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Global Exchange Rate Instability and Its Implications for Georgia

The prominent Austrian economist Joseph Schumpeter labeled capitalism a system of "creative destruction," by which he meant that new goods, innovative technologies, and ideas force uncompetitive goods and outdated technologies and ideas out of the market. Such change promotes the country's advancement while, at the same time, causing the destruction of the old system. The socialist system was the complete opposite of a market economy. It could be labeled a system of "conserved nonconstruction." Although production kept growing, it was of no actual benefit to the public. During the transition to a market economy (the positive impact of which in the long-term perspective cannot be questioned), many economic activities lost their competitive qualities, which, in part, was the result of growing economic and financial globalization. If one adds to this the collapse of external economic relationships between the countries of the former socialist bloc, resulting in significant declines in exports, the reasons behind such a deep economic crisis become more than apparent.

Over the past couple of years, dozens of countries have embarked on comprehensive reforms oriented toward democracy and market economy. The key idea on which all of these reforms have been based is that the

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country's prosperity and improvements in living standards can only be achieved if a healthy market economic system, closely integrated with the global economy, is established. Only today can it be stated with sufficient confidence that a universal consensus in favor of market economy has almost been achieved. Furthermore, whenever the market is coupled with a social security system, it becomes possible to cover—if not completely, at least partially—the social costs of the market-based system.

The collapse of communist regimes and the expansion of market-based systems (which, inter alia, includes the vast majority of postcommunist countries; see, e.g., Stroev, Bliakhman, and Krotov, 1999) significantly improved the "quality" of economic and financial globalization (see, e.g., Rumer, 2000). At the same time, the transformation of "closed" into "open" economies, closely integrated with international highly competitive commodity, currency, and financial markets, increased the likelihood of the economy's exposure to external shocks. It also enabled the more efficient resource use (see, e.g., Dornbusch, 1993).

Under such circumstances, economic developments taking place in any particular country can have an increasingly powerful impact on the global economy, especially as the world's financial system is based on electronic links, and the dissemination and exchange of information, as a factor of production, takes place automatically. Although there is a vast scientific and analytic literature on the problem of economic and financial globalization, a major set of issues still has to be discussed, involving the most sophisticated practical or theoretical problems that have not yet been solved. Along with its many benefits, globalization also causes some serious problems (see, e.g., Ellwood, 2001; Stiglitz, 2002), particularly in small countries (see, e.g., Rondeli, 2003). Not all of these problems can be solved in a short period of time (see, e.g., Zhukow, 2000). At the same time, in many cases the problems caused by globalization are identical in various countries, which makes the development of some standard solutions very important. Nevertheless, economic "recipes" for "small" and "big" countries can be different and it would be a mistake to apply a uniform approach to all of them (see, e.g., Connolly and de Melo, 1994).

This article concentrates on several very important aspects of the situation in Georgia. The focus is on monetary policy characteristics specific to the postcommunist transformation. Furthermore, the impact of inflation on economic growth is reviewed, and, based on the Georgian example, it is argued that under the conditions of transition to the market, high inflation cannot promote economic growth. The article also evaluates the potential development of an international monetary and financial system in the context of the "corporate crises" that started in the United States in late 2001 and their probable impact on international financial markets and changing international business activities.

In this connection, two quite sensational forecasts made during the past three years regarding the collapse of the U.S. dollar are analyzed. These forecasts paint a fairly "gloomy picture" of the future of both the U.S. dollar and the international monetary system. It is argued that such a scenario is not likely to occur. It is further maintained that with the introduction of a common European currency, the euro, a "new three-pole world currency system" was established, which will have a significant impact on global economic stability.

The substance of the "new economy" (see, e.g., Kelly, 1998) is explored and it is argued that the growing disproportion between the "new" (informational) and the "old" (traditional) sectors of the economy is not responsible for the international economic crisis because, under the conditions "of the new economy," the improved management of information streams and—owing to new technologies—more efficient inventory management have increased efficiency which, coupled with increased productivity and greater competition, will keep inflation under control. One must also take into account the "shortcomings" of financial accounting and standards, which can satisfy the requirements of the "new economy" only in part. To some extent, these are also responsible for the spread of the "corporate crisis."

As a small economy, Georgia cannot have any substantial influence on global economic developments. However, if it succeeds in pursuing a relatively reasonable economic policy, it may generate some positive results, not to mention minimizing clearly negative ones.

The impact of inflation on economic growth: Lessons from postcommunist Georgia

Inflation's impact on economic growth—in general as well as in the specific context of postcommunist transformation—has been the subject of numerous studies (see, for example, Allen, 1999; Anikin, 2000; Anušić, Rohatinski, Šonje et al., 1995; Asatiani, 2000; Cottarelli and

Doele, 1999; Cukrowski, 2000; Fisher and Sakhai, 1997; Gaidar, 1997; Gamsakhurdia, 1997; Ghosh et al., 1996; Gurgenidze, Lobzhanidze, and Onoprishvili, 1994; Jochem, 1999; Kakulia, 1998, 2001a, 2001b; Kakulia and Aslamazishvili, 2000; Kistauri, 2000; Klaus, 1997; Kornai, 1993; Kovzanadze, 2002, 2003; Krasavina, 2000; Managadze, 2002; Melo, Denizer and Gelb, 1997; Meskhia, 2000; Papava, 1997, 2000; Patrytski, 2000; Schmieding, 1993; Sušjan and Lah, 1997; Wang, 1998; Wellisz, 1996, 1997; Zak, 1999; Zhirnii and Iarochinskii, 1997; Zukowski, 1996). One of the most commonly debated themes in Georgian economic and political circles is the tight monetary policy pursued by the National Bank of Georgia (NBG), which has been the key to both price and exchange rate stability. Critics argue that such a monetary policy is the main obstacle preventing the country from achieving greater economic growth, and, therefore, they insist that the government should increase the money supply, thereby allowing devaluation of the lari and higher inflation. Such an attitude reflects an unquestionable dilettantism in the economics of those who propose such ideas, as well as the obvious interest of some critics in further expanding their already sizable wealth—the source of which, by the way, is quite suspicious—through increased money supply, greater inflation, and a devalued lari.

Before discussing the theoretical aspects of the problem (Papava, 1997, 2000), we will address the alteration of key economic parameters in Georgia over the past couple of years and some of the reasons behind it. Since the fall of 1994, owing to a well-organized financial stabilization program, Georgia managed to escape from a hyperinflationary spiral (under which inflation reached 50–70 percent a month). In 1995, the Georgian government implemented a successful currency reform and introduced a quite stable national currency, the lari. In 1996–97, after a long period of deep depression in 1989–94, the Georgian economy started growing and reached a quite high GDP growth rate. All this expressed in figures paints a very impressive picture: while in 1989–94, as a result of decline, the status of the economy deteriorated more than three times, in 1995 GDP grew by 3.3 percent and in 1996 and 1997, by 11 percent and 10.8 percent, respectively. During the same period, there were significant decreases in inflation: in 1995 it fell to 53 percent; in 1996 to 13.5; and in 1997 to as little as 7.3 percent (Papava, 1995, 1996, 1998, 1999; Papava and Beridze, 1998; Papava and Chikovani, 1997).

In 1998, the economic situation deteriorated drastically. This time, the slowdown was triggered by the renewal of hostilities in the Gali District of Abkhazia and a new tide of internally displaced persons fleeing their native region, by the budgetary crisis caused by the government's mistakes in financial policy, and by the currency crisis sparked by the turmoil in Russia's financial system. All these troubles were accompanied by a severe drought that dealt a serious blow to the country's agricultural and hydro energy sectors. Even under such unfortunate circumstances, the national economy continued moving upward (even though this time the growth rate was really low—2.9 percent). Although the NBG started using its hard currency reserves to support commercial banks—which was the only correct step during a severe currency crisis—and introduced a floating exchange rate regime, in 1998, inflation never got out of hand and stabilized at 10.7 percent.

In 1999, due to the impetus inherited from the economic developments of preceding years, the GDP growth rate was maintained at 3.0 percent, whereas annual inflation was fixed at 10.9 percent. Were it not for irresponsible forecasts about the expected fall of the exchange rate and potential growth inflation that were made public by some high governmental officials in December 1998 and January 1999, which fed inflationary expectations, the annual inflation rate could be even lower. In 2000, economic growth was registered at 2.0 percent, whereas inflation fell to 4.6 percent. In 2001, the same parameters changed to 4.5 and 3.4 percent, respectively.

During the whole period, a significant change in the lari exchange rate occurred just once—during the currency crisis of 1998 (Kakulia, 2001b). Before and after that it remained more or less stable. Thus, in 1998–99, as a result of a 70 percent devaluation of the lari that took place in late 1998, the inflation rate exceeded a benchmark of 10 percent, whereas GDP growth could not overcome a 3.0 percent limit. There is no reason to believe that drastic devaluation of the national currency and higher inflation have ever played any positive role in pushing the economy of postcommunist Georgia.

As was noted above, the most of critical remarks about the NBG were made in relation to its tight monetary policy, the main goal of which was to keep inflation at a minimum. Opponents believe that low inflation is an obstacle to production growth and expansion of the country's export potential, and, in the long run, blocks the growth of exports. Accordingly, as they claim, the time has come to say no to the tight monetary policy and replace it with a more liberal (or, at least, "moderately tight") approach, which will consist of a "controlled increase" in money supply. Indeed, economic theory admits that higher inflation may encourage production. Furthermore, historic examples have demonstrated that in some countries, under certain circumstances, the stated approach was successful in terms of production growth.

Two questions must be asked:

- Are Georgian companies really able to expand production under the conditions of high inflation?
- Will high inflation cause positive results in all spheres of economic life?

Only after obtaining satisfactory answers to the above questions, can one consider the issue of switching to a more expansive policy regime.

Let us start with the question of whether or not our companies are able to develop under conditions of high inflation. Unfortunately, it must be recognized from the very beginning that, for a number of reasons, the answer is a negative one. Most Georgian enterprises from the communist era (like those in other republics of the former Soviet Union) own outdated equipment and technologies that cannot produce competitive (high-quality and low-cost) goods. In other words, the share of the "necroeconomy" (Papava, 2002) in the overall national economy of Georgia is still very high. This means that unless serious investments are attracted and new (or renewed) markets are found (both of which will take time), it is senseless even to dream of prosperity for those enterprises. Investments, in turn, could be attracted from the following three potential sources:

- the company's own financial resources;
- bank loans; and
- foreign investment.

The first source might be available for just a handful of enterprises that have already found foreign partners. The remaining (vast majority of) Georgian enterprises suffer from serious financial hardships such as enormous debts to the state budget and to other enterprises. Only a few enterprises can afford bank loans, because of the high short-term interest rates set by commercial banks for nontrade operations. Under the conditions of growing inflation, interest rates are likely to increase further, leaving even less access to loans for companies involved in nontrade (and perhaps even trade) operations. Thus, the second source of investments cannot be used either (especially in the case of higher inflation) as a favorable condition for production growth.

Foreign investments represent one of the most effective factors for improving Georgia's manufacturing potential. However, according to many experts, their flow into the Georgian economy has been a drawn-out process. Worldwide experience has shown that a time lag between stabilization (of political, and especially financial, conditions) and the flow of considerable foreign investments into the economy averages three years. Since 1998 Georgia has permanently suffered from a deep budgetary crisis, and that the country's criminal record has deteriorated drastically over the past couple of years, it must be recognized that a potential foreign investment boom cannot be anticipated until three years after these problems have been solved. From the standpoint of foreign partners, growing inflation is very likely to be interpreted as a deviation from the stabilization course, in which case the flow of foreign investments into the Georgian economy will be delayed indefinitely. This means that under conditions of higher inflation, the third source of investment finance will not be available either.

Thus, in the Georgian context, increased inflation not only is not likely to boost production, but also is likely to block access to those already scarce resources that still might be available to Georgian companies to enhance their nontrade operations.

Such a conclusion is more than enough to refute the assertion that high inflation will boost production in Georgia. Nevertheless, the complexity of the issue requires that special consideration be given to the possible outcomes of high inflation in different sectors of economy. First of all, some ten years ago Georgia had no national currency at all. A huge majority of the Georgian population, and, particularly disappointing, those in charge of the Georgian government at that time could not even imagine that Georgia could ever introduce and ensure proper regulation of its own currency. To illustrate this, it is sufficient to recall the situation in early 1993, when Russia, by halting the supply of rubles to Georgia (which by then had already proclaimed independence), caught the government of Georgia unawares; furthermore, in April 1993, some representatives of the same government publicly apologized to the people for having to introduce a transitional national currency, the Georgian coupon; in fact, it was a public confession of their inability to endow the coupon with the functions of money. When combined with the unrestrained lending (for various "generous" reasons) that pushed Georgia into the spiral of hyperinflation, it is no surprise that at the time nobody believed we would ever have our own currency and a normal lending system. In the meantime, the voices of those (especially in the higher echelons of government) who insisted that Georgia should have begged Russia admit us into the "ruble zone" were growing increasingly louder.

Although a tight monetary policy initiated in the fall of 1994 enabled us to curb inflation, implement a successful currency reform, and maintain a stable exchange rate for the newly introduced national currency, the lari, gloomy memories of the recent past have stuck in people's minds. This prevents the lari's acceptance as a reliable currency. Specifically, people's confidence in the lari, as a store of value, is still very fragile; that is why particularly costly objects (such as houses, apartments, vehicles, land parcels) are usually sold for U.S. dollars. Under such circumstances, growing inflation would further undermine trust in the lari as a means of accumulation. Furthermore, it will diminish the results that have already been achieved: while today the lari is used everywhere in retail trade, tomorrow, with growing inflation, the situation may change to the opposite.

As long as prices are kept relatively low, exchange should involve not only low-value lari bills but also coins. Since in Georgia low-value dollar bills are in short supply, U.S. coins are not available at all, and that after the 1998 Russian financial crisis confidence in the ruble fell noticeably, neither the lari nor the tetri (Georgian coins) have any real "competitor" in the sales and purchases of low- and medium-value goods and services. If inflation grows, this advantage of the lari (and especially the tetri) will be lost (one- and two-tetri coins have already been removed from circulation), and the lari's standing will weaken further. Russia's negative influence on the situation in Georgia is still very strong: at Russian military bases, salaries are paid in rubles (through the Russian military bank). Companies located at those bases also receive donations from the same source in rubles. The Russian side has paid no attention to the Georgian government's repeated protests against such practices. It is impossible to predict when such monetary sabotage can be eliminated and civilized forms of banking relationships with Russia can be established.

For these reasons, higher inflation would reduce the demand for the lari and encourage the use of the U.S. dollar and the Russian ruble for savings and retail purposes, respectively. Under conditions of higher inflation, it will be more difficult to implement restructuring and privatization programs. Under conditions of higher inflation, the general social picture will worsen. Finally, under conditions of higher inflation, living conditions, all other things being equal, will inevitably deteriorate. This process may be less painful in countries where the minimum wage is well above the subsistence minimum. In Georgia, however, the minimum wage is just a small percentage of the subsistence minimum, and wages and pensions are many months in arrears. Growing inflation would therefore strike badly at the most vulnerable social groups, which make up not less than a quarter of the entire population of Georgia. Even based on the most optimistic forecasts, the minimum wage, not to mention the minimum pension, will not exceed the subsistence minimum for the foreseeable future. None of this should be taken as an argument for expansionary policies in favor of inflation.

In conclusion, we address the issue of why it is so important to maintain a stable exchange rate. While a devaluation could increase customs revenues, it would also increase foreign debt servicing costs as well. For a small country like Georgia, where imports play a leading role in external trade, a devaluation will increase import costs, and thereby stimulate inflation, the potential negative results of which were discussed above. All positive and negative effects of a devaluation need to be offset against each other. The country's present economic situation (particularly the deep fiscal crisis that has not yet been overcome) makes it obvious that negative effects still prevail over positive ones.

The Russian scenario of the U.S. dollar crisis

The horrible act of terrorism of September 11, 2001, against the United States was a tremendous shock to the whole world. However, this event and the ensuing consequences are likely to have an even greater impact on the international economy. Debates concerning the stability of the U.S. dollar and the chances for America and its economy to maintain a leading position in the world in the long run, had started long before the drama of September 11. Let us consider a scenario providing a quite sensational prognosis, suggested by Russian experts insisting on the inevitability of the downfall of the U.S. dollar (Khazin and Grigoriev, 2001). On what is this prognosis based?

Growing imbalances between the "new" (informational) and "old" (traditional industrial) sectors are regarded as factors provoking a global crisis. While income generation in the "old economy" has remained comparatively moderate and stable, in the "new economy" it has been rising at rates of up to 10 percent per month (Khazin and Grigoriev, 2001, p. 16). In the economic report of President Bill Clinton to the U.S. Congress delivered on January 12, 2001, the most attention in the national economy was drawn to the leading role of the "new economy," but this phenomenon (as well as its definition) has not yet been fully explored (see, for example, Deikin, 2001, p. 3). This is not surprising, given that many American theorists have expressed doubts about the introduction of the term "new economy" (Deikin, 2001, p. 22). In particular, the question of whether the "new economy" is an advanced phase of the postindustrial society or a new one—an "upper postindustrial" stage (Deikin, 2001, p. 20)—is still being analyzed on a theoretical level. Despite this, let us try to define the meaning of the "new economy" (see, for example, ECE, 2000, pp. 3–5).

One of the significant features of the "new economy" (e.g., Internet technology) is that it requires large initial investments, the benefits of which may be realized only through the very large-scale development of a given project. From any given level of profitability, even small growth in investment can lead to significant profit growth. At the same time, some controversy has arisen concerning profitability and productivity; expectations that the "new economy" would facilitate a sharp increases in productivity have not panned out. Nobel laureate Robert Solow was the first to express doubts concerning the link to computerization productivity growth; these doubts have been empirically confirmed by other American economists (Deikin, 2001, pp. 22–23).

Bill Gates—a living legend in the computer business—has argued that, whereas previous periods of economic development were characterized by long-term stability with short-term revolutionary interventions (called "an interrupted equilibrium"), today, electronic information is creating a permanently changeable environment, which he refers to as "interrupted chaos" (Gates, 1999, ch. 6). While prices for "old economy" products are determined by demand and supply, the prices for "new economy" products are dependent on future yield. Moreover, the current equity value of "new economy" companies is defined by future, in a sense, "virtual" profit and not by the current balance of income and expenditure (Khazin and Grigoriev, 2001, p. 19). The authors argue that this hampers stock market stability: markets increasingly display the features of a financial pyramid, and their sustainability is based on psychology. Insofar as the initial base of the "new economy" assets is rather dubious, any significant slowdown in equity values could entail a large-scale crisis.

The study further argues that after the upturn of the 1970s, the economic growth experienced by the United States derived from the collapse of the Soviet Union and U.S. expansion into its former markets, as well as from the creation of the "new economy," which "pulled in" extensive financial resources. Hence, the United States returned to the phenomenon of the 1920s—rapid economic growth without inflation. The authors acknowledge the peculiarity of the American case, when the "old economy" had started to lose against the "new economy" in the competition for credits and investment and in the labor market, leading to an increase in the cost of factors of production, which in turn affected overall production costs (Khazin and Grigoriev, 2001, p. 23). Thus, a steady decline in the relative profitability of the "old economy" is regarded as a "release mechanism" for the global economic crisis. In particular, should producers raise prices they will fail to compete with importers, resulting in growth of imports and deterioration of the trade balance; while in case of maintaining supply at low prices, local producers will face a real danger of loss.

Under this scenario, a substantial enlargement of the financial capacity of the "new economy" reduces savings and increases consumption, provoking inflationary processes and higher interest rates. The appreciation of the U.S. dollar against other currencies is seen as an additional factor intensifying the inflationary process, resulting in import stimulation. During seven-month period of 2001, the trade balance deficit reached US$20.6 billion, which is 46 percent greater than the same indicator for the relevant period of the previous year (ibid., p. 24). If U.S. companies refuse to contract production in order to protect market share, or produce for inventory (with stock growing substantially—by some 1 percent of GDP per quarter), and publicly present this as expanded production, there is a danger of "excessive" production (ibid., p. 25).

These processes could be further intensified by unstable movements of the colossal amount of U.S. dollars and securities placed outside the

United States available for return at the first sign of a global crisis. This scenario would make growth in the Dow Jones (measuring the performance of the traditional economy) and NASDAQ (measuring the performance of high-technology sectors) indexes unlikely, indicating that the profitability of investment in the U.S. stock market has diminished. At the same time, the index variation has widened, indicating the speculative behavior of "market makers." Other Russian experts (Doronin, Zagashvili, and Pripisnov, 2001) have delivered similar verdicts of the U.S. stock markets. According to them, the fall in prices of shares of high-technology "growth companies" at the end of 2000 and the beginning of 2001 was caused by:

• excessive capitalization; the share of high technology companies in total sales and employment did not exceed 10 percent of the corresponding indicator for nonfinancial companies, but nonetheless represented 36 percent of U.S. stock market capitalization;

• ineffective use of the attracted capital; namely, in 1995–99, 80 percent of US$150 billion was spent by U.S. Internet companies on advertising, investment bank fees for primary distribution of shares, and subsidization of the cost of the services offered; and

• the speculative nature of the uptrend on the high technology stock market, causing the overvaluation of "growth companies."

According to an assessment by Merrill Lynch experts, the fall in U.S. share prices is likely to be followed by a fall in consumption by up to US$100 billion, in turn resulting in a 1 percent reduction in GDP (Doronin, Zagashvili, and Pripisnov, 2001). Half of total U.S. shares are owned by individuals. A devaluation of "paper assets" could therefore significantly reduce consumption spending and therefore aggregate demand, exacerbating (and perhaps prolonging) a potential economic crisis (Rubtsov, 2001, p. 44). This scenario identified November 2001 as the beginning of the economic crisis, since this is the time when enterprises publish their quarterly balance statements (Khazin and Grigoriev, 2001, p. 29). Under the scenario, if by this time inflation is high, the U.S. dollar would depreciate further. According to one author of this scenario, Michael Khazin, €0.96–0.97/$1 is a critical exchange rate; upon reaching this level, the exchange of global holdings of U.S. dollars into euros could greatly accelerate, resulting in the fall of share prices, which in turn could provoke a large-scale international economic crisis.

In sum, the conclusions presented in this scenario with regard to the effects of the crisis are quite pessimistic (Khazin and Grigoriev, 2001, pp. 29–32):

First, the collapse of the foreign exchange market by various estimates could entail a loss of US$7–15 trillion. The market would also lose its function as "hot money" neutralizer, further intensifying inflationary processes and leading to return to the United States of dollars accumulated outside the country after World War II.

Second, financial institutions, the largest part of whose assets consist of securities, would go bankrupt.

Third, budget incomes would diminish, which in turn would be reflected in reduced financing for social programs. With a reduction of 1.5–3 times in average consumption worldwide, the cutback of private consumption in order to recover long-term savings rate would further lower living standards in the United States.

Fourth, the collapse of the World Trade Organization (WTO) would be inevitable, thus encouraging protectionism. Under such circumstances, the U.S. dollar will lose its function as an international currency while the euro is not yet in a position to replace it. As a result, a multicurrency trading system would be restored.

Fifth, countries would shift to the budgetary crediting of production, with inflationary consequences.

Sixth, major exporters to the United States.such as Japan, China, the countries of Southeast Asia and Russia, and the countries of Latin America would suffer, the former through reduced exports to the United States, and the latter through depreciation of the U.S. dollar (because for them it is a parallel currency).

In the short-term, U.S. markets are positively correlated with those of most of the developed and developing countries (Rubtsov, 2001, p. 41), providing a base for the large-scale dissemination of this crisis. While a generation ago it took weeks and even months for stock market and currency crisis to expand, now a crisis can spread in just one day (Gates, 1999, ch. 6). The authors of this scenario believe that, provided Russia creates a relatively flexible Labor Code and succeeds in assuring investors of the immutability of "the rules of the game," given a highly qualified workforce, it will be possible to invest free capital released from U.S. financial markets in Russian natural resources (Khazin and Grigoriev, 2001, pp. 29–31). However, in our opinion it is rather doubtful that large-scale investment would result, given the high level of corruption, high risk factors, and poor protection of foreign investors.

The Russian view of China's economic policy

Since under the Russian scenario of the U.S. dollar crisis protectionism is expected to deepen, Russian experts regard China's financial and economic policies as attractive in providing maximum protection from the anticipated global crisis. However, it is notable that in contemporary China there is a progressive trend that is openly aimed at reaching economic and perhaps even political domination over the rest of the world and the key slogan is "The twenty-first century is the century of China" (Gelbras and Kuznetsova, 2001, p. 119).

The Chinese financial strategy, positively appraised by the Russian experts, can be characterized as follows (Anisimov, 2001, pp. 124–38):

- a comparatively high level of price controls (sectors producing raw materials are fully state owned, allowing the state to use low prices to stimulate exporters while protecting domestic producers with tariffs);
- an average tax burden and customs tariffs, which encourages competition;
- high private savings rates that provide large financial inflows to banking institutions;
- large state investments (state credits average US$3 billion per year, of which medium and long-term credits issued exceed US$1 billion); and
- a managed exchange rate system, which also implies two currencies: first, the Hong Kong dollar, which is effectively used on foreign markets, and a relatively "soft" but on the whole sufficiently "strong" yuan.

China's state, financial, and economic structures are so specific that their "replication" to other states is difficult. At the same time, as history has demonstrated, state responsibility for significant market functions raises serious questions about the sustainability of this growth strategy in the long run.

The weakest point of the scenario prepared by Russian specialists is its overdramatization, which is most apparent in the assumption that trends in the U.S. economy will inevitably turn into a dollar crisis and global economic collapse. Although we partially agree with the main approaches presented in this scenario, it is difficult to agree that the dollar crisis has definitely been caused by development of new technologies. In particular, the main arguments in favor of the "new economy" are that new information technologies and market liberalization have changed the principal macroeconomic relationships between output growth, inflation, and unemployment. New technologies ensure more effective management of reserves; enhanced management of information flows allows a more economical use of resources; while the Internet provides the consumer with a wider choice of products which, other things equal, leads to low inflation (ECE, 2000, pp. 2–5).

Modification of the Russian scenario in the conditions of antiterrorist war

The Russian scenario of the U.S. dollar crisis does not allow for correction of the above-mentioned processes based on the possibility of wars (Khazin and Grigoriev, 2001, p. 33). With a qualitatively new antiterrorist war having broken out in the world today, questions naturally arise regarding the possibility of global economic crisis and whether the United States will retain its economic hegemony in the world. The answers to these questions depend on the scale of the antiterrorist campaign and its territorial spread. Two scenarios can be considered:

First, the limitation of the antiterrorist campaign to Afghanistan and Iraq, particularly if there are no retaliatory terrorist assaults on the United States or allied states. In this case, the antiterrorist war would acquire the features of the U.S. war waged against Vietnam or Iraq (in the early 1990s) or that of NATO against Yugoslavia. The U.S. economy may perhaps even benefit from such a course of events. Military spending needs may "drain" the economy of excessive financial and material resources, thus further extending the economic recovery. In addition, the U.S. leadership of the antiterrorist campaign has to some extent prepared companies and the population to consider the risk of war in their decisions. Thus, according to the first scenario, a global economic crisis is practically excluded.

The *second* scenario involves the occurrence of successive acts of international terrorism causing the fight against it to go beyond the boundaries of one particular state. In the case of expanded terrorist aggression, it would be quite difficult to defeat international terrorism by means of so-called targeted attacks, thus further complicating matters. *First,* if the terrorists again succeed in committing significant acts of aggression, it may seriously undermine confidence in the effectiveness of antiterrorist operations as well the United States. If this happens, a loss of trust in U.S. financial institutions could result. In particular, belief in the omnipotence of the United States and its currency may be damaged.

Unfortunately, the immediate signs of this trend have apparent in the past decade. While the 1989 share of the U.S. dollar in total foreign exchange market turnover was 45 percent, in 1995 it was just 41.5 percent (the U.S. share in world GDP is 20.7 percent and in world exports—15.2 percent); similar indicators for the European Union are 20.4 percent and 14.7 percent, respectively. During this period, the share of the deutsche mark increased from 13.5 percent to 18.5 percent and of the French franc from 1 to 4 percent; the impact of the Swiss franc decreased from 5 percent to 3.5 percent; the Japanese yen fluctuated between 12 and 13.5 percent (Tavlas, 2001, p. 4). An analysis of M2 growth rates for 1996–2000 gives the same picture: in particular, in the United States M2 fell by 4.7 percent, while, on the contrary, in Japan it increased by 47.9 percent, in the euro zone by 47 percent, in Great Britain by 47 percent, for the Asian Four (Korea, Singapore, Taiwan, and Hong Kong) by 39.7 percent, and in Switzerland by 3 percent (IMF, 2001a, p. 802; 2001b, p. 216). This appreciation of the major world currencies was not inflationary: in Japan, in 1996–2000 there was 6.6 percent deflation combined with significant growth in monetary aggregates (by 47.9 percent). In Great Britain, a 13.6 percent rise in prices insignificantly exceeded that of the United States, while the growth of monetary aggregates was much more significant (47 percent) (IMF, 2001b, p. 205). Following these trends, further reductions in demand for the U.S. dollar can be expected.

Second, the U.S. balance of payments deficit may continue to grow in the short-term, which, together with reductions in the use of the U.S. dollar, may provoke its devaluation. *Third,* the U.S. antiterrorist campaign will to some extent utilize excess resources and postpone a possible crisis of excessive production. *Fourth,* U.S. government demand for safety measures for high technologies will increase, "diverting" private investments to state investments (the "crowding out" of private investments by state ones). This in turn may put upward pressure on interest rates which, considering the high transparency of the U.S. economy, would increase capital inflows, leading to an improved external position and an appreciation of the U.S. dollar again (although it may be difficult for it to return to its former position of primacy). *Fifth,* the aviation and insurance sectors have suffered serious damage, which may also affect other sectors. Insurance and reinsurance companies could generally increase insurance premiums, ultimately resulting in increased production costs and hence increased prices.

Terrorists may try to use computers to disrupt electronic connections in various fields. Using this form of aggression in financial markets could make a worldwide financial and economic crisis inevitable.

Under the second scenario, with the antiterrorist war under way, prospects for evading a global economic crisis largely depend on the success of military actions by the United States and its partner countries. The success of antiterrorist operations carried out in Afghanistan and Iraq has significantly lessened the potential for a second occurrence.

A significant rise in oil prices is not very likely to occur. A moderate rise could result from increased insurance costs in oil production and transport, and of certain delays in supply. Terrorists are unlikely to carry out terrorism against oil-producing Islamic countries, as this would deprive them of a potential justification to declare jihad—religious war—against the West. It is dubious whether this will contribute to the political attractiveness of the Baku–Tbilisi–Ceyhan oil pipeline. Likewise, antiterrorist hostilities seem unlikely to hamper the functioning of the Georgian transport corridor. Should this happen anyway, it would favor the development of Russian transport links and Russia will naturally make maximum use of this opportunity. The U.S. government decision to use U.S. military advisers to prepare Georgian army units to carry out antiterrorist operations will improve the national security situation, which in turn will contribute to the further increase of the international role of the Georgian transport corridor. In the U.S. war against terrorism, the understanding and support of such Europe-oriented Islamic countries as Turkey and Azerbaijan has been growing. This will further increase the role of the Georgian transport corridor for energy from Azerbaijan to Turkey.

When Russian experts conclude that a global economic crisis as inevitable (which in our opinion is somewhat exaggerated), questions arise concerning Georgia's monetary policy in the case of a possible devaluation of the U.S. dollar and the advantages and disadvantages of maintaining the current rate of the Georgian currency—the lari. Georgia's large shadow economy is "served" mostly by the U.S. dollar. The shadow economy would suffer most in case of a significant U.S. dollar devaluation. In Georgia the share of statistically unrecorded production in total output was 35 percent in 2002, while in the entrepreneurial sector this indicator is 56 percent (SDSG, 2002, p. 5). A severe devaluation of the U.S. dollar would place almost one-third of the Georgian economy (i.e., the shadow economy) and over half the entrepreneurial sector at risk of total destruction. A shift to the legal sector will be prevented by a similar situation inside the shadow economy; as of 2002, deposit liabilities and the amount of loans in U.S. dollars issued to the nongovernmental sector from the banking system exceeded 80 percent (ibid., pp. 29, 31).

For the legal sector of the Georgian economy, a positive effect of possible U.S. dollar devaluation would be reduced lari expenditures on foreign debt servicing and repayment, which would lessen the burden on Georgia's state budget. At the same time, some negative effects should also be considered:

first, import growth, which would further increase the balance of payments deficit;

second, reduction of tax incomes to the budget from foreign investments; and

third, fewer possibilities to cover budget liabilities from external sources.

Georgia faced certain challenges, owing to the financial crisis in Turkey, its major trading partner. However, support from the International Monetary Fund (IMF) has relieved the tension.

Along with tightening customs control, Georgia should introduce certain restrictions based on international quality standards in order to protect consumer interests in Georgia and to improve the balance of payments.

In the case of a possible devaluation of the U.S. dollar, the diversification of currency reserves by the NBG is very important. According to some experts, in view of the confrontation of the United States and its allies against Islamic terrorists, it is likely that the greatest stability will be maintained for the currencies of countries that are less involved in military actions. This includes, first of all, the Japanese yen and the Swiss franc. Hence, the currency reserves of the NBG should reflect a five-pole economy (U.S. dollar, euro, yen, pound sterling, Swiss franc). Because the IMF unit of account—special drawing rights (SDR)—is characterized by high stability, the NBG could also manage its currency reserves of the NBG according to the structure of the SDR "basket" (see, e.g., IMF, 2003). Indeed, the NBG has recommended that commercial banks and private entities diversify their deposits in order to minimize risk (Papava and Chocheli, 2002).

Prospects for the formation of a "tripolar world exchange system"

In this section, we discuss the opinion of well-known multimillionaire and philanthropist George Soros, that in the near future the U.S. dollar is likely to lose one-third of its value (see, e.g., "Soros Warns," 2002). In his opinion, confidence in the U.S. administration's economic management has been undermined throughout the world. Merrill Lynch experts, who forecast a rate of €1.25/US$1 by the end of 2003, made a similar prognosis; and their colleagues from Goldman Sachs went even further, predicting €1.35/US$1 (see, e.g., Mikhailovich, 2003, p. 13).

According to Soros, the depreciation of the U.S. dollar will affect the world economy and the accounting scandals and corporate frauds in certain major American companies will stimulate an outflow of capital from the United States. This statement has given rise to a new wave of debates concerning future prospects for the U.S. dollar and the U.S. economy as a whole. About ten years ago, Soros made similar statements concerning the British pound. He converted his assets into sterling when its rate had reached minimum value, thus gaining high profits (see, e.g., "Dollar and Euro," 1999).

While we could perhaps partly concur with these forecasts, it seems less probable that events will develop in such a dramatic way and that the U.S. dollar will experience such a strong devaluation. This would create a threat to the international exchange system and hence to the normal functioning of the world economy.

The United States, Japan, and the euro zone produce 45.3 percent of world GDP and they also account for 42.8 percent of world imports and 40.9 percent of exports (Iša, 2002, p. 13). Severe economic shocks in these countries might provoke a worldwide economic crisis, which is not in the interests of these (or any other) countries. A successful peace operation in Iraq would have a positive impact on ongoing economic processes in the United States and the rest of the world. In particular, it would increase the real incomes of households and corporations, which would benefit from a steady fall in energy prices. However, should partisan warfare persist on any scale, Iraq is likely to lose any attractiveness for investment.

The wave of corporate crises that first occurred in Great Britain in 1995–99, and which reached the United States at the end of 2002, to a great extent destroyed the myth of American economic omnipotence and weakened the position of the U.S. dollar. Nevertheless, it is too early for the U.S. dollar to be "written off." At first glance, a purely American problem has initiated the formation of a "three-pole world exchange system," which we believe will become of paramount importance for the global monetary system. What are the grounds for drawing such conclusions?

The prognosis that the creation of the euro would shake the leading positions of the U.S. dollar has come true. Its initial depreciation proved to be only temporary and subsequent economic developments have proved the validity of the above assumptions. In May 23, 2003, the euro was worth US$1.1837, exceeding by $.01 the rate of US$1.1747 in January 1, 1999, when the euro was introduced. It is also worth noting that the hypothetical euro rate during the past decade, calculated on the basis of the currencies comprising the euro basket, is somewhat higher than the maximum euro quotation. As estimated by the vice president of the European Central Bank, Lucas Papademos, the maximum euro rate is close to the average hypothetical euro rate for the past fifteen years ("Euro Rises to Record Level," 2003). This suggests that the euro still has the potential for further appreciation. The introduction of the common European currency has significantly reduced transaction costs between these countries to zero, thereby increasing its potential for further appreciation. Moreover, free movement of goods and services, capital and labor will contribute to the more effective distribution of resources.

However, it is unclear whether a further devaluation of the U.S. dollar is reasonable, and how acceptable a "cheap" dollar is for the economy of the European Union, Japan, and other developed countries. The answer will definitely be negative, as a significant devaluation of the U.S. dollar could set off a cascade of devaluation processes in its major trade partners, leading to increased protectionism and a downturn in the global economy (Papava and Chocheli, 2002). This suggests that an effective appreciation of the euro is less acceptable and parity with the U.S. dollar will either be maintained or exceeded. Although the economic situation in Europe is much better, a further strengthening of the euro would diminish the competitiveness of European goods both on domestic and foreign markets, thereby endangering economic growth in the euro zone.

Unlike the U.S. Federal Reserve System, the European Central Bank has a cushion (reduction of the interest rate) for maintaining currency stability and promoting growth. The further enlargement of the euro zone (through Great Britain's potential accession) would also promote euro stability, as economic growth in Great Britain has consistently exceeded the euro-zone countries. However, as was recently underlined by the chancellor of the Exchequer (minister of finance), Gordon Brown, five tests intended for Great Britain, which were supposed to ascertain its readiness to enter the euro zone, have produced negative results, postponing its accession for an indefinite period of time ("Germany's Euro Test," 2003).

Several other factors will influence exchange rate trends. Let us consider the factors putting downward pressure on the U.S. dollar.

The first factor is shrinking confidence in the U.S. economy, which will weaken the dollar on foreign exchange markets and reduce the share of dollars held in central bank reserves. Until recently, trade in oil and gold was carried out in U.S. dollars and approximately 50 percent of central bank reserves were held in U.S. dollars ("Euro Rises Near to Parity," 2002). The impending collision between the "old" and "new" economies is one such driver of these pressures: As explained above, this situation introduces "pyramid scheme" elements into the U.S. stock exchanges, reducing their stability. The bankruptcy of giant corporations such as Enron and WorldCom and a catastrophic fall in the share values of other companies was a tremendous shock to the whole world. This crisis has touched auditing companies, stock market regulators, commercial banks, rating agencies, and corporate management. Owing to the U.S. economy's openness, these developments will have a significant effect on the economic situation in other leading countries as well. These problems are aggravated by elements of the so-called bubble economy, in which prices for securities and real estate undergo unjustified and destabilizing speculation (see, e.g., Bok Zi Kou, 2002, p. 178; Nariai, 2002, pp. 56–57). Taken together, these characteristics can have a significant macroeconomic effect on the country's monetary and fiscal system.

Second, corporate scandals have significantly distorted the U.S. capital account, which is reflected both in increased capital outflow and decreased capital inflow. U.S. balance of payments deficits have traditionally been covered by net capital inflows. While in 1999, 91 percent of the current account deficit was financed through foreign direct investments, by 2002, this indicator had fallen to 43 percent ("A Cliff-hanger," 2002, p. 69). Experts believe that this downtrend will persist. This trend reflects a lack of confidence in the U.S. economy.

Third, the depreciation of the dollar persuades foreign investors to sell securities and shares, which reduces their price. Foreigners possess some 40 percent of U.S. Treasury bills as well as one-third of other securities and 13 percent of real estate (ibid., p. 70).

Factors that work to prevent the devaluation of the dollar include:

First, central banks have been intervening in foreign exchange markets to support the dollar and prevent the appearance of an "expensive" euro or yen that would cause excessive reductions in exports. These banks have been willing to increase the share of the dollar in their official reserves, via collective foreign exchange market interventions. The analysis made by a professor at the University of Tokyo, Takatoshi Ito, showed that joint interventions by central banks of various countries in the 1990s proved twenty to fifty times more effective than intervention by the Central Bank of Japan alone (ibid., p. 69).

Second, a small depreciation of the dollar will stimulate U.S. exports and increase corporate profits and investment. At the same time, it will facilitate implementation of structural reforms and corporate restructuring in the euro zone and Japan, thus raising efficiency in the regions and benefiting the international economy as well. According to one estimate, the dollar's 20 percent depreciation will cause 1 percent growth worldwide (ibid., p. 70). However, as noted above, such a depreciation seems unlikely.

These developments are pushing the world toward a "three-pole exchange system" (U.S. dollar, euro, and yen). However, gold as an international reserve asset has become of paramount importance again. Hans Tietmeyer, a professor and former president of the Deutsche Bundesbank, emphasizes that gold accounts for about €40 billion (15 percent) of the reserves of the Central Bank of Europe and 10.5 percent of Russia's international reserves ("Gold Important," 2001). This trend persists in other countries as well: countries in Latin America and Asia insist on increasing the role of the euro in the international monetary system. For instance, the MERCOSUR (Southern Cone Common Market) countries of Latin America and countries of Association of Southeast Asian Nations +3 (China, Japan, Korea) are interested in regional monetary integration which, in their opinion, has been successfully implemented in the euro zone (Thygesen, 2002).

The new global monetary system and monetary policy in Georgia

The postwar organization of Iraq will significantly influence the international economic order. This will be a key factor that will affect U.S.

economic activity. After hostilities ended in Iraq, the United Nations Security Council adopted a resolution on the reversal of economic sanctions against Iraq, which fully authorizes the United States and Great Britain to attend to the postwar reorganization of the country and to manage its oil deliveries (see, e.g., Episheva, 2003, p. 26). Before the war, oil deliveries of Iraq to the world market had reached 2 million barrels per day. While there was severe damage to the oil industry infrastructure, it is a matter of time before oil production surpasses its prewar levels. According to more optimistic forecasts, Iraq will be able to increase production to 6 million barrels per day, ranking it fourth in the world in oil production after Saudi Arabia (8.8 million barrels), the United States (7.2 million barrels), and Russia (7.1 million barrels) (Sichinava, 2003, p. 21). At this level of production, Iraq will be able to offset some of OPEC's impact on oil prices.

If increased deliveries of Iraqi oil significantly reduce world oil prices, global economic dislocation could result. This would be particularly dangerous for Russia, with the lion's share of its budgetary income received from oil exports. It also represents a danger for Georgia, as a possible devaluation of the Russian ruble could considerably affect Georgia's trade with Russia. This could sharpen pressures on Georgia's balance of payments and endanger the stability of the lari—the only "bright spot" in Georgia's financial picture.

Such developments would raise questions about what Georgian monetary policy should be in circumstances of "expensive" and "cheap" foreign currency, as well as the pluses and minuses of maintaining the current exchange rate. Since Georgia's monetary system is undeveloped, control of the general price level is no less important than control of the real exchange rate. Empirical and theoretical research shows that in transition economies, institutional and structural factors have a stronger impact on exports than the exchange rate (see, e.g., Chocheli, 2003, Papava, 1997).

The euro has become the world's second major currency, creating the third pillar of "world money" together with the U.S. dollar and yen. The exchange rates among these "three islands" of stability will become the most important prices of the world economy (Mundell, 2000). This makes diversification of the NBG's official reserves a priority. It also raises questions about:

• the extent of actual diversification of NBG official reserves;

• the extent of diversification of deposits for commercial banks and private companies; and

• the enabling of mechanisms for option transactions (so-called no-loss operations), which can protect the real value of assets belonging to commercial banks and other economic agents.

For 2002, deposits in euros made up just 2 percent of total deposits (Kakulia, 2003, p. 33). Should the euro become strong while a large part of deposits is in U.S. dollars (83 percent), "losses" of economic agents will be significant (NBG, 2003, p. 12). Diversification of official reserves is also essential for maintaining public confidence in the lari, which could put the remaining stability of the banking system at risk. In January–March 2003, national currency deposits shrunk by GEL [Georgian lari] 8.9 million and foreign currency deposits grew by GEL 9.4 million (ibid.). Expectations of economic agents, as compared to the relevant period of the previous year, in 2003 were much more pessimistic. This is a result both of Georgia's undeveloped fiscal environment and of global economic developments. In particular, economic agents have decided that the dollar's depreciation reflects the economic situation in the United States

It should be underlined that the biggest threat to the Georgian economy is not the formation of a "new monetary order" in the world, but rather domestic economic policies that produce fiscal imbalances and make Georgia less attractive for investment. Likewise, the biggest threat to Georgia is not external shocks but the existing crisis situation inside the country (Gotsiridze and Kandelaki, 2001; Tokmazishvili, 2004). This can never be overcome unless corruption (Papava, 2000) is deprived of its economic basis and poverty is eliminated through economic recovery (FIAC, 2003), which in turn requires carrying out serious system reforms.

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