

# GEORGIAN ECONOMIC TRENDS

## **Quarterly Review**

**October**

**2007**



This project is funded by  
the European Union

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## OPINION.

### CURRENCY BOARD AGAINST THE BACKGROUND OF DUTCH DISEASE

A discussion is becoming increasingly popular in recent times on whether or not the so-called Currency Board should replace the country's central bank; that is, the National Bank of Georgia (NBG). An American expert, Steve Hanke, has even visited Georgia for this purpose and had meetings with top echelon government representatives. He tried to convince the Georgian Government of the advantage of the Currency Board over the central bank institution. Given the topicality of the issue, I would like to comment briefly upon what the Currency Board means and how it can benefit present-day Georgia.

#### **Currency Board Paradigm**

The essence of the Currency Board is to anchor a national currency at a fixed rate to a stable foreign currency or a currency basket and carry out the conversion with that specific currency or one of the basket currencies without any restrictions in an automatic regime. This will require the country to have large amounts of foreign currency in order not to impede currency conversion operations at a fixed rate. Normally, foreign currency reserves of the state should be more than 100 percent of emitted money. This, however, can be achieved in the case of a stable source of large foreign currency inflows. From an ethical standpoint, the institute of the Currency Board is welcomed because it restricts discretionary rights of the state in this specific area.

The Currency Board mechanism rules out the issuance of any debt to the government by a central bank let alone the deficit in the central budget. It requires that the government put an end to the state budget deficit and to have at least an insignificant budget surplus in order to set up special funds (for example, a stabilisation fund). It is also noteworthy that under such circumstances, commercial banks heighten their credit policy which, given the equality of other conditions, is expressed *inter alia* in their refusal to participate in quasi-fiscal deficit projects when the government calls for crediting economically unattractive projects (for example, to issue credits to Georgia's agricultural production and food processing industry in the setting of the trade embargo imposed by Russia upon respective products).

Normally, the introduction of the Currency Board mechanism is expedient when there is a very high inflation rate in the country; that is, in the case of hyperinflation because the simultaneous existence of a stable exchange rate and budget surplus (or, at least, the budget without deficit) is an effective instrument to achieve macroeconomic stability. This has been proven in practice and it was precisely through applying this instrument that an annual inflation in Brazil, for example, which reached 2700 percent in the early 1990s was curbed. The same mechanism was used in Estonia, which reduced its inflation rate of 1069 percent to 29 percent in 1992-95, whilst in Lithuania, the 309.2 percent inflation went down to 72 percent in 1994 as compared to the previous year. It is noteworthy that hyperinflation in Georgia occurred only in 1993-94 with a monthly inflation rate comprising 50-70 percent. Nevertheless, the financial stabilisation programme of that time did not envisage the introduction of the Currency Board (although this idea also existed at that time) because the country did not have a stable source of foreign currency reserve and the government lacked the ability to pursue a relatively effective fiscal policy.

It should also be emphasised that the Currency Board does not necessarily guarantee the protection of the countries with open economies (Georgia represents this type of economy now) from a financial crisis in any other country because such a situation creates a fertile ground for speculative operations. An obvious example of the above said is the devaluation of Mexican peso in 1994 when even the Currency Board failed to protect Argentina from the flight of foreign capital.

As an institute, the Currency Board is appropriate for the period of transition to macroeconomic stability. Besides, it is impossible to use it simultaneously across the world because therein the economically developed countries would be forced to move to the gold standard and, thus, necessitating other countries to do the same at the end of the day.

#### **Recurrences of Dutch Disease**

After the Rose Revolution, Georgia contracted the so-called Dutch Disease;\* that is, large foreign currency flows (mainly USD) started coming into the country. This created the long-term tendency of strengthening the national currency, the lari, which, first and foremost, had an adverse effect upon the current account balance. Amongst the causes of this disease, those worth noting are the establish-

\* Aslamazishvili, N., "Dutch Disease" in *Georgian Economy: Current Reality and Potential Threats*, Georgian Economic Trends, Quarterly Review, October 2006; Papava, V., "The Baku-Tbilisi-Ceyhan Pipeline: Implications for Georgia" in *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West*. Eds. S. Frederick Starr and Svante E. Cornell. Uppsala, Uppsala University, 2005, pp. 90-96, online [http://www.silkroadstudies.org/BTC\\_5.pdf](http://www.silkroadstudies.org/BTC_5.pdf)

ment of the fiscal order in the country (especially at the customs) where importers pay the state taxes in lari out of previously hidden and accumulated revenues in US dollars and a large-scale privatisation implemented with the participation of foreign capital and foreign direct investments. In order to carry out these transactions inside the country, foreign investors have to convert US dollars into the national currency. Georgian labour migrants' remittances (usually in USD which is converted into lari to cover current costs) is another factor which facilitates the appreciation of the lari.

It is well known that the Currency Board is a rather inflexible mechanism against a real appreciation of a national currency of any particular state. It was also one of the reasons that this mechanism was not applied in the past in Georgia since it was expected that the financial stabilisation would be followed by a real appreciation of the lari, which, in fact, happened on a certain scale but that was not a result of the Dutch Disease.

In order to impede the process of appreciation of the lari caused by the Dutch Disease, the NBG permanently purchases US dollars flowing into the country. On the one hand, this transaction increases NBG reserves and somehow "smooths down" the appreciation of the lari but, on the other hand, pushes up the inflation by putting an additional supply of lari into circulation. In such a situation, it is very important to have a state budget surplus which should become an effective mechanism for curbing inflation. In reality, however, a deficit in the state budget still exists whilst the increase in separate costs contributes to the inflation.

### **What Wonders Does the Currency Board Promise?**

Large inflows of foreign currency, accompanied by the Dutch Disease, create, at a glance, a prerequisite for introducing the Currency Board regime as the large inflows of foreign currency lead to the increase in foreign currency reserves of the state. The deficit in the state budget, however, makes it not only impossible to introduce the Currency Board but also contributes to the aggravation of the Dutch Disease. If the Currency Board is nonetheless introduced, it will be necessary, given the fixed exchange rate, to emit increasingly more currency which will further accelerate the inflation.

In the event the abovementioned causes of the Dutch Disease become weaker or completely disappear, the foreign currency reserves, considering Georgia's scarce export potential and trade embargo imposed by Russia, will instantly deplete and become a cause of a deep financial crisis.

It should also be taken into account that the government is, first and foremost, a political body whereas the central bank is a professional one. That is why the central bank leadership has far more guarantees of protection whilst the government may be replaced at any aggravation of a political situation. Putting the primary responsibility of maintaining a moderate inflation rate only upon a political body such as the government (which is a principal requirement of the Currency Board), then, is associated with political threats.

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