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## Georgia's Economy

### The Search for a Development Model

*Since its declaration of independence, Georgia has failed to create an economic system that can provide the basis for stable economic development. The expectations and reforms undertaken after the “Rose Revolution” have not been met. What has developed as a result is a poor country’s consumer economic model. After the opposition victory in Georgia’s October 2012 parliamentary elections, another opportunity to create and develop a competitive real sector has appeared, but taking advantage of it will require a free trade regime with the European Union (and in the slightly more distant future, with the United States) and the resumption of trade with Russia. Concerted government action is necessary to implement these tasks.*

#### Before the next elections

On October 1, 2012, the Georgian people not only had to elect a new parliament but also had to make a fundamental choice about whether to maintain the policies pursued by the National Movement party, in

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power since the Rose Revolution in November 2003, and its leader, President Mikheil Saakashvili, or to abandon them. The dilemma was not incidental, since most voters in the parliamentary elections voted against Saakashvili's policies. Because billionaire Bidzina Ivanishvili's Georgian Dream coalition offered the only realistic opposition force, many considered a vote for him essentially a referendum on seizing power from Saakashvili.

Notably, Georgia's 2012 parliamentary elections were not an exception in this context, because the principle of voting "against someone" rather than "for someone" has deep roots in this country. After Georgia's independence was restored in 1990 by the election of the Supreme Council, the people chose Zviad Gamsakhurdia and his Round Table party in order to keep the communists out of power. In 2003–4, voters opposed Eduard Shevardnadze and his Union of Citizens party, preferring Saakashvili and National Movement.

We know that voting "against someone" cannot be considered constructive, given that it provides blind voter support to the alternative. As a result, those who come to power in this way feel no special responsibility toward the electorate. This danger threatens Georgian Dream, as well.

The main reasons voters were opposed to Saakashvili and his party were, above all, the gradual strengthening of authoritarian rule, the systematic violation of human rights, and the restriction of free speech. It was no less important that the economy had accumulated a number of problems that played a significant role in the electorate's behavior in the October parliamentary elections.

This is why understanding the given economic situation in Georgia and defining its main challenges and directions of economic development are major tasks for the expert community. We should begin that process by analyzing the economic reforms of recent decades.<sup>1</sup>

### **On economic reform in post-Soviet Georgia**

During the more than twenty years that have passed since the country regained its independence, Georgia's economy has undergone great changes. The first years were extremely difficult, with the country involved in armed conflict, and in the absence of any meaningful economic policy. Serious blunders occurred, especially at the initial stages of transition from the command economy to a market economy.<sup>2</sup>

As a result of these mistakes, gross domestic product (GDP) in 1993

amounted to 28.6 percent of GDP in 1989, and annual inflation in 1994 exceeded 7,840 percent.<sup>3</sup> In other words, the country had fallen into a hyperinflationary spiral.

In 1995, currency reform was successfully implemented, resulting in macroeconomic stability and almost 24 percent GDP growth for two years, 1996–97.<sup>4</sup> During this period, the implementation of economic reforms based on the well-known “shock therapy” idea was supported by the International Monetary Fund (IMF) and the World Bank, although not all of their recommendations were beyond reproach.<sup>5</sup>

Georgia’s fiscal and energy crises were exacerbated by the negative effects of Russia’s 1998 default on its economy, mistakes made in its own reforms, and growth in the extent of corruption. In 2002–3, 52–55 percent of Georgia’s population earned less than a living wage.<sup>6</sup>

After Georgia’s Rose Revolution in November 2003, a war against corruption began, as a result of which the budget and energy crises were overcome. Since 2005 the tax burden has been appreciably reduced thanks to a new tax code, the procedures for starting businesses have been significantly simplified, and a new labor law has been adopted, giving employers complete license vis-à-vis their employees. As a result, Georgia became a nation of neoliberal reforms.

This topic has produced much discussion, including agitprop that gives a one-sided view (aligned with the successes) of the ongoing reforms of the Georgian economy. This is how the myths of the exceptional success of reforms undertaken by the Saakashvili government came to be.

Despite the seemingly successful reforms, in 2003 Georgia was first among its Caucasus neighbors by the most general economic measure (GDP per capita: Georgia, \$922; Armenia, \$917; and Azerbaijan, \$884), but in 2011 it fell to last place (Azerbaijan, \$6,916; Armenia, \$3,305; Georgia, \$3,203), according to World Bank data.<sup>8</sup> An appreciable increase in the production and export of oil and gas explains the substantial economic growth in Azerbaijan. As for Armenia, it became the leader (at least regionally) in economic reform, managing to grow at a faster pace than Georgia without any “color revolutions” or world-famous neoliberal reforms.

In recent years a number of articles have been published to expose these myths by more or less objectively analyzing the success and mistakes of the Saakashvili government.<sup>9</sup>

Among the economic mistakes made in the first nine years after the Rose Revolution, the most significant were the violation of property

rights, the establishment of government control over big business, the heavy monopolization of the economy due to the abolition of antitrust laws and related services, and rampant elite corruption that replaced the more widespread bribery-focused corruption. The costs of these mistakes grew as the judiciary branch was further subordinated to the administration.

These violations (especially of property rights) are by nature akin to neo-Bolshevism, as a result of which Georgia's postrevolutionary economy has become a symbiosis of neoliberalism and neo-Bolshevism.<sup>10</sup>

Using modern public relations technology as well as his oratorical skill, Saakashvili long maintained his image as a Western-oriented democrat and reformer of post-Soviet space. This may explain why people blindly supported the Saakashvili regime without noticing its authoritarian nature. Considering this background, it is no surprise that the IMF and World Bank chose to turn a blind eye to the failures of his government's economic policy.<sup>11</sup>

Saakashvili's authoritarian style of governance, supported by elements of despotism (people began to discuss this openly after videos taken in Georgian prisons were exhibited in mid-September 2012) made his regime neo-Bolshevik and his administration "rose-colored," which seems to emphasize its rise to power through the Rose Revolution on the one hand, and its heredity from the faded "red" Bolsheviks on the other.

### **A poor country's consumer economy**

During Georgia's more than twenty years of national independence, and especially after the Rose Revolution, the problem of choosing a development path has always remained relevant for the country. Naturally, the problem is no less relevant in the post-Rose period, following National Movement's losses of the parliamentary majority and leadership. In this regard, it is necessary to understand the basic nature of the economic model that has taken shape in contemporary Georgia to the present day. Unfortunately, it is based not so much on production growth, but on stimulating consumption, which has created many negative consequences. Stimulating consumption without proper development of the economy's real sector has led, for example, to the fact that imports have been more 3 times greater than exports in recent years.<sup>12</sup> No less than 22 percent of this export is automobiles and 8 percent is scrap metal. However, as we know, Georgia has no automobile industry, so this 22 percent of exports

derives from the country's position as a transshipment point for the import of automobiles for resale in neighboring countries. The significant lag between exports and imports, as well as the fact that 30 percent of exports are not produced in the real sector, indicates the economy's relative backwardness.<sup>13</sup>

That the Georgian economy is oriented more toward consumption than production is further evidenced by the fact that the total volume of private and public consumption is about 90 percent of GDP.<sup>14</sup> Despite the relative backwardness of production, consumption growth is ensured due to the inflow of funds from abroad. For the first few years after the Rose Revolution this was accomplished through foreign direct investment (FDI),<sup>15</sup> and remittances to Georgian citizens from relatives living abroad.<sup>16</sup>

FDI generally accumulated in real estate, which created additional financial resources within the country. Acting mainly through the banking system, it contributed to the growth of housing construction, which became a financial pyramid scheme due to inadequate state control.

After the country regained its independence, many residents of Georgia emigrated for one reason or another. To date, about 20 percent of Georgia's population (more than 1 million people) live abroad—two-thirds of them live in Russia, with others in Greece, Turkey, Ukraine, the United States, and Spain.<sup>17</sup> The size of remittances through banking channels alone exceeds \$1 billion annually.<sup>18</sup> The funds are used primarily to meet essential needs.

Due to a low level of savings, the main source of replenishing and growing the credit resources of commercial banks was borrowing on the European financial markets, which mainly offered loans for construction businesses and household appliance purchases. But since there is no production of household appliances in Georgia, consumer loans from national commercial banks contributed to real sector development in those countries where the production took place. In other words, the Georgian banking sector turned out to be a financial conductor of foreign borrowing for the benefit of a third country's real sector development.<sup>19</sup> Thus, the growth of financial currents in Georgia after the Rose Revolution created new demand without fostering development in production.

After the onset of the global financial economic crisis, FDI flowing into Georgia fell sharply. The Russian–Georgian war in August 2008 also contributed to this. At the same time, the international community

offered war-afflicted Georgia \$5.8 billion in financial assistance,<sup>20</sup> which softened the effect of the crisis on the country.

Due to insufficient development of the economy's real sector, the unemployment rate is high. According to official numbers, it is consistently in the range of 13–15 percent,<sup>21</sup> although in various public opinion polls conducted by both local and foreign nongovernmental organizations, 70 percent of respondents consider themselves unemployed.<sup>22</sup> This is primarily because, in recent years, some 50–70 percent of the workforce is self-employed,<sup>23</sup> and their wages are so low that they do not consider such work to be employment.

More than 80 percent of the self-employed are in agriculture. While 54 percent of the workforce is employed in the agricultural industry, the production share of this sector in GDP is just slightly more than 8 percent. This suggests a crisis of underproduction for Georgia, which has excellent environment and climate conditions for agricultural development. This in turn explains why the food basket accounts for 80 percent of imported products.<sup>24</sup>

The sector has also suffered because, since 2006, Russia's Chief Sanitary inspector has banned the import of agricultural products of Georgian origin allegedly due to their poor quality.

The development of tourism in Georgia has led to growth in the demand for food, which during this agrarian crisis can only be met by increasing imports. Considering the effects of agflation on the global economy, we can say that Georgia has "imported" agflation, as well.

It is no surprise that 40 percent of the population lived below the poverty line during the Rose regime.<sup>25</sup> According to experts, 86 percent faced severe social problems.<sup>26</sup>

After the Russian–Georgian war in August 2008, the European Union (EU) expressed its readiness to grant Georgia a Free Trade Agreement (FTA), contingent on the prior fulfillment of certain conditions, among which the most important was the implementation of European institutions for antitrust market regulation and consumer protection, particularly in regard to food security.<sup>27</sup> Unfortunately, the Saakashvili government did everything it could to stall the beginning of the negotiation process with the EU, hampering the implementation of these conditions.

At the beginning of 2009, the United States and Georgia signed a Charter on Strategic Partnership, which would provide Georgia with an FTA from the United States. However, real steps in this direction, or at least to the beginning of negotiations on this topic, have not yet been taken.

In the search for a model of economic development, Georgia has been formally and actively promoting its orientation toward Europe without taking any real steps in that direction. According to President Saakashvili, Georgia needed to develop its economy along the Singaporean model.<sup>28</sup> In choosing this path of “Singaporization,” the government in fact increasingly alienated Georgia from the EU and from European-style economic mechanisms as a whole.<sup>29</sup>

### **Hope for a change**

The primary task of the new leadership is to lead Georgia out of poverty by increasing the country’s export potential through stimulating development in competitive domestic production. It is especially important to understand the prospects for Georgia’s economy to position itself internationally.<sup>30</sup>

Solving these economic problems in 2013 is especially difficult because of the current political situation in the country. In particular, the constitution mandates presidential elections in October, which will undoubtedly continue the rivalry between Saakashvili and Ivanishvili. At the same time, we must not forget that the judiciary branch, local governance and self-governance agencies, the National Bank of Georgia, and the State Audit Service are all subject to the president, and after losing the parliamentary elections he officially announced that, as leader of National Movement, he would be switching over to the opposition (although the notion of a “president in opposition” is, in our opinion, fundamentally contrary to common sense). Complicating the work of Georgian Dream’s government, the secretary general of National Movement and former prime minister Vano Merabishvili has threatened that his party will not give this new administration four years.<sup>32</sup> But despite all these difficulties, the new administration is trying to implement its election promises.

Of the possible scenarios for developing Georgia’s economy in the medium term, we can officially eliminate the one that involves maintaining Saakashvili’s economic policy of stimulating consumption. From the results of the October 2012 parliamentary elections, the probability of this scenario became practically zero with the victory of the opposition coalition Georgian Dream. Criticizing the Saakashvili government’s economic policies, the coalition campaigned on promoting the development of the economy’s real sector through social welfare for the poor.

The most likely scenario in this new reality is the acceleration of negotiations with Brussels in order to achieve an FTA with the EU. The new administration's willingness to implement international obligations on antitrust regulations<sup>33</sup> and European-style consumer protections is inspiring confidence.

Antitrust regulation will promote the development of competition. Demonopolization of the Georgian economy, together with what leaders of Georgian Dream have repeatedly and clearly declared a repudiation of informal interference in business,<sup>34</sup> will offer a strong impetus for business development.

It seems that an FTA with the EU could be achieved no later than 2014, which would create conditions for attracting private investment in the Georgian economy's real sector. At the same time, the relative cheapness of labor (compared with the EU), the simplified business registration system and relatively low tax burden (again, compared with the EU) may prove to be stimulating factors in the creation of new jobs in the national economy. Because the EU's economic indicators are currently 2,000 times higher than Georgia's,<sup>35</sup> an FTA with the EU would create qualitatively better conditions for expanding the market scope for Georgia's economy.

If the country produces high-quality products for the EU market, it can also find demand in the Turkish market, given the 2008 FTA with Turkey.<sup>36</sup>

This scenario of Georgian economic development based on an FTA with the EU and growth of exports to the EU and Turkey is a completely realistic one.

Considering that nearly four years have passed since the United States and Georgia signed their charter, while the process of negotiations for an FTA has still not begun, it seems apparent that an FTA with the United States is more likely to be achieved closer to 2020. Consequently this hypothetical agreement will have only a very small effect on Georgia's economy.

The possibility of full recovery of trade relations with Russia in the near future is less predictable,<sup>37</sup> for reasons more political than economic. That both countries are World Trade Organization members is not a sufficient condition for establishing trade between them. So it is difficult to take full-scale trade relations with Russia into account when projecting Georgian economic development in the medium term. Nevertheless, promoting trade relations with Russia is of paramount importance for the new Georgian government.

Based on a realistic scenario of achieving an FTA with the EU and consequently expanding trade relations with Turkey, we can assume that Georgian economic growth in 2013–20 will be, on average, 5–10 percent. We can base the more pessimistic 5 percent growth on exacerbating effects of the global crisis, and the more optimistic 10 percent growth on stable development of the global economy. So in the best-case scenario, GDP per capita in 2020 will be 2.3 times higher than in 2011, and will be more than \$7,367 per capita (in 2011–13 U.S. dollars).<sup>38</sup>

Based on World Bank economic development indicators, Georgia's economic situation in 2020 will be approximately the same as certain EU countries in 2011, similar to Bulgaria (\$7,158 per capita) and Romania (\$8,405), but worse than Latvia (\$12,726) and Lithuania (\$13,339).<sup>39</sup>

Economic policy should encourage investment in industry and agriculture, since both industries have considerable potential for development.

Studies of Georgia's relative economic advantages identified certain sectors: transportation, especially of energy resources, the agriculture and food industry, hydropower, and tourism. Naturally, the above-mentioned economic growth will be achieved in the sectors where Georgia enjoys a relative advantage.

Development of the economy's real sector, adoption of new, European-style labor laws, and appropriate social policies will all help to improve the quality of life for citizens of Georgia.

The main danger that the new leadership of Georgia faces is the "business trap" which threatens successful business figures who enter politics. Because they tend to have a wealth of business experience, they try to use their managerial skills in government, which turns out to be a profound mistake. There is an obviously fundamental difference between state and company, and if Ivanishvili does not take this into account, the more or less optimistic prognoses for Georgian economic development will remain unfulfilled.

## **Key findings**

During the economic reformation years in post-Soviet Georgia, unfortunately, an economic model focused on successful and sustainable development of the country failed to develop. The Rose Revolution offered Georgia a historic opportunity to solve this problem, but the administration's authoritarian style and conflicting economic reforms

that combined neoliberalism with neo-Bolshevism led to the country's developing a "poor country's consumer economy" instead.

After the October 2012 parliamentary elections, Georgia has been given another chance to create the economic foundations for successful development. The opposition coalition Georgian Dream's victory could also be crucial in economic terms, if it is able to create and develop a competitive real sector in the economy. At the same time, the new administration must avoid the "business trap," that is, to exclude the methods of business management from public management.

The top priority for the Georgian government is the speedy achievement of an FTA with the EU and the use of all potential opportunities offered by economic integration with the EU. To accomplish this, state economic policy should focus on promoting the development of production by implementing European-style antitrust regulation, consumer protections, and labor relations.

It is necessary to begin negotiations for an FTA with the United States under their Charter on Strategic Partnership, and it is very important that this regime does not conflict with the terms of the FTA with the EU. This will require appropriate coordination between Brussels and Washington with the active involvement of Tbilisi.

Georgia's new government should assist domestic companies in their intention to return to the Russian market. Companies themselves must provide Russia's chief sanitary inspector with all the necessary documentation to certify the quality of their products as well as evidence of these products' entrance into the markets of other countries (the United States, the EU, China, Japan, and others). The next time their products are rejected from admission to the Russian market, the Georgian government should protect the interests of its companies within the World Trade Organization framework.

Implementation of these recommendations will encourage the expansion of Georgia's export potential, a goal of paramount importance for the country's social and economic development.

## Notes

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4. *Ibid.*, p. 72.

5. See also V. Papava, "O nekotorykh oshibkakh Mezhdunarodnogo valiutnogo fonda v Gruzii," *Voprosy ekonomiki*, 2002, no. 3.

6. I. Meskhia, "Living Standards and Poverty in Georgia," *Georgian Economic Trends*, May 2008, p. 57.

7. For example, see L. Gurgenzidze, "Georgia's Search for Economic Liberty: A Blueprint for Reform in Developing Economies," American Enterprise Institute for Public Policy Research, *Development Policy Outlook*, 2009, no. 2, June.

8. World Bank, GDP per capita (current U.S. dollars), 2012.

9. For example, see V. Papava, "Ekonomicheskie uspekhi postrevoliutsionnoi Gruzii: real'nost' i mify," *Vestnik instituta Kennana v Rossii*, 2011, no.19; N.A. Mendkovich, *Tsena reform, ili Pochemu u Gruzii ne poluchilos'?* (Moscow: RISI, 2012).

10. Papava, "Ekonomicheskie uspekhi postrevoliutsionnoi Gruzii," pp. 13, 18. See also M. Jobelius, *Georgia's Authoritarian Liberalism: South Caucasus—20 Years of Independence* (Tbilisi: Friedrich-Ebert-Stiftung. 2011).

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17. Samson, "Medium-Term Prospects for the Georgian Economy," p. 74.

18. See <http://nbg.gov.ge/index.php?m=306/>.

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22. "Unemployment the Major Problem in Georgia," *Messenger*, May 10, 2010.

23. Samson, "Medium-Term Prospects for the Georgian Economy," p. 71; Tokmazishvili "Socio-Economic and Institutional Aspects of Labour Market."

24. Tokmazishvili, "Socio-Economic and Institutional Aspects of Labour Market."

25. Meskhia, "Living Standards and Poverty in Georgia."

26. D. Giorkhelidze D. "Sotsial'noe polozhenie: sushchestvuiushchiie problem," *Kavkazskii aktsent*, 2010, no.10, p. 40.

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35. "Medium-Term Prospects for the Georgian Economy," p. 75.

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38. World Bank, GDP per capita (current U.S. dollars), 2013.

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