INDEPENDENT EXPERTS' CLUB

Georgia, 2009

Post-War Challenges & Perspectives

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About The Independent Experts' Club (IEC)

Founded on October 15, 2008

The war of August 2008 in Georgia created a new reality for the country. Motivated by these new challenges and a desire to better understand the situation – past, present and forthcoming – a group of independent experts engaged in the fields of policy analysis, economic, social, legal, security and military research, conflict resolution and other important issues has come together to collectively address and advance these topics.

The Club's activity is based upon professionalism, equality, transparency and pluralism. Civil servants and members of political parties cannot be members of the IEC.

The Club seeks to develop a more active expert and civil involvement in the assessment and evaluation of the events and processes currently ongoing in Georgia whilst making these processes more public and providing an opportunity for co-participation in expert analysis within various interested and engaged civil society groups. The Club will attempt to integrate and focus current local intellectual potential (inter-alia international potential) upon enabling a further understanding of the current situation in Georgia and developing a dialogue with the Government of Georgia and international organizations as concerns a wide range of current and potential challenges.

The first study of IEC - "Crisis in Georgia, 2008- Preconditions, Reality and Perspectives" - was published in February 2009.

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POST-WAR ECONOMY OF GEORGIA: NEW CHALLENGES AND OLD MISTAKES

It has been over a year now that Georgia survived Russia's military aggression. In this period of time economic crisis has gained momentum in the country. Having hit the national roots it has also been conditioned by global financial crisis. In this span of time Georgian government made new mistakes as well, primarily concerning antirecessionary measures that they have elaborated and implemented.

Below we will discuss new challenges, as well as the existing situation regarding the improvement of old mistakes[1].

Financial "Compensation" of Russian-Georgian War

After a five-day Russian-Georgian war, Georgia faced new economic challenges given the existing global financial crisis. In particular, liquidation of economic damage inflicted by war, avoidance of bank crisis, prevention of further growth of relatively high level of inflation, maintenance of the stability of the national currency -GEL exchange rate.

At donors' conference in Brussels held on 22 October, 2008, the decision was adopted according to which Georgia could receive financial aid in the amount of USD 4.55 billion: 2 billion as a grant and 2.55 billion – the credit. Georgia started receiving this aid in 2008 and this process will continue until 2010. The considerable part of this aid should be used for the elimination of the damage inflicted as a result of Russian military aggression, while part of it will be used for the rehabilitation of the country's economy. It is noteworthy that USD 4.55 billion is devised for both, state and private (especially banking) sectors.

Georgian government had to bear additional costs because of social problems related to internally displaced persons from conflict regions. In the first place, we should mention that the government is building temporary residential houses for these people, which on the one hand revives the economy – additional demand appears on construction materials, workers are being employed, but the costs incurred for construction are eventually still inflationary in the short-term, since it is the government that is buying these houses and not people. However, the government has no other choice.

In the post-war Georgia, the flow of foreign direct investments (FDI) diminished, which is caused primarily by the fact that under global financial crisis, the investors are trying to invest in safer countries than is Georgia under Russian aggression. Remittances from Georgians living abroad to their relatives have also reduced under global crisis. And if we also take into account that Georgia has an extremely negative foreign trade balance, where import exceeds export four times, it should not be surprising that the maintenance of stability of GEL exchange rate came under threat.

After the August war, International Monetary Fund (IMF) allocated USD 750 million credit for maintaining macroeconomic stability in Georgia under the Stand-By Arrangement, out of which 250

1. While discussing old mistakes the author has used the results of analytical research "Georgian Economy: Mistakes, Threats and Resolutions" which has entered in the volume prepared by Independent Experts' Club "2008 crisis in Georgia: Preconditions, Reality, Perspective."

USD million was put to National Bank reserves in the fall of 2008. On 6 August 2009, the IMF allocated additional USD 420 million within the limits of the same program. As was determined, the program was to last until 14 June 2011. This sum, together with the abovementioned USD 4.55 billion provides the guarantee that Georgia will avert currency crisis.

It is noteworthy that the acceptance of USD 4.55 billion in full amount depends on the one hand on how efficiently and purposefully the allocated funds will be used and on the other – how successfully Georgian government will carry out the following rounds of negotiations with donor countries and organizations in order to get the promised funds. It should be noted that the Georgian government is successfully coping with negotiations and fortunately, there have not been any obstructions on the way to receiving the aforementioned financial aid so far.

Economic Crisis and the "Paradox OF War"

It was due to poor development of Georgian financial market that global crisis did not have that dramatic impact to cause the crash of economy in Georgia. But at the same time it can't be said that global crises has had no impact whatsoever on the Georgian economy. For instance, the volume of foreign direct investments reduced, money transfers from Georgian citizens living abroad decreased, relatively low-interest rate loans from European financial markets have become less available for Georgian banks as they have become expensive under global crisis.

It is no less important to underscore that the ongoing economic crisis in Georgia has got purely national roots. The most important among them are the following:

1. Most part of FDI in the country was concentrated on the acquisition of the property right, privatization being one of the ways. But they were directed at the development of the real sector of economy to a lesser extent. As a result, the imbalance created between financial resources in the country and the development of the real sector of economy was quite obvious.

2. When the government abolished regulatory function in the construction business, many companies in this sector of the economy started to build their activities on "financial pyramid" principle, i.e. when the money for the fulfillment of old obligations is already spent and the company takes up a new obligation in order to compensate the loss, but sooner or later the pyramid collapses as usual.

3. Most Georgian banks would invest considerable part of relatively cheap credit resources obtained on the European financial markets in construction business and household technologies. Doing so, on the one hand they supported the maintenance of the abovementioned "financial pyramid" mechanism and on the other, instead of crediting national economy they were crediting import. The latter favored strengthening of the existing imbalance between financial resources that the country received and the development of the real sector of the economy.

Economic crisis was directly reflected in the growth of Gross Domestic Product. Namely, in the first quarter of 2009 compared to the same period of the previous year it reduced by 5.9%, in second quarter by 10.1% and by the end of the year, as is attested by the IMF, it is anticipated that GDP will reduce by 4%. The fall of economy had a direct impact on the reduction of tax revenues, for which reason in July 2009 the state budget of 2009 was amended and tax revenues were reduced by GEL 500million which made up 10.5% of the projected tax revenues. However, the budget still increased by GEL 312 million, which was mainly due to the abovementioned foreign injections.

The spring of 2009 was a due date for the repayment of foreign debt of 500 million GEL for Georgian banks but they did not dispose of these resources. Banking crises was averted in the country by the help of foreign investments mentioned above from which they received USD 636 million which not only was enough to repay foreign debt but it also availed the banks to have the necessary resource to remain sustainable.

The fact that Georgian economy remains sustainable is in the first place thanks to donors' aid which Russian aggression made "more easily available" for the country. The war and especially the lost one is a negative occurence by itself, but if not that, it is doubtful that Georgia would ever be able to receive such significant financial aid under global crisis so swiftly, which lays the grounds for sustainability of the country's economy. Therefore, we are obviously dealing with the so called **"Paradox of War",** when such an extremely negative event as war allowed the country to avert economic collapse.

Anti-Crisis Measures

Under global financial crisis, the governments of different countries are normally trying to elaborate anti-crisis program. Taking into account the fact that after the Rose Revolution the Parliament was not able to come up with any program on economic development, it should not be surprising that neither there is any program in the country under the recession, which is unfortunate.

What the government managed to come up with, though, is the so called "New Financial Package" which mainly cocerns banking and construction sectors.
The steps made with regard to banking sector were mutually exclusive. Namely, on the one hand, by alleviating the regulatory normatives of banks, the National Bank of Georgia (NBG) favors the emergence of additional credit resource in the country, and on the other hand, because banks have difficulties in placing their credit resources during the ongoing recession, the government took the decision on the emission of GEL 260 million of treasury bonds. In other words, the government reduces credit resource by GEL 260 million that could have been used for crediting the real sector. The government is going to spend financial resources obtained in the above manner on infrastructural projects.

Emission of treasury bonds will not serve as anti-crisis measure – just the opposite, by reducing credit resource it restrains the possibility of the development of the real sector.

It is worth pointing out that three weeks before declaring the decision on the emission of treasury bonds, the Ministry of Finance stated that they had GEL 50 million of free funds on treasury account and in order to make the better use of it a tender was announced between banks as a result of which they lended the sum to the winner bank. It is interesting that the winnert was one of the most problem banks which can now buy treasury bonds with the money, which means that the government will pay the bank the difference in interest rate for its own money. This operation seems obviously doubtful and it necessarily requires adequate response from law-enforcement bodies.

As for the support of the construction sector, construction companies will be able to get bank loans under the Tbilisi Municipality guarantee for the renewal of the residential fund of old Tbilisi.

Taking into account that many construction companies function by the principle of "financial pyramid", the aforementioned government measures should be preceded by the initiation of bankruptcy procedures against these types of companies. Otherwise the above support of construction sector will in reality mean supporting "financial pyramids" as well, which in the long run will adversely affect not only construction, but the banking sector as well, to say nothing of inappropriate use of the corresponding funds of the city budget.

Unfortunately, the abovementioned "new financial package" does not envisage any measures for the improvement of social conditions of the population at all, which, as a rule, is a recommended action under recession period in order to stimulate the demand.

"Jehovah's Witnesses Syndrome" In Tax System

In the second half of 2009, the president of Georgia offered the country the so called "Act on Economic Freedom", which later developed into a draft bill of the Georgian Constitution on "Making Adjustments to the Georgian Constitution" and the organic law of Georgia on "Economic Freedom, Opportunity and Dignity".

Some proposals reflected in the above mentioned organic draft law are virtually like "crushing into the open door", since similar problems in Georgia have been long resolved and today they are not urgent at all. In the first place it concerns GEL conversion. From the very first day (i.e. more than 14 years ago), of its introduction in the country it has been a convertible currency. Moreover, in 1997 Georgia joined article 8 of the agreement of IMF, according to which the country undertook the obligation that GEL convertibility would not be restrained, and having become the member of the World Trade Organization (WTO) in 1999 likewise obliges Georgia to not restrain GEL conversion. And international agreements stand higher than the country's legislation.

The situation is similar regarding the state regulation of prices. For more than 13 years now the prices have been liberalized: prices on bread were last liberalized in 1996. Since then, Georgia, being a member of the WTO has undertaken the commitment which does not allow any regulations of prices.

Georgia has had the law on investments for more than 13 years, under which the investor has unrestricted rights on repatriation of the profit. Being the member of the WTO also makes Georgia liable for the above.

The requirement that the state must not have its share in commercial banks is hard to understand. In particular, it is not understandable the share of which state should not be in banks – of any state or only of the Georgian one. Today Georgian state does not have any share in conmmercial banks anyway, but in Georgian banking reality there are two commercial banks that are state banks as well. For instance, "VTB" is a Russian state bank, and "International Bank of Azerbaijan" is an Azerbaijanian bank.

Saying no to the introduction of new regulatory institutions (which is one of the requirements of the draft law) signals the fact that Georgia says no to European integration, as European market is a regulated one.

It is not justifiable to set budget parameters in advance by non-budget legislation, as there occurs the precedent which in the future may turn into an expanded list of such parameters.

According to amendments to be made to the Constitution of Georgia, it turns out that the issues such as introduction of new taxes or the increase of the current tax rates must be resolved by means of the Referendum. Taking into account that nobody would agree to the increase of taxes, holding the Referendum does not make any sense, since the result is pretty predictable.

Such procedure reminds us of principles of Jehovah's Witnesses, who will always go against blood transfusion, even being aware of how vital it is for their health, but the physicians are obliged to offer them the procedure anyway, although knowing that their suggestion will be ignored. Thus, in the case of making the aforementioned amendments to the Constitution, Georgian tax system will face the threat of "Jehovah's Witnesses syndrome."

Tax policy, being the part of economic policy, should normally vary according to the situation. By making the abovementioned amendments to the Constitution, Georgian state will be deprived of one of the efficient instruments of economic policy.

Old Mistakes

Property Rights. One obvious mistake made by the government which came to power after the "Rose Revolution" was the infringment upon property rights. Unfortunately, over the past year, not a single case of returning or compensating for forcefully expropriated property to its lawful owner has been reported. What is more, lately there have been reported even more precedents of infringement upon property rights.

Alienation of State Property. A large-scale privatization process which began in 2004 has been going on with full defiance of the law. Unfortunately, even today, this process is not transparent. Especially accute issue is that of the alienation of the Georgian railway, the available information about which simply does not exist. The situation is similar concerning Enguri Power Plant.

Limitation of Competition. At the end of 2004, as if under the veil of reforms, anti-monopoly legislation was abolished and so was the State Anti-Monopoly Agency which favored the development of monopolies on the market. Despite the fact that the restoration of anti-monopoly legislation is the requirement of European Union and represents one of the preconditions for granting Georgia a free trade regime, the government refuses to restore it on principle.

State Statistics. The State Department of Statistics was incorporated within the Ministry of Economic Development in 2004, which obviously presents a conflict of interests. According to the new law the Department of Statistics has to develop into an independent institution, however, the authorities of the banks and the Ministry of Finance and Economic Development have to be the members of its supreme body – the supervisory council which means that the conflict of intersts will actually persist.

Stimulation of Inflation by the Government. Unfortunately, it became quite typical for our post-revolutionary Government to initiate populist economic programs which practically facilitated the growth of inflation.

The one that desreves attention is the so called National Program aiming at increasing employment rate. Businesses were imperatively told to hire an unemployed individual for a three – month term who would be paid GEL 150 per month from the state budget in 2006 and GEL 200 per month in 2007-2008. Fortunately, after the war the government abandoned carrying out similar populist initiatives.

Budget Manipulations. Starting from 2008, a new methodology for the formation of the national budget was introduced which led to the "disappearance" of the phenomenon of a budget deficit, as such. Unused budgetary sums during the year, that is, the excess of budgetary revenues over expenditures, is called a budget surplus. In reality, national budget revenues imply tax revenues and not one-time collections. If these revenues exceed budget expenditure then we have a budget surplus, but if revenues fall below, then the budget is deficit-ridden. That is exactly why, in all those documents meant for "foreign use," the national budget is reported to be deficient, although for domestic use the government is deliberately promoting the surplus budget. Unfortunately, not only has this drawback of the budget legislation been improved by the government, but nothing is going to be done about it at all.

Employer - Employee Relations. According to the version of the labor code adopted by the post-revolutionary government, an employer is granted maximum rights whilst depriving an employee of all rights. Despite the fact that one of the pre-conditions set by the European Union for granting Georgia a free trade regime is to adopt European type of labor legislation, the government resolutely refuses to change the existing Labor Code.

In 2006, it was the presidential initiative to combine 20 percent social tax and the 12 percent income tax into a single income tax set at 25 percent (taking into account that social tax and income taxes are computed from various tax basis makes it is absolutely impossible to combine them). So the new tax change was made effective from 2007. From 2009 the income tax rate was reduced to 20% which is certainly a benefit for employees but we should bear in mind that this rate was only 12% about three years ago.

Free Economic Zone – A Trap for Economic Development. Under the ongoing economic liberalization measures carried out in the country, the establishment of a Free Economic Zone seems less expedient as the list of possible tax benefits and their scale are diminishing exactly due to such liberalization. Currently (in pre-war and especially post-war periods) Georgia is experiencing the lack of investments, i.e. investment "hunger" and the creation of a free economic zone under these conditions will cause its deepening even more, which in the long run will impede the development of the entire economy. Unfortunately, the government's decision is to create a free economic zone not only in Poti, but also in Kutaisi, which means that the economic development of Poti and Kutaisi will take place at the expense of the rest of Georgia.

Weakening of the NBG. In the spring of 2008, the government deprived the NBG of its bank supervisory function and left it with only one function – to regulate inflation. In addition, the responsibility of the President of the NBG was linked to violation of the upper margin of the annual inflation rate, which in turn, made him dependent upon the Government, since more powerful instruments to influence the annual inflation rate are rather at Government's disposal than at the NBG's. In 2009 a new draft law on the NBG was prepared and the removal of the responsibility of the NBG President for the violation of the upper margin set on annual inflation rate can be considered its positive side. According to the new law, financial supervisory function of the bank was resumed, which is fully justifiable. Despite the fact that the government has never admitted the mistakes that caused the institutional weakening of the NBG, the steps to be taken in 2009 with the aim to improve those mistakes, deserve approval.

Issuance of Eurobonds and Increasing External Debt by an Additional USD 500 Million. In April 2008 the government increased the foreign debt of Georgia by USD 500 million by issuing Eurobonds. Unfortunately, until now, there is no public information whether this sum has been spent or not. If yes, then we are not aware of what it was spent on and if it has not, then it is interesting to know where the money is. It is necessary to have this information since the debt is due to be repaid in 2013.

"Green Friday". On Friday, 7 November of 2008, the demand of commercial banks for the USD exceeded USD 31 million given the zero supply on the Interbank Currency Market (with the trend continuing for more than one month). The NBG could satisfy only USD 270 thousand of the demand and then stopped the currency market operations under the excuse of technical reasons. The panic started the same day: ATMs were emptied instantly and exchange shops raised the USD rate significantly, often refusing to sell dollars. Thus, the NBG arranged a "Green Friday" in the country. The panic on the currency market of Georgia continued over the week-end as well.

Reserves of NBG and the guaranteed source of their replenishment through donors' aid provide objective grounds that no sharp rise and falls will occur in the process of establishing the GEL exchange rate. From 2009, NBG stopped the operations on interbank currency market and substituted it by currency auction mechanism held according to Bloomberg system. Unfortunately, after that it became actually almost impossible to obtain information about currency reserves dynamics which bears a threat that the bitter experience of "Green Friday" might occur again.

Economic Program. The 2008 Presidential and Parliamentary pre-election slogan "United Georgia without Poverty!" turned into the title of the program passed by the Parliament at the end of January 2008. This document, however, may only be called a program conditionally, as it is limited to several pages of some slogans and appeals. Unfortunately, the government remains indifferent, being unable to create a serious document which would serve as the government program in all intents and purposes.

As for poverty reduction, the only serious step taken by the government was the implementation of GEL 5 insurance packages, which, unfortunately has not had any tangible effect.

Conclusion

All the signs characteristic for economic recession have finally come to the surface in the post-war Georgia. That the economy remains sustainable whilst the national budget stays undiminished, is in the first place due to donors' financial aid earmarked to Georgia as to the victim of Russian aggression as a result of the decision adopted at the conference in Brussels on 22 October, 2008.

Unfortunately, Georgian government does not have any antirecessionary program for the given situation except for those several measures elaborated by the government that clearly proved to be unsatisfactory.

As for the mistakes of previous years, Georgian Government has never admitted committing them and neither has it taken any pains for their improvement so far.