to take risk. Secured (trade and other) creditors are subordinated to employees, tax authorities and other parties when proceeds from assets are distributed. Debtor reorganization and new financing to effect reorganization are not adequately addressed. In the end, bankruptcy is not a commonly used tool in Georgia. When it is used, the amount of time is long (3.2 years), and recovery rates are low (20 percent).[43]

- *Labor code rigidity*: Additional problems relate to the rigidity of the Labor Code, with the most cumbersome problems associated with firing employees once permanently hired.[44] Such labor protection reduces incentives for SMEs to hire, and has resulted in a fragmented labor market. High mandatory social payments have also deterred permanent hiring, although recent changes in the Tax Code make this less of a financial burden.[45]

- *Taxation*: Recent changes in the Tax Code may lead to reduced informality and tax evasion. However, the biggest problems have to do with administration and enforcement, including better information and valuation systems, simplified procedures for compliance and collection, and a fair system of appeals.

While legislation is sometimes problematic, the real challenge has to do with legal enforcement and the incentive structure under which institutions operate. As such, the key problems in Georgia's legal framework relate to the functioning of the judiciary and

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[40] This compares with 412 days on average in Europe and Central Asia, yet at only 18 percent of disputed debt amounts. OECD countries generally require 229 days, but the cost is only 11 percent of disputed debt.
[41] The Law on Proceedings in Bankruptcy of 2002 governs the insolvency framework.
[42] A summary of bankruptcy/insolvency weaknesses is based on an EBRD Legal Assessment (see EBRD 2004 Strategy for Georgia, Annex 7), and "SME Environment Assessment", GEGI, 14 February 2005.
[43] This compares with 3.3 years in Europe and Central Asia, where recovery rates are 31 percent. OECD countries require 1.7 years on average, with recovery rates of 72 percent. See *Cost of Doing Business*, World Bank, 2005.
[44] According to a World Bank survey, difficulties firing employees are far more severe in Georgia than in the region as a whole, let alone OECD countries. Likewise, Georgia's level of rigidity is higher than for the transition countries of Europe and Central Asia (and OECD). See *Cost of Doing Business*, World Bank, 2005.
[45] Recent changes reduced social taxes from 33 percent to 20 percent, and personal income taxes from 20 percent to 12 percent. Corporate tax rates remain at 20 percent, but the reduced social taxes may provide greater incentive to hire permanent staff.

other support institutions (e.g., registries), rather than the actual legislation itself. This undercuts the ability to enforce contracts, provide needed protection for risk-taking, and build a framework for formal transactions and market development. Major problems include:

- Commercial training and experience of judges.
- Judicial infrastructure support, such as support staff and automation/computers for caseload management.
- Excess reliance on courts for all matters, instead of rationalization and specialization.
- Underutilized out-of-court dispute resolution mechanisms (e.g., via specialized commercial courts).
- Absence of centralized and automated systems for enterprise, property and collateral registration.
- Absence of a credit information bureau.
- Corruption.
- Procedural delays.
- Lack of judicial independence from government authorities.
- Implementation and enforcement of tax policy, namely shortcomings in tax and customs administration.
- Underdevelopment of property registration systems and market-based accounting and appraisal systems (which reduces property tax revenues).
- Transfer taxes on properties, which serve as incentive to undervalue assets, resulting in lower property tax revenues.

These and other weaknesses undermine confidence, and discourage banks and other creditors from lending. This likewise has the effect of discouraging SMEs from placing deposits with banks and seeking loans, instead bypassing the formal legal (and tax) system. This fosters a climate of illicit payments, fragmented information, and general lack of trust and transparency. All of this undermines prospects for market development, adds to uncertainty, and reduces the willingness of lenders or investors to commit resources for anything but short periods of exposure.

4. Regulatory/Supervisory

While NBG is considered comparatively strong and sound as a regulator, the real sector is burdened by a variety of regulatory bodies that add confusion, cost and difficulties for SMEs. This is common around the globe, and not specific to Georgia. Apart from unified supervisory frameworks in some countries for financial sector institutions, there is no commonly accepted model for one-stop regulatory and supervisory oversight anywhere in the world, given the uniqueness and complexity of differing economic sectors, agents, and impact on society. However, modern information systems make it much more feasible to facilitate information flows in support of numerous economic and governmental functions. *Georgia suffers from institutional weaknesses in many supervisory bodies, often manifested in unnecessary, overly frequent, burdensome, and/or costly inspections carried out by public sector offices. That there are at least 44 bodies* *responsible for various inspections and supervisory functions adds to the complexity and confusion, reducing the incentive of SMEs to be compliant with norms. Thus, there is a need for movement to a knowledge-based economy in which many of these functions are simplified and streamlined in support of a better functioning environment for SME development*.

A general criticism is that laws and regulations are unclear or inconsistently enforced, with both the judiciary and government inspectors either unqualified to carry out their jobs or corrupted. There are also complaints about the lack of due process or suitable appeals process. In many cases, larger enterprises or those with contacts are able to make illicit payments for favors, resulting in unfair competition and trading practices, collusion, price fixing, and other abuses.[46] In the end, this serves as a disincentive to SMEs to grow and to operate more openly in the formal market.

The approach the government had traditionally taken (until recently) in the post-Soviet period is to have official inspectors check on companies for compliance with regulatory standards and requirements. However, in practice, many of these standards have been overlooked in exchange for illicit payments, resulting in inadequate regulatory enforcement and a lack of protection in critical health and safety matters for consumers. Key weaknesses[47] in this domain include:

- There is insufficient monitoring and control of licensors and inspectors.
- The issuance of licenses and permits is subject to local discretion, resulting in corruption. This is particularly prevalent in construction and trade, and is likewise reported to be a problem with customs at border posts.
- Notwithstanding recent improvements and lower costs, inspections are viewed as disruptive, burdensome in terms of documentation, and inconsistent as inspection rules sometimes change.
- The worst offenders are tax authorities, sanitary and fire inspectors, electricity supervisors, and the Sakstandarti.
- Local testing and certification is mandatory and costly, yet ineffective and unaccepted by international trade partners, thereby undermining export competitiveness while adding cost for domestic market production.
- Local testing and certification is burdened by corruption and lack of choice in certifying institutions.

5. Information Exchange: Accounting, Transparency and Disclosure

Georgia's traditions and corporate culture are not consistent with global "best practice" concerning open information exchange to facilitate sound governance, modern methods of management, and active involvement with financial market institutions subject to prudent underwriting and regulatory conditions. Instead, the business culture and most

[46] See "SME Environment Assessment", GEGI, 14 February 2005.
[47] See "SME Environment Assessment", GEGI, 14 February 2005, and "Monitoring of Administrative Burden to Small and Medium Enterprises in Georgia", GEGI.

enterprises are closely-held, privately-run, and managed by one person. As such, there is little scope for adoption of modern standards of accounting, transparency and disclosure.

Licensed financial institutions, companies registered with the GSE and other joint stock companies with at least 50 employees are required to be "reporting companies", with regular financial reports submitted in compliance with IAS/IFRS. However, the number of companies like this in Georgia is low. Accounting is still generally tax-oriented, as it is with most small companies around the globe. *The unwillingness to divulge information undercuts Georgian SMEs' chances of obtaining outside financing when they seek it. Weak accounting and financial information, along with other information deficiencies in the system related to markets, competitors, performance and the like make it difficult to construct reasonable business plans with sound financial scenarios*.

6. Rating Agencies/Systems

There are no sovereign ratings for Georgia. Fitch Rating assigned CCC+ ratings to TBC and the Bank of Georgia (as of late 2003), and to ProCredit in late 2004. Apart from these three banks, no other ratings have been obtained by banks in Georgia. The closest approximation is the NBG CAMEL rating system.

There are plans to establish a credit information bureau in Georgia, which may reduce some of the credit intelligence obstacles faced by financial institutions in determining credit worthiness. This initiative has reportedly received the support of three or four of the largest banks, and possibly others. However, as of early 2005, there is no formal credit information bureau or credit rating agency in Georgia. This adds further obstacles to the banks and other creditors in determining whether to make loans, how to price these loans, and levels of collateralization needed to underwrite the loan.

7. Business Media

There are several journals in Georgian and English that report on business activities in Georgia. However, these are more general with regard to basic financial results, general needs of entrepreneurs, new investments and markets, etc.

8. Physical Infrastructure

Georgia's infrastructure is partly worn down from lack of investment. The economy is punished by the isolation of rural areas from urban centers, where most people live and enterprises operate, thus interfering with the national supply chain from primary to secondary and tertiary markets. Roads are often in disrepair. Rural areas often lack sufficient irrigation. Power supplies are unreliable, adding a burden to all enterprises and households affected. Telecommunications capacity lags many markets, as there has been limited direct investment, and the original fixed-line monopoly continues to dominate the sector. Territorial disputes exacerbate some of the claims on resources, which can also undermine the functioning of critical infrastructure (e.g., roads, power).

9. Business Associations

There are several business associations that have formed in recent years, generally with donor support. However, SMEs do not have a history or tradition of forming business associations, lobbying government, establishing market linkages, arranging for bulk purchases, disseminating specialized and useful trade information, or related tasks carried out by business associations in more developed markets. Capacity is needed at this level for associations to play a constructive role when lobbying government for policy reforms and institutional changes. Likewise, a more systematic approach is needed from government to facilitate regular consultation with SMEs.

10. Educational Infrastructure

Georgia has a well educated work force, and general literacy rates and participation in primary and secondary education are high. However, anecdotally, academic institutions in business and executive management fields do not have a strong reputation.

Some of the problem is that the academic system has not yet adapted to the needs of a market economy. Likewise, the relatively limited direct investment from abroad (apart from recent investment in the oil and gas pipeline) has also limited on-the-job training that usually comes with major investment. Donor efforts in this regard are reported to be uncoordinated.[48] Enterprises also tend to hire friends and family, rather than the most qualified individuals, partly due to issues of trust and control. These represent weaknesses in efforts to strengthen conditions for SME development.

[48] See "SME Environment Assessment", GEGI, 14 February 2005.

III. SME Development and Finance Constraints

A. Businesses' Impediments to Obtaining Financing

There are several factors that inhibit the financing of Georgian enterprises. Major challenges include the size of the market, limited direct investment (apart from the oil and gas pipeline), the small size of most businesses, and enterprises' traditional business culture:

- *Market*: In general, the Georgian market is characterized by low levels of purchasing power, and reluctance of enterprises to expose themselves to the tax authorities by openly making large purchases or investments. This reduces the scope for open transactions, limiting the market for formal institutions.

- *Investment*: There has been limited investment by large-scale firms (apart from the oil and gas pipeline and a few other sectors), reducing possibilities for supplier relationships to be formed with SMEs. This reduces prospects for SMEs to generate needed contracts and cash flow, consequently reducing their financial capacity to increase borrowings. Investment is particularly needed in agriculture and the industrial sector to increase productivity levels and achieve standards for export competitiveness.

- *Scale*: Georgian businesses are generally very small. This limits their capacity for borrowings, whether secured or unsecured, given low levels of cash flow generation and limited asset values that could be secured. Moreover, even credit worthy operations can only generate a certain amount of cash if the scale of the enterprise is very small. This precludes meaningful contract awards as suppliers to larger firms.

- *Governance and Business Culture*: The traditional approach of business in Georgia is closely held, with one manager responsible for most/all key decisions. This approach does not lend itself to sound governance principles, information sharing, and accountability to external parties. As such, many companies are unable to comply with underwriters' reporting requirements as a precondition for financing.

B. Financial Sector Issues

While the banking sector showed significant growth in 2004, penetration as reflected in intermediation levels and assets-to-GDP are still fairly low. Lending to the real sector increased, and deposits have likewise increased. Moreover, because the interest rate environment is becoming more stable, banks are looking to lend more to stimulate greater earnings. A stable macroeconomic framework characterized by declining inflation rates, low fiscal deficits, reasonably stable exchange rates, and manageable debt service also reduces the role of government as a potential encroachment on financing of the real sector. As the banking system consolidates, average capital will likewise increase, and a broader array of products and services will be made available to the market. All of this bodes well for SMEs and households. Nonetheless, most SMEs still operate without financing from banks or other licensed institutions, and average loans are still small. Several impediments persist in the financial sector, making it difficult for SMEs to obtain needed amounts of financing at more affordable rates and for sufficient maturities to meet investment needs. **Supply-side** issues for **banks** include:

- *Regulatory and Capital Limitations*: One of the reasons for banks' not making larger loans is due to regulatory issues concerning loan exposures. Based on NBG prudential norms, banks are not permitted to make loans to individual enterprises in excess of 15 percent of capital. Moreover, total combined loans to individual firms cannot exceed 25 percent of capital. Given that only eight banks had capital exceeding $5 million-equivalent at year-end 2004, most banks have limited capacity for lending to large-scale firms, or to firms whose equipment needs exceed $1.5 million. On the other hand, even the bank with the least amount of capital could have made individual loans up to $437,000, which would be enough for some of the fixed asset needs of small enterprises. With average capital of about $10 million, regulatory restrictions represent modest impediments relative to medium-sized financing needs, and fairly substantial impediments for large-scale enterprise financing needs.

- *Lack of Syndication*: Banks have not engaged in the practice of syndicating loans, possibly because they are unfamiliar with how to syndicate, and partly because of competitive instincts that preclude cooperation with rival banks. Changing this practice would effectively constitute a change in commercial bank lending cultures in which they share information on the prospective borrower and project to be financed, and then co-finance. This is a common technique in functioning markets, and is used to spread risk and free up capital for other loans. Originators also frequently sell these loans to other banks for fees as well, again freeing up capital for new loans while generating fee income that contributes to banks' ROA and ROE targets. However, in Georgia, this has been a rare occurrence.

- *Maturity Mismatches*: Banks have attracted greater deposits in recent years, but most of these are either demand deposits that can be withdrawn at any time, or term deposits in which maturities are usually for less than one year.[49] The lack of long-term funding makes it difficult for banks to lend on a long-term basis due to asset-liability matching practices. The absence of hedging mechanisms in the market pushes banks to pursue excessively conservative asset-liability management practices, with very little willingness to take on open loan positions (where loans exceed deposits on a maturity basis). However, in the case of most manufacturing firms and many SMEs, their financing needs are for machinery and equipment or premise expansion that take years to cover. These investments require long-term loans (three to five years, sometimes longer) given the high up-front cost and time required to generate cash flow to help service the loan and

[49] Only 14 percent of deposits had terms of more than one year as of year-end 2004.

ultimately repay. However, most banks' deposits are current or short-term in nature, and long-term loans cannot be matched with most funding. (Where there are exceptions on this are in the housing market, although these are basically booked as one year loans that are rolled over on the condition the borrower meets debt service and principal repayment requirements.)

- *Enterprise Deposits*: While banks have increased deposit collection in recent years, most of this has been from individuals and households. Enterprise deposits remain low, at no more than about 15 percent of total. In addition to general matching strategies, many banks are wary of lending to enterprises that are unable or unwilling to place deposits with the banks. This not only reduces the total value of the relationship, but also deprives bankers of an opportunity to monitor company cash movements for needs, seasonality, etc.

- *Lack of International Ratings*: The broad absence of ratings in the banking system precludes opportunities for Georgian banks to participate in the international syndicated loan market. As such, Georgian banks miss out on one of the most fundamental ways to extend maturities for lending. However, given banks' surplus liquidity, there has been little incentive to take action to increase term funding for long-term loans.

As for **non-banks**, there is currently very little financing. MFIs have been the only other active segment of the financial sector that has effectively delivered credit to Georgian enterprises. However, their loans have been exceedingly small, at about $420 on average. Other non-bank issues include:

- *Leasing*: This sector is nascent in Georgia, and current difficulties include capacity to obtain financing as well as the legal environment. Recent changes in the tax code provide generous depreciation schedules. However, leasing companies will need to be able to access additional financing to meet demand for needed equipment and machinery, estimated by IFC to be about $20 million and likely to grow.

- *Credit Unions*: The credit union movement has had a difficult time mobilizing resources and becoming effective in lending markets. It is unclear if the credit union movement will be successful in Georgia, particularly as it is targeting rural areas where savings are low. In urban areas, banks themselves are attempting to capture individuals and small businesses, another target audience for credit unions.

- *Contractual Savings*: Both the insurance sector and pension funds are small and limited in resources. Both sectors are preparing for reforms to eventually raise their profile in the economy and financial markets. However, it will be several years before insurance penetration increases, pension funds accumulate assets, and contractual savings companies play a role as institutional investors.

- *Capital Markets*: The Georgian capital markets barely function. There is no real tradition of private sector securities issuance (e.g., corporate bonds, equities), nor is there an active private placement market. Any effort in this regard should be structured as a long-term effort, with particular focus on instruments in which institutional investors (e.g., insurance companies, pension funds, banks) would show interest for portfolio management and fiduciary purposes. (The authorities might consider joint listings with other exchanges to accelerate potential investment interest to the extent it can be developed.)

Demand-side challenges include credit risk, maturity mismatches, exchange rate risk, interest rate risk, and other risks related to the reputations and operations of firms that are often difficult to manage. In the case of Georgia, risk management itself is difficult due to weak levels of information disclosure, poor governance standards, and a heretofore unfavorable legal environment for creditors. Thus, exposure limits and other supply-side constraints are not the only reason for SME difficulties in accessing finance. Demand-side issues that constrain lending to SMEs include:

- *SME Non-Compliance with Underwriting Standards*: In many cases, the SMEs themselves are unwilling or unable to meet banks' underwriting standards and requirements. Key among these (according to the banks) are the lack of assets SMEs have or are willing to pledge as collateral for loans, and difficulties verifying information presented. As such, many enterprises and their financing proposals present credit risk that banks need to manage or are unwilling to underwrite. Failure for banks to do so results in non-performing loans, which can ruin a bank's financial position and, at a minimum, trigger the need for corrective action that constrains lending activities (as well as other banking operations and transactions). In this regard, banks are often being prudent.

- *Insufficiency of Collateral Due to the Legal Environment*: While there is credit risk, the traditional response is that secured loans can offset risks associated with SME inability to service and repay loans from cash flow. However, in Georgia, property rights are poorly defined and enforced, the legal environment for secured transactions is weak, institutional mechanisms for credit risk evaluation are underdeveloped, and dispute resolution mechanisms are notoriously slow or unreliable. As such, banks themselves are not automatically secured, even when collateral levels are two to three times loan values. Techniques that banks can pursue to offset this risk include broader value chain relationships that are more cash-based and provide banks with greater opportunities to monitor SME cash flows. However, if SMEs are unwilling to make these commitments or comply with requirements, they are unable to access needed financing.

- *Inadequate Equity Levels*: The sector characteristics of loans and maturities are also significant because, in the case of housing loans, households often have high equity stakes. This results in low loan-to-value ratios, meaning that households are not excessively leveraged or over-exposed. By contrast, many SMEs expect banks to finance most or all of their investment needs with loans, which represents a highly exposed position for the banks. As such, many SMEs themselves do not have sufficient equity reported in their companies, reducing the amount of loans banks are willing to make. (SME loans were greater than $46 million-equivalent at year end 2004, but there is no precise figure. However, from donor-financed programs, only $2.3 million was outstanding to agriculture, and $3.4 million for fixed asset purchases. Most SME loans were in the services, presumably in high turnover and liquid businesses.)

- *Inadequate Working Capital Levels*: Enterprises themselves also make mistakes with regard to needed working capital once financing for property, plant and equipment is obtained. In some cases, enterprises in the past have managed to obtain needed financing for fixed assets, only to find their operations constrained by the lack of working capital. This has resulted in capacity underutilization, which has translated into insufficient cash flow for debt servicing.

- *Market Intelligence*: Market information and research is weak in Georgia. This makes it more difficult for SMEs to more accurately ascertain what their market prospects are, and to plan out investment strategies and needs accordingly. The inability to do so raises doubts about the accuracy of plans submitted to banks for financing, and certainly raises the risk of taking on such exposures. Even loans made against contracts are not necessarily safe, given that contracts can be easily breached.

- *Interest Rates*: When SMEs do obtain financing, interest rates are often high. This is partly due to risks associated with the firms and/or the project, but mainly due to weak protection for creditors. Difficulties and costs related to loan recovery have substantially added to the risk premium banks assign to such exposures. In a worst case, the high interest rate burden can jeopardize credit quality, and lead to losses for both borrowers and lenders.

C. Business Environment Issues

There are many weaknesses in the business environment that constrain sources and uses of finance for economic growth and development. These are cross-cutting issues that involve both the public and the private sector. Fortunately, with increasing stability in the macroeconomic environment and efforts by government to implement anti-corruption practices, there is a positive climate for reform. Likewise, changes in the business environment will inevitably reduce the problems currently faced with regard to many of the market-based, firm-specific, or financial sector issues. However, many of the challenges are institutional, complicated by traditions and business culture, or inadequately addressed due to capacity limitations. The required changes will take years as a result, with many of the desired successes more likely to be medium- or long-term objectives rather than quick fixes for rapid formalization of income or employment generation. Major challenges and reform needs encompass issues of policy, legal, regulatory, institutional, informational, and infrastructure shortcomings.

In terms of **policy** and approach, there are several weaknesses involving trade and competition that have stifled SME growth. Not all reforms can be acted on immediately. Nonetheless, a more open market than currently exists will be required of Georgia, partly due to WTO obligations, partly due to EU aspirations, and largely due to the likelihood of greater prosperity that will result, notwithstanding some interim dislocations and setbacks.

- *Strategic Planning and Vision*: SMEs believe that more systematic and open dialogue with Government is needed to move forward with development of a stable investment climate, and that greater certainty in policy is needed to mitigate risk. (Despite pervasive complaints, this may have improved in recent months, with the new Tax Code serving as one example.[50] Formation of the new Investment Council may also help.) Donors are also criticized for a lack of coordination. Haphazardness, *ad hoc* approaches, and weak capacity in business associations as well as government have resulted in the absence of a comprehensive framework and strategic approach to SME development.

- *Trade Policy*: Trade policy and the number of tariff bands unnecessarily complicate customs administration and add scope for corruption. Moreover, they sometimes constitute protectionist measures that slow the march to competitiveness. Such tariff bands serve as an incentive for smuggling. They also add to the cost of legally imported intermediate goods that many SMEs require for additional capacity and productivity, while also adding to the cost of inputs for agricultural producers and consumer items that can push inflation rates up and serve as a barrier to competition.

- *Competition Policy*: While the economy is broadly market-based, natural monopolies have benefited from protectionist measures. Several sub-sectors have likewise benefited from monopolies or duopolies due to the small size of the market. This has sometimes resulted in charges of collusion and price-fixing. Meanwhile, long standing corruption has distorted competition, with larger, wealthier and better connected businesses extracting favors at the expense of a genuinely free market.

Legal framework issues abound, and represent a key challenge of which the current government appears fully aware. These include shareholder rights, property rights, secured transactions, contract enforcement, the insolvency framework, and labor rigidity in the formal sector.

- *Corporate Governance*: Shareholder rights are insufficiently protected, boards lack sufficient responsibility and qualifications, and management is often closely-held and accustomed to insider dealings. These will need to change to create a more conducive investment climate, particularly when seeking to attract investment from abroad (whether direct or portfolio).

[50] See "Unprecedented collaboration", AmCham News, January 2005.

- *Secured Transactions and Collateral*: There are inadequate provisions for moveable properties for use as collateral. Pledges are recognized, but retention of title upon sale, financial leases, and other forms of security are not recognized.

- *Contract Enforcement*: Several weaknesses exist with regard to creditor hierarchies, distribution of proceeds from auctioned properties, out-of-court enforcement fees, and general procedures that add time, cost and uncertainty to the process. Length of time to enforce contracts is high, and recoveries are low. This has resulted in reluctance by banks to lend to SMEs, high required levels of collateral when banks issue loans, and high risk premiums as reflected in high loan interest rates.

- *Bankruptcy Legislation and the Insolvency Framework*: The definition of insolvent debtors is insufficiently precise, procedural delays reduce salvageable asset values, and creditor hierarchies subordinate secured (trade and other) creditors to employees, tax authorities and other parties when proceeds from asset sales are distributed. In the end, the insolvency framework is ineffective for restructuring and financial recovery.

- *Labor Code Rigidity*: The Labor Code makes it cumbersome to release unneeded employees once they have been permanently hired. Such labor protection reduces incentives for SMEs to hire on a permanent basis, reducing the fiscal base and complicating formal job creation initiatives.

To the extent that the legal framework is less an issue than enforcement, these issues come together when dealing with regulatory implementation and institutional capacity. As for **regulations** and enforcement, key challenges are the administrative burden imposed on SMEs, and testing and certification requirements that are ineffective and costly.

- *Regulatory Oversight of Enterprises*: There is excessive and unneeded focus on control of matters unrelated to safety and health. There is also insufficient monitoring and control of licensors and inspectors, and an unwieldy administrative structure in which 44 or more agencies are responsible for inspections. The issuance of licenses and permits is subject to local discretion, resulting in corruption. These characteristics add cost to SMEs and encourage informality and corruption.

- *Testing and Certification*: Local testing and certification is mandatory and costly, yet ineffective and unaccepted by international trade partners. Local testing and certification is also burdened by corruption and lack of choice in certifying institutions. These characteristics add cost to SMEs, encourage informality and corruption, and weaken prospects for exports.

Legal and regulatory constraints are partly a function of **institutional capacity** deficiencies. In some cases, they reflect the challenge of shifting traditional practices to the needs of a market economy, such as the judicial system or modernization of tax and customs administration. In other cases, they reflect next step challenges after initial progress has been made, such as simplified business registration procedures. In other cases, such as a comprehensive collateral registry, they reflect the need for a broadened approach and application of modern systems and technologies within a revised legal framework.

- *Institutional Judicial Capacity*: Judges lack commercial training and experience. Infrastructure support, such as support staff and automation/computers for caseload management, are inadequate. There is excess reliance on courts for all matters, instead of relying on more specialized approaches with streamlined procedures. (Progress is under way in developing alternative dispute resolution mechanisms. However, it is nascent.) There is also a reported lack of judicial independence from government authorities.

- *Business Registration and Licensing Systems*: Registration and licensing is conducted at local court levels, where there is little capacity. Systems are fragmented and manually recorded. The absence of electronic access slows the collation of information for business and tax purposes. The absence of specific identification numbers causes errors. Such a system makes it more difficult for creditors to confirm information is accurate (e.g., precise borrower/company names), resulting in higher costs of credit risk evaluation. Verification requires the submission of requests to local courts, adding time and cost. The absence of needed information adds risk (and cost) to the banks, slows processing time, or prompts them to reject credit applications.

- *Property Rights*: Property rights are poorly defined and largely unregistered, although this is now changing with improvements in the property registry systems. However, despite increasing registration of land and structures, the systems are not integrated or electronically accessible for credit-related purposes.

- *Collateral Registry*: There is no centralized collateral registry or protocols for electronic access. This limits information flows, drives up costs of credit, and reduces access.

- *Credit Information Bureau*: There is no centralized credit information system that provides useful information on the credit-related performance of potential borrowers.

- *Tax and Customs Administration*: As noted, trade policy and the number of tariff bands unnecessarily complicate customs administration and add scope for corruption. Underdevelopment of property registration systems and market-based accounting and appraisal systems reduces property tax revenues. Transfer taxes on properties serve as an incentive to undervalue assets, resulting in lower property taxes. In general, better information and valuation systems, simplified procedures for compliance and collection, and a fair system of appeals are needed for modern tax and customs administration. They are currently lacking.

Apart from these issues is the traditional approach to non-transparency, resulting in severe **information** constraints in the economy. Market economies thrive and trade on information, and non-disclosure restricts these activities. These constraints are reflective of the traditional business culture, but will need to change for the market to expand and modernize. This will require standards-based associations in the private sector to play the necessary role in providing information, as well as working with the public sector in a self-regulatory role to ensure that constantly evolving ethical and professional standards are maintained without the need for heavy-handed regulation.

- *Information Disclosure*: Accounting is still generally tax-oriented, and there is no real tradition of open disclosure. There is no credit information bureau. The lack of comprehensive property and collateral registries weakens the environment for credit and investment. The absence of tradition undermines development of adequate governance and management structures. The unwillingness to divulge information undercuts Georgian SMEs' chances of obtaining outside financing when they seek it. Weak accounting and financial information, along with other information deficiencies in the system related to markets, competitors, performance and the like undermine competitiveness.

- *Business Associations*: SMEs do not have a history or tradition of forming business associations, lobbying government, establishing market linkages, arranging for bulk purchases, disseminating specialized and useful trade information, or related tasks carried out by business associations in more developed markets. Capacity is needed for associations to play a constructive role when lobbying government for policy reforms and institutional changes. Likewise, the business community needs to drive the research activities of these associations for useful market information and development.

There have also been **infrastructure** weaknesses that have adversely affected the ability of SMEs to operate and compete. These include physical infrastructure as well as new approaches to education and training to utilize the skill sets that currently exist.

- *Physical Infrastructure*: Georgia's infrastructure has only recently begun to attract the investment needed to turn its power sector around. Frequent electricity cuts interfere with possible IT solutions on a large-scale for institutional capacity development. Likewise, telecommunications requires additional investment, and modernization of the fixed-line network and introduction of mobile telephony are still relatively recent developments. This is particularly the case in rural areas where much of the future economic growth is projected to come from. Roads are often in disrepair, another weakness for an economy expecting significant growth from transit-related activities and tourism. Territorial disputes exacerbate some of the claims on resources, which can also undermine the functioning of critical infrastructure (e.g., roads, power).

- *Educational Infrastructure*: Georgia has a well educated work force. However, a significant effort is needed to make the work force more productive and innovative, rather than dependent on low cost labor for competitive advantages. There is no commonly acknowledged strategy to build a knowledge-based economy.

IV. Donor Activities in SME Development and Finance

A. Summary of Donor Funding

In preparation for a mid-year 2004 donor conference, the Government of Georgia presented its financing priorities for 2004-06 along with its strategic vision. Total needed financing was estimated to be $485 million, with larger amounts for subsequent years. A total of $1.1 billion was pledged, most of it grant financing. Thus, there is no shortage of donor funding for Georgia's current government. Thematic areas where the government sought funding included:

- *Corruption and governance*: Public administration and judicial reform, and strengthened presence and involvement of NGOs and other elements of civil society.

- *Energy*: Rehabilitation, regulation, movement to cost recovery and new investment, and future development of hydro-electricity.

- *Poverty reduction and social services*: Health, education and social protection.

- *Private sector development*: Improved business environment, increased competitiveness, tourism development, and strengthened financial sector capacity.

- *Agriculture*: Increased competitiveness, and development of a food security system.

- *Infrastructure*: Roads, transport, water/sewerage, housing, and environmental protection.

B. USAID

USAID has supported private sector and financial sector development in Georgia since the 1990s. These activities have included banking development and banking supervision, rural credit, micro-finance support, credit union development, accounting reform, capital markets development, commercial law, and more recent support for leasing and development of a credit information bureau.

USAID currently has a five-year strategic plan for Georgia from 2004-08. While there are cross-cutting issues (e.g., Infrastructure and Energy deal with needed supplies and better service delivery, Democracy and Governance deal with the judiciary and local governments, Health and Social Development deal with pensions, and Anti-Corruption affects all segments of society), most of USAID's initiatives in support of SME development are under Economic Growth.

The Strategic Objective is "Accelerated Development and Growth of Private Enterprises to Create Jobs", under which several intermediate or sub-intermediate results are expected:

- Improved Policy and Business Operating Environment (IR 1.31.1)
- Improved Regulatory Environment for Business (IR 1.31.1.1)
- Reduce Corruption as a Barrier to Business Growth (IR 1.31.1.2)
- Increase Access to Financial Services (IR 1.31.2)
- Develop Land Markets (IR 1.31.2.1)
- Develop Financial Institutions (IR 1.31.2.2)
- Increase Market- Driven Production and Sales (IR 1.31.3)

C. Other Donors

Total debt outstanding (domestic and publicly-guaranteed external) as of year-end 2004 was $2.3 billion, of which $1.8 was external, mostly to official creditors. Key donors (apart from USAID) have been the IMF, World Bank Group, EBRD and European Commission. Specific to SME development, GTZ and KfW (Germany) have also been important bilateral donors.

- The IMF has provided in excess of $434 million in lending to the Government of Georgia, some of which has been tied to modernization and reform of the banking and payment system. While not directly tied to specific SME programs, the macroeconomic effect of IMF-supported policies has a major influence on SMEs, including money supply and interest rates, exchange rates, and fiscal requirements (tax rates and administration, as well as customs administration).

- The World Bank Group (IDA, IFC, etc.) has provided in excess of $900 million since 1992. This has included several projects focused on enterprise and banking system reform, legal reform, and rural development (including credit union development). Meanwhile, the IFC is specifically focused on improving the investment climate and increasing financing for SMEs by focusing on governance, leasing, and SME development. IFC is a shareholder in ProCredit Bank, has played a role in shaping tax legislation for leasing, and supported two bank-owned leasing companies (Bank of Georgia and TBC).

- The EBRD had more than 30 projects dating back to 1994, amounting to more than €185 million in net commitments (as of year end 2003). This was primarily in the form of loans, but also included nearly €12 million in equity. EBRD commitments have included (i) equity stakes in Bank of Georgia, IBSB, Absolute Bank and ProCredit (Microfinance) Bank; (ii) loan funds for the Bank of Georgia (twice, in 1998 and again in 2003), Tbiluniversalbank, Absolute Bank and ProCredit Bank (twice); (iii) SME finance facilities via Intellectbank, TBC (twice), Tbilcombank, Tbilcreditbank, Tbiluniversalbank; and (iv) foreign trade guarantees via Bank of Georgia, TBC, and twice via United Georgian Bank. These four categories of financial assistance (loans and equity) totaled €48 million (about $60-$65 million). EBRD has also invested nearly €1.9 million in medium-sized companies via a private equity fund. The major program focused on SMEs, the Small Enterprise Lending Program, had a loan portfolio of $11.5 million at year end 2004.[51]

- The European Commission provided €369 million in total grants from 1992-2003, and had plans to provide an additional €137 million in 2004-06. The TACIS program is the primary vehicle for institutional and legal reforms, private sector development, and development of infrastructure networks. Total TACIS grants were €84 million through 2003, and cumulatively approximated €100 million as of year end 2004. This includes participation with EBRD in the Small Enterprise Lending Program.

- GTZ and KfW have provided about €160 million in assistance since 1997, expected to reach a cumulative €200 million by 2005. This has included €15 million to update the land cadastre, and investment in and loan funds for ProCredit Bank. KfW is also taking the lead role in assisting NBG with development of a deposit guarantee scheme.

- Other donors active in varied SME activities include the Canadian International Development Agency (support for the IFC's SME activities), UNDP (business advisory services and business incubators), Oxfam (regional database for trade links), and the Eurasia Foundation (grants for tourism and business association development).

[51] With 6,154 loans outstanding, this is an average of about $1,869 per loan. Loans are generally for 15 months, with interest rates ranging from 17-36 percent. Minimum loans are $200, and maximum loans are $50,000.

V. Recommendations to USAID for SME Activities

A. General Approach

Many of the issues affecting SMEs are cross-cutting, and cannot be easily segmented into neatly defined categories without recognizing the linkage to other factors. As such, **the approach taken should be comprehensive, involving public and private sector activities, and involving financial sector and enterprise sector reforms**.

The approach also requires strategic vision and coordination, which is not currently as developed as it should be. This includes better coordination among government, private sector institutions and donors. Thus, **it is recommended that the soon-to-be established Investment Council actually take the lead in serving as a vehicle for strategy development on a number of different areas of focus**. This can and should be done by establishing Working Groups with key government officials to map out strategy in critical areas of importance (e.g., tax and customs administration, non-bank financial sector development, facilitation of regulatory compliance) that can foster SME growth and development.

USAID's proposed role (along with other donors) would be to lend support to these Working Groups focused on policy, laws and regulations, institutional capacity building, information flows and infrastructure development. An appropriate role for USAID would be to work with the government and World Bank to provide support to the Investment Council, with direct assistance (to be defined) at the Working Group level.

B. Summary of Recommendations

There are seven specific recommendations presented below. In order of priority to increase SME access to affordable finance (Economic Growth IR 1.31.2) and to sustain development of financial institutions (Economic Growth IR 1.31.2.2),[52] it is recommended that USAID:

- **#1: Support establishment of a viable secured transactions framework**. This is already under way with USAID's focus on a One Stop Shop. This would be comprehensive, integrated, and cross-cutting in terms of legal, regulatory, institutional, and informational requirements. As USAID (and others) have already begun work in this regard, the main recommendation is to implement a comprehensive and integrated approach, intensify the effort, and establish the electronic linkages necessary for property and collateral registries to properly function.

[52] These priorities are based on what interventions are likely to have the greatest impact in support of SME access to finance and financial sector development. They are not driven by the scores in the templates reviewing criteria for support, which offer slightly different results due to the broad benefits of mortgage finance development, and the potential risks of non-performance in the leasing sector to which a DCA guarantee may be exposed.

- **#2: Build on current efforts to promote leasing market development**. This would include the one direct financial intervention from USAID, the potential use of a DCA guarantee to permit leasing companies to raise term funds for lease contracts of three to five years. Leasing is considered a useful interim approach to equipment and machinery lending on a term basis while work continues on developing a viable secured transactions framework, and in the absence of a viable corporate bond market.

- **#3**: If USAID is committed to further involvement in more fully developing financial institutions, **it should conduct a comprehensive financial sector assessment for the next round of reform**. (If USAID is explicitly not interested in non-bank financial sector development and next-generation issues in banking, this assessment is not needed.) There is a common view that neither Government nor donors have a coherent strategic vision for Georgia with regard to financial sector development, SMEs, and private sector development. Given that the FSAP was concluded several years ago and the system is poised for considerable change and development in the coming years, this initiative would provide USAID with the framework needed to provide it and the Government with the vision needed for systematic reform. As recently shown in Armenia, this could be done in close coordination with the IMF and World Bank should the Government of Georgia seek an updated FSAP.

- **#4**: As an extension of #3, **USAID should consider another round of assistance for the National Bank of Georgia, in this case tied to commercial bank training to support modern credit practices and related risk management features**. While this initiative would be particularly focused on exposing lenders to market-based practices to stimulate increased lending and how to manage risks, it would also tie in with key financial stability needs. This is considered essential as the system consolidates, deposit insurance comes into existence, and banks lend more and diversify (including into non-bank activities) to generate higher earnings in a lower interest rate environment.

- **#5: Support development of mortgage finance markets**. This initiative would be an extension of #1 as well as #3-4. The reason to consider mortgage finance development is that it serves as a convenient framework for other desirable reforms for a sound economy and financial market. Mortgage finance reform may largely benefit households rather than SMEs. Nonetheless, given how small SMEs are in Georgia, home ownership would serve as a useful collateral asset to increase access to credit. Moreover, this initiative would include commercial property development, which would include hotels, warehousing, office space, and other properties needed for SME development. (This also points to the importance of #3, as this effort will require development of the insurance sector to accommodate property and casualty needs.) Reforms under this initiative would also have fiscal benefits (property tax administration), potentially point to ability of governments to float municipal bonds[53] (based on property tax revenues collected and targeted), improve the permit and licensing process, shore up building codes, serve as a catalyst for realty association development, serve as a basis for strengthening valuation procedures, and help to meet a critical social objective of increasing the supply of affordable housing.

- **#6: Support development of a credit information bureau**. USAID should consider further assistance to help the market introduce a credit information bureau if other private initiatives falter. The benefit of having a bureau that is comprehensive, up-to-date, and accessible is that it reduces barriers to credit access for credit worthy borrowers, permits better information for the pricing of risk, and provides information that allows for unsecured (non-collateralized) lending to increase. The presence of the bureau is highly desirable. The reason for it being a lower priority than some of the others is related to confidence about prospects for success. Given the obvious benefits, bankers and other creditors should be pushing for this bureau to be established. That progress has been slow suggests possible doubts about the willingness to share information needed to expand markets.

- **#7: Support linkage of academic institutions and think tanks with innovative initiatives and enterprises**. This effort would likely be the highest in terms of risk and cost. However, it is designed to promote a more competitive, innovative SME sector that is knowledge-based, essentially the way much of the global economy is moving. By focusing on increasing linkage between research and thought centers and SMEs, there are opportunities for information flows, improved standards, centers for certification and accreditation, and commercialization of products. Such centers would likely serve as a magnet for support services, including vendors focused on specialized services (e.g., research, information systems and integration, finance). Such an approach also helps to train people, and provides opportunities for market-based business associations to emerge.

C. Initiatives to Increase SME Access to Finance

1. Supply Side

There are several initiatives USAID could support as a basis for increasing SME access to finance. It should be recognized that banks are increasing their lending, including at micro levels, and they are interested in increasing their exposures to boost earnings. As such, traditional lines of credit or loan guarantee funds are not recommended, as resources are increasingly available to and through the banks. What is needed is development of banks' capacity to manage the increasing risk they want to assume to boost earnings. As such, recommendations focus on increasing risk management capacity at the banks, while also seeking to develop the financial system as a whole (banks and

[53] Such bonds would likely require a sub-sovereign guarantee as they would be too small to rate and sell in international markets.

non-banks) so that SMEs are not wholly dependent on banks for their formal financing needs. To accommodate such an approach, adequate regulatory and supervisory capacity must also be in place. This is usually a phased development.

In addition, specific proposals are also made for increased lending flows to SMEs via leasing and housing finance. This does not call for direct USAID funding for loans. Rather, assistance appears justified to help with the market development framework. These interventions would all address the major supply-side weaknesses identified apart from being able attract international ratings. However, at some point in the future, Georgia will obtain sovereign ratings, and more interest will be shown in rating individual banks. When this occurs, the proposed interventions will increase prospects for satisfactory ratings that might allow the banks to participate in the international syndicated loan market, and to possibly be able to attract portfolio investment from institutions abroad.

► **Commercial Bank Training Coordinated with the National Bank of Georgia**

As funding increases and the interest rate environment reduces margins, banks will be taking on more credit risk. Likewise, banks will be introducing new products and services, and becoming active in leasing, housing finance, commercial finance, consumer finance, and insurance. Along with consolidation, new entrants from abroad, a deposit guarantee scheme, and rising capital requirements, the financial system is slated to go through changes in the coming years.

Specific to SMEs, these are all beneficial developments. However, there are certain areas that could help to increase access to finance while these changes evolve. These include bank training for commercial bankers on:

- How to manage credit and market risk as increasingly open loan positions of long-term loans evolve (longer term loans exceeding the supply of long-term deposits)
- How to encourage “value chain” strategies by offering an array of services to SMEs that would induce them to increase their deposits, and for banks to make small unsecured loans that grow over time based on satisfactory performance
- How to establish liquidity facilities for MFIs (e.g., similar to factoring operations)
- Leasing
- Housing and commercial property finance
- Commercial finance
- Consumer finance
- Loan syndication
- Foreclosure and loan restructuring
- Money laundering and financial crime (AML/CFT)

In general, training should be done privately and without donor support. However, to serve as a catalyst for faster development of credit markets for SMEs, this could be done with USAID support. In this regard, it is recommended that any training be coordinated with NBG to ensure such training is consistent with prudential norms and risk management requirements of banks. This could also involve closer association with NBG in designing a revised chart of accounts to ensure more precise information is regularly reported by banks, particularly in terms of loan growth related to consumer loans, housing finance and commercial property development to be able to monitor for loan quality and potential asset bubbles. As such, any training for bankers would flow from assistance provided to NBG to reinforce financial stability.

Banker Training

Criterion	Positive	Negative	Score
Counterpart "buy-in"	NBG appreciates earlier assistance provided by USAID and would welcome subsequent assistance to help develop credit risk management capacity; banks appear to welcome donor support	Banks should finance own training, or take more active participation in financing a training institute for bankers	2
Sustained long-term impact	Introduction of sound lending standards are needed as the system takes on more risk to boost earnings and capital	Training impact variable across countries	2
Major results from budgetary resources	There would likely be a multiplier effect resulting from some incremental loans with longer maturities than currently exist	Uncertain if such training would generate "major" results	2
Fill(s) major gaps	There is a clear need for SMEs to be able to access loans with maturities exceeding 1-2 years; apart from leasing, there are no credit programs that extend exposures beyond two years		3
Consistency with USAID strategic objectives	The training objectives are consistent with Economic Growth IR 1.31.2.2 to strengthen financial institutions		3
Confidence of success	NBG has made progress in stabilizing the banking system, and banks likely to emerge from the upcoming round of consolidation will have refined their lending practices; however, the next generation of challenges requires that banks develop their risk management capacity as they increase loans to boost their meager earnings	Uncertain how effective training would be, although NBG recognizes its usefulness as part of its effort to ensure financial stability	2

► Strategic Planning and Evolution of Risk-Based Supervision

The National Bank of Georgia has been effective at implementing recommendations from the earlier FSAP, and this has contributed to increased soundness in the financial system and a more stable economy. However, this work commenced in 1998, and it has been several years since the FSAP recommendations were adopted and implemented. NBG has a strategy for subsequent banking and credit union development, yet there is no overarching design for the financial system as a whole. Rather, there are many surveys being conducted simultaneously, and review of portions of the financial system without any linkage across financial services as a whole.

USAID is encouraged to follow the recent example in Armenia in which USAID financed a comprehensive assessment of the financial sector prior to a joint IMF-World Bank update of the earlier FSAP. The USAID assessment produced useful information for all parties concerned, while also identifying five key interventions for sustained support for the coming years. With Georgia preparing for banking sector consolidation, introducing leasing legislation, seeking to develop its fledgling credit unions, interested in mortgage markets, contemplating pension reform, interested in insurance sector development, and hoping at some point for securities market development, now would be a fortuitous time to conduct a comprehensive assessment so that the authorities could pursue financial sector reforms and strengthening in a systematic way. This would naturally be accompanied by revised regulatory and prudential requirements, with a focus on the evolution to risk-based supervision. Greater certainty and focus would provide the framework needed for banks and other financial institutions to determine how to finance SMEs.

Comprehensive Financial Sector Assessment

Criterion	Positive	Negative	Score
Counterpart "buy-in"	NBG and Insurance Supervisory Agency welcome assistance to strengthen financial markets, particularly in the design of needed prudential requirements and development of capacity of market players to adhere to these principles in support of a more developed and stable market	World Bank currently helping with insurance sector development, and the EU has likewise supported these efforts in other countries, so USAID assistance might be redundant	2
Sustained long-term impact	A strategic approach would provide a mapping of needed reforms on a short-, medium- and long-term basis		3
Major results from budgetary resources	A strategic approach would generate significant cost savings to the effort, as donor activities would be less redundant and more focused on key needs and comparative strengths		3
Fill(s) major gaps	There is a need for a strategy across financial services, just as Georgia benefited from the earlier FSAP	The basics of a financial sector strategy already exist, although greater specificity and detail would help	2
Consistency with USAID strategic objectives	The assessment would provide a coherent framework for all Economic Growth IRs, but be particularly useful for IR 1.31.2 while reinforcing the other IRs		3
Confidence of success	NBG has made progress in stabilizing the banking system, and a more cohesive strategy would allow for a sound prudential framework for subsequent developments in banking and credit, as well as insurance, pension and possibly securities market development		3

► Leasing Sector Development

The leasing sector is just getting off the ground. Two banks have established leasing companies, with others likely to follow. There is a legal framework evolving, and support from the government for this sector to have opportunities to complement the role of banks as credit providers. The benefit to SMEs is that leasing companies can provide term financing without facing all of the obstacles banks face concerning secured loans. However, the benefits should not be over-estimated. While repossession by lessors may be easier when lessees default, there are no guarantees that secondary market sales will lead to high recovery rates on defaulted debt. Nonetheless, there are clear benefits to having a strong leasing market to handle many of the fixed asset needs that SMEs have.

The main constraint facing leasing companies is access to financing for long-term contracts. In this regard, leasing companies will face the same problems banks face in attracting funds with maturities of longer than 18 months or two years. The absence of an active corporate bond market, private placement market, and syndicated loan market make this even more of a challenge. Areas where USAID can help (some of which it is currently doing) include:

- Credit enhancement (e.g., DCA) to provide extended maturity financing of three to five years to permit leasing companies to acquire needed equipment and machinery for lease
- Legal framework assistance
- Market information and dissemination through the Association of Leasing
- Coordination with regulatory authorities (NBG) to ensure that leasing subsidiaries do not pose major transfer risk issues for banks on a consolidated basis

Leasing Sector Development

Criterion	Positive	Negative	Score
Counterpart "buy-in"	Government supportive	IFC currently taking the lead, so USAID assistance might be redundant; banks are also moving in this direction, irrespective of donor support	2
Sustained long-term impact	Leasing will likely have a long-term impact, particularly if Georgia comes close to achieving international norms in terms of leasing-to-GDP		3
Major results from budgetary resources	Magnitude of results will depend on amount of funding and performance of lease contracts	Risk of non-performance	2
Fill(s) major gaps	There is a need for leasing to provide term lending to SMEs for machinery, equipment, vehicles, and other assets; the main constraint leasing faces in 2005 is the ability to generate long-term funds to finance asset purchases	The market is likely to move in this direction, so it is unclear if USAID assistance is necessary; OPIC has already provided $1 million to TBC	2
Consistency with USAID strategic objectives	The intervention would support Economic Growth IR 1.31.2 while also reinforcing efforts in agribusiness (IR 1.31.3)		3
Confidence of success	There is little reason to believe leasing would not contribute to increased access to finance for SMEs	There are risks with regard to performance	2

► Mortgage Finance Development

While not specific to SMEs, a comprehensive housing finance framework would address several of USAID's strategic objectives while serving as an effective way to develop and implement a financial sector strategy. Sound mortgage finance markets generally reflect functioning financial markets, sound accounting and appraisal standards, viable property tax systems, effective land use planning practices, and targeted financing for infrastructure development at community levels. Once primary markets are functioning well, they often provide a logical push for secondary market development, as well as (sometimes) municipal bond market development as a result of property tax revenue flows that are targeted for local development. Areas where USAID could help (some of which it is currently doing) include:

- Legal framework assistance
- Market information and dissemination through a realtors association and an association of appraisers
- Helping specialized Working Groups to develop needed positions on the legal framework, standards-setting, building codes, permits, zoning, etc.

- Coordination with regulatory authorities (e.g., NBG) to ensure that mortgage market exposures do not create major credit or market risk problems for bank portfolios

Mortgage Market Development

Criterion	Positive	Negative	Score
Counterpart "buy-in"	Government supportive		3
Sustained long-term impact	Mortgage finance development is long-term by nature		3
Major results from budgetary resources	Assistance could be provided with minimal outlays		3
Fill(s) major gaps	This initiative would be broad, and not restricted to SMEs or housing; it would benefit SMEs by including commercial property as part of the approach, making it easier to access credit for premises (commercial property development as well as housing)	Prudential norms may limit most banks to small housing loans, rather than premises that might provide more needed support for SMEs	2
Consistency with USAID strategic objectives	The intervention would support Economic Growth IR 1.31.1 and 1.31.2	Housing is not featured prominently in USAID's 2004-08 strategy	2
Confidence of success	There is little reason to believe lenders would not want to increase loans for housing	Impact on SMEs may be less than other initiatives	2

2. Demand Side

Two interventions are proposed to address demand-side issues. One is discussed in "Business Environment Reforms" below concerning the secured transactions framework, and addresses the insufficiency of collateral due to the legal environment. (This is largely covered by USAID's "One Stop Shop" project currently being designed.) A second would serve as a corollary to the training intervention for bankers listed above, with a focus on business advisory services to link business plan templates to key underwriting criteria of banks. However, this is not recommended as a separate stand-alone project or intervention. Rather, this should be viewed as an extension of the training proposed for bankers with regard to credit and market risk. Corollary efforts to train SMEs in underwriting requirements are the job of the banks. However, USAID can supplement this effort by working with associations, helping with public awareness efforts, and strengthening the business environment so that borrowers are aware of their contractual rights and responsibilities. In this regard, USAID might consider teaming with UNDP to supplement resources with their network of business advisory services located throughout most of the country, and now positioned to support cluster formation in most major areas of activity in Georgia. Beyond that, and given the intensification of competition that has already occurred in credit markets, educating prospective borrowers on underwriting requirements and compliance with loan covenants is a banker's responsibility.

D. Business Environment Reforms

There are many weaknesses in the business environment. Positively, the government is aware of these and is supportive of efforts to reform the environment in favor of economic development. This should lead to a more encouraging business climate for SMEs in the future. However, until reforms are implemented, constraints to finance and other aspects of SME development will remain in place, albeit less severe than in the past.

There are many initiatives that should be supported that are not covered here, partly because they are less directly related to increasing SME access to finance. Nonetheless, they are mentioned because they are important in creating a supportive environment for SME finance. These include:

- Reducing the number of tariffs for imports, and simplifying the system to reduce the costs of intermediate goods needed for enterprises to be more competitive
- Increasing competition where feasible[54] and not yet achieved, particularly in areas of the economy (e.g., power and telecommunications sector) where costs have been high and service levels inadequate
- Introducing Government procurement procedures that provide small businesses with opportunities to serve as vendors (when feasible)
- Making privatization procedures more open and transparent, and encouraging greater participation in privatization auctions by providing greater financial information on assets being sold
- Battling corruption to reduce unfair trade practices
- Rationalizing the regulatory regime for enterprises, with emphasis on simplification and direct oversight on health and safety
- Developing standards and quality assurance procedures that are certified by major export market recipients (to stimulate exports)
- Providing e-based services that facilitate tax payments and provide needed information

Key priorities for an improved business environment that are *directly* linked to SME access to finance include:

- Strengthening the framework for secured transactions, including accelerated progress in institutional support areas to stimulate lending and simultaneously reduce the risk premium for such exposures
- Considering assistance in the formation of a credit information bureau
- Designing strategies for a more innovative, knowledge-based economy that can provide critical mass in leading edge activities

[54] Given the small size of the Georgian market, robust competition in many sectors of the economy may not be possible, particularly when there are high entry costs.

► Comprehensive Framework for Secured Transactions

To date, USAID and others (e.g., World Bank) have focused on the need for an improved secured transactions framework. However, progress to date has been fragmented, partly because the approach has not been comprehensive or integrated. It is recommended that USAID support the following initiatives to create a viable secured transactions framework that is comprehensive, unified and automated. This is largely under way with the One Stop Shop project. Achievement of these should make a major contribution to SME access to affordable finance.

- Assign unique business identification (BIN) and tax identification (TIN) numbers
- Develop a comprehensive property registration system building on progress already under way, and linked to unique BINs and TINs
- Make registration and property records electronically accessible (subject to prospective borrower's approval[55])
- Expand the legal definition of collateral to include retention of title upon sale, financial leases, and other acceptable forms
- Establish a collateral registry, and make this registry electronically accessible to all prospective creditors
- Work with banks to develop standardized contracts
- Work with judicial and approved out-of-court authorities to develop protocols for contract enforcement and foreclosure

Secured Transactions

Criterion	Positive	Negative	Score
Counterpart "buy-in"	Government supportive of initiatives to strengthen the legal framework		3
Sustained long-term impact	Would provide the basis for sustainable lending on commercially viable terms for lenders, while increasing access and reducing costs for borrowers		3
Major results from budgetary resources	High probability of results	Expensive, as this involves establishment of property registries and a collateral registry plus electronic interface to make these systems work on an integrated basis	2
Fill(s) major gaps	This initiative would be comprehensive, and would make it feasible for lenders to provide more credit for longer periods		3
Consistency with USAID strategic objectives	The framework would support all Economic Growth IRs		3
Confidence of success	This would strengthen creditors' rights while putting the institutional framework in place to increase secured lending		3

[55] Creditors would presumably deny the credit application if denied access to registry records.

► e-Credit Information Bureau

There have been reports of a credit information bureau being formed with the support of the major banks. However, as of early 2005, the credit bureau has yet to be formed. There are clear benefits to the presence of a credit information bureau that is electronically accessible to all creditors (e.g., banks, trade creditors, installment finance, factoring) and investors. At a minimum, a comprehensive bureau that provides up-to-date performance records is a logical extension of institutions required for an effective secured transactions framework. It is also essential for pushing unsecured lending, as performance records provide evidence of credit worthiness and needed information to creditors about levels of exposure that are desirable and how to price risk.

On the other hand, an argument can be made that bankers themselves should be responsible for making sure this credit bureau comes into being, either through a bankers' association or simply through common recognition of the need to exchange information to broaden and deepen the market for lending. In the Caucasus and elsewhere, there is still resistance to sharing information with rivals. However, one of the benefits of a credit information bureau is that it provides needed information for a more competitive market, and clearly provides information that serves as a stimulus for increased SME access to credit.

Credit Information Bureau

Criterion	Positive	Negative	Score
Counterpart "buy-in"	Government supportive	Banks slow to bring the credit bureau into being	2
Sustained long-term impact	Would help creditors to more accurately determine and price risk, providing a catalyst to SMEs for increased access to finance; increasing competition and fuller records would also bring down the cost of credit to sound performers		3
Major results from budgetary resources	High probability of results if the bureau functions properly	Unwillingness of many market players to share information undermines prospects	2
Fill(s) major gaps	This initiative provides needed performance records, allowing creditors to reward credit worthy performers and limit credit exposure to weak or non-compliant borrowers	Georgia is reported to be so small and tightly knit at the local level that informal channels provide the information needed on credit worthiness	2
Consistency with USAID strategic objectives	The bureau would support Economic Growth IR 1.31.2		3
Confidence of success	This would strengthen credit worthy SMEs' prospects for increased access to affordable finance, including unsecured loans	Success depends on comprehensive, accurate, up-to-date records that are easily accessible	2

► **Knowledge-Based Activities**

Several measures can be introduced or expanded to advance innovation in Georgia, make SMEs more competitive, and make them more attractive to creditors and investors. In many markets, universities and think tanks have spawned innovative companies that later make major contributions to GDP and employment. In particular, this has occurred when there is critical mass, meaning sufficient resources for R&D that ultimately create knowledge-based clusters that then attract ongoing financing as a result of their innovation and potential for major returns. Georgia may not be able to achieve all of this, but efforts to create a more integrated approach to research, information dissemination, and commercialization have potential to enhance competitiveness, particularly in some of the chosen sectors that are expected to generate foreign exchange revenues in the future (e.g., agro-processing, tourism). Some of these ideas might be considered for inclusion in the One Stop Shop project as a way of building private sector capacity for standards-setting, monitoring and enforcement. Possible interventions include:

- Support for competitive research programs for research centers, think tanks and universities, including enhanced information dissemination
- Support for Metrology and Patent offices with greater legal, institutional and laboratory infrastructure capacity
- Establishment and refinement of national standards (in line with international standards) via a National Accreditation and Quality Council
- Support for the commercialization of R&D outputs, research centers, think tanks, universities and enterprises by upgrading laboratory facilities and staff skills, modernizing HR systems and business processes, improving marketing and commercialization functions, enhancing incentives for applied research, introducing competitive research programs, and promoting joint projects with industry and other R&D organizations
- Support for current initiatives that promote technology parks and niche clusters

Moreover, SMEs generally lack data needed for market research and the development of viable business and financial plans. There are also limited vehicles for business-to-business exchange that could help create contracts and vendor relationships. One approach in the effort to support market research would be to link this function with business schools/research institutes/think tanks/associations in support of product and market development. This could be accompanied by enhanced communications facilities that would make business-to-business exchanges more possible.

Knowledge-Based Initiatives

Criterion	Positive	Negative	Score
Counterpart "buy-in"	Government supportive	Would require significant focus and reorientation of academic training; requires commitment to more open disclosure of information, formation of teams	2
Sustained long-term impact	Would help SMEs become more competitive, and possibly have a high multiplier effect	Would require substantial resources for sustained impact, and be subject to mismanagement; also requires far greater telecommunications capacity and a shift in the culture to more open sharing of information	2
Major results from budgetary resources	Probability of results in the long-term given already high levels of education and the need to adjust institutions to more market-oriented approaches	Risk of mismanagement plus limited prospects for commercialized outputs from R&D	2
Fill(s) major gaps	This initiative provides a needed adjustment in academic approaches, and serves as a convenient means to concentrate innovation that can be spread throughout the economy	Depends on management and willingness to deal more openly with information flows	2
Consistency with USAID strategic objectives	Would be a way of reinforcing some of the initiatives under the One Stop Shop	Not highlighted in 2004-08 strategy, although could be integrated into some of the focus on agribusiness and business associations	1
Confidence of success	This might provide SMEs with better access to information and research, strengthening their competitiveness; linkage with institutions abroad can make this option more feasible	Success depends on sustained resource commitments	2

ANNEX 1: LIST OF MEETINGS

- Fady Asli, President, American Chamber of Commerce
- Dan Berkshire, Business Associations and Credit Advisor, GEGI
- Natalia Beruashvili, Legal Reform Manager, GEGI
- Roger Bird, Leasing Director, AgVantage
- Garland Boyette, Commercial Law Advisor, GEGI
- Robert Christiansen, Resident Representative, IMF
- Ed Coll, Senior Advisor, Bank of Georgia
- Amy Denman, American Chamber of Commerce
- Michael Djibouti, Chairman, National Securities Commission
- Ekaterine Gureshidze, First Deputy Minister, Ministry of Justice
- Tariel Gvalia, Deputy Chairman of Supervisory Board, Bank of Georgia
- Giorgi Isakadze, Executive Director, Georgian Federation of Businesses
- Rati Japaridze, Operations and Research Coordinator, IFC
- Natia Jorjikia, Head of Credit Union Development Center
- Tatyana Kandelaki, Financial Specialist, World Bank
- Murtaz Kikoria, Head of Banking Supervision, National Bank of Georgia
- Irina Kokaia, SME Consultant, IFC
- Michael Kortenbusch, Program Coordinator, EBRD Small Enterprise Lending Program
- Frank Lever, Project Manager, Georgia Business Development, IFC
- Zurab Nikvashvili, Partner (Audit Practice), Ernst & Young
- Revaz Sakvarelidze, Executive Manager, UNDP
- Archil Tsertsvadze, Head of the Service, Insurance State Supervision Service of Georgia
- David Tsereteli, Head of Department for Relations with International Financial Institutions, TBC Bank
- David Tsiklauri, Manager of Department for Relations with International Financial Institutions, TBC Bank
- Don Van Atta, Restructuring Assistance and Policy Advice, Ministry of Agriculture

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