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HIGH INFLATION DOMINATES INCREASED BUDGET REVENUES – EXPERT

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“Current official state statistics that the inflation level stands at 11%-12% in Georgia now is false,” says economic analyst Vladimer Papava.

Prof. Vladimer Papava, former Minister of Economy (1994-2000), former MP (2004-2008) and Senior Fellow at the Georgian Foundation for Strategic and International Studies was a vocal critic of the economic, financial and monetary policy even when he was serving as Deputy Chair of the Parliamentary Committee for Budget and Finance.

Speaking with Georgian Business Week, Papava says the government keeps misinforming the public about the inflation, economic growth rate and the state budget which ostensibly has surplus.

Q: Why should Department of Statistics be distorting the figures about the inflation rate?

A: After the Rose Revolution Department of Statistics became part of the Ministry of Economic Development. This means, that the government which is responsible to develop and

implement economic policy, published the data itself depending on the results of its policies. Therefore, there is an obvious instance of the conflict of interests.

Q: That is Department of Statistics tried to misrepresent the reality because it is under the influence of the Ministry?

A: Since Department of Statistics is part of the Ministry of Economic Development, the government has always a temptation to portray the situation better than it is in reality. This is not only the temptation of the Minister or Prime Minister. If I were Minister, I would also faced the temptation. This is why the figures are corrected and this is why I am saying there is conflict of interests.

Q: And what is the result of this erroneous figures and data?

A: It's really disastrous as not the government neither the people have accurate data about the actual state of the Georgian economy. Consequently, the government's action plan, which would say what should be changed and how, is developed in the wrong way. It is like if a man suffers from heart infraction and the cardiogram would now show that. Will not this patient die? This is the situation in Georgia. Department of Statistics does not have local points in the regions and accordingly it does not have access to first-hand data. The Department of Statistics obtains the data from the Ministries and in better case from the local self-governance bodies. The Department of Statistics does not have to receive information from the government and other state bodies – it should obtain first-hand information itself.

Q: What is actual rate of the inflation and how will that affect the pockets and the economy of the country?

A: Inflation rate today is high enough and we are going to feel that on our pockets. However, official data says that the inflation stands at 12%. Since they published this rate, I suppose the inflation in actuality might be running an 18% high. As the employees of the Statistics Department note in personal conversations inflation hit 3.4% in January but official figures said it was only 2.5%. This means that the Department reduced the rate by 1/3 and more. That is, if they put the rate at 12%, the actual inflation rate might be at least 18%.

Q: Are there any alternative means to define inflation?

A: Economic theory says that the nominal interest rates should be higher than the annual inflation. Otherwise the loan will be loss-making for the bank. Therefore, there is an elementary interdependency – the nominal annual interest rate is higher than the inflation. The commercial banks in Georgia set the annual interest rate at 36%. It is absolutely unimaginable that the inflation rate is 12% and the banks set their interest rate at 36%. So, the Banks have grasped how high the inflation is and they take into account not only the current level of the

inflation, but the inflation expectations as well. Based on these assumptions and data, I can say that upper limit of the inflation (the annual inflation + inflation expectations) is 30%-32% and the lower margin might be 18%. I cannot tell you the exact data. We need to have an independent Department of Statistics for that.

Q: How would the rising inflation affect the activity of the banks?

A: It will not certainly have a positive effect. As the Banks have to raise the interest rates, the number of the potential creditors would go down and this will hit hard our economy. As the loan is one of the means to increase turnover and other resources.

Q: In July 2008 the government amended the state budget in July this year saying the economic growth reached 7.5% instead of 9%. Do you think these figures are erroneous as well?

A: The government explained that it expected 7.5% economic growth by 2008 but in reality the growth would be as high as 9% which would generate additional tax revenues. The logic in itself is right. However, if the Department of Statistics is cheating us with its inflation figures, its economic growth rate would be false too. But let's assume that the government's economic growth rate is accurate to some extent. If they projected 7.5% growth in the budget and now this rose to 9%, in reality the growth is just 1.4% (109 would be divided into 107.5) while the government told us that the tax revenues would increase 4%. That is, the tax revenues grow faster than the GDP. The question is How? – This might happen either by changing the tax policy or using administrative resources. The government has not amendment its tax policy this year while it enacted its administrative resources fully in 2004 and there is no additional resource left as business and the people started paying taxes.

Q: Then what is your explanation? Why do tax revenues grow faster than the economy?

A: Very simple: high inflation increases the tax revenues. That is, when the price rises, more tax payments would go to the budget but the real value of these additional revenues is less. The government receives more tax revenues but not because it is working well but because there is high inflation. This is known as Oliver-Tanzi Effect in economic theory. No one wants to talk about this but the fact is that we have two sources of increased tax revenues: one is economic growth and another is high inflation.

Q: How does the government's economic team respond to these threats?

A: As for stopping inflation, I can say that I fully agree with NBG's policy. It has issued certificates of deposit to reduce the money supply on the market and this is a right step. However, it is impossible to regulate inflation fully and needs government's support. The

government made a very unpopular step recently when it cut funding to the Ministry of Health and Social Protection with 30m GEL. But if this was done to curb inflation then this is a right decision and I would welcome that. The government should not push inflation by assuming new social responsibilities. A big portion of the expenses which goes to the Ministry of Health and Social Protection will then appear on the consumer market and will effect consumer prices ultimately.

Q: But the government is implementing a number of other social projects and spends millions of laris on them. For instance cheap credit program...

A: Yes, such programs are implemented but as far as I know these programs have been put on hold lately. The government should actually compose the budget with surplus.

Q: The government says that Georgia does have a budget with surplus today...

A: The budget sees surplus when the tax revenues exceed the expenses and these expenses are not spent during the year but is accumulated. This is not the case in Georgia. The government does not spend the revenues fully whether they are tax revenues or others. Therefore, the revenues in general exceed the expenses and this is how it sees surplus. What counts is the economic essence not the term – budget with surplus. For instance, the privatization windfall has inflation effects, because it is a revenue from non-economic activity. Just imagine, Georgia increased its foreign debt with additional 500m USD by issuing Eurobonds. This is source of the deficit and how can we have surplus in the budget? This is why I am saying that we have ‘virtual surplus.’ The government should start thinking how to generate surplus where tax revenues will be higher than expenses. But the fact is that it is not going to do so as the acting legislation does not define surplus this way.

Q: Is it because lack of expertise or?

A: I do not rule out that this is due to lack of expertise. But the second part of your question “or” -, that is, what is meant in this ‘or’ is also possible.