

Georgia's economy: post-revolutionary development and post-war difficulties

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The article discusses the problems of the successes and the failures of Georgia's post-revolutionary economic development. Amongst the positive results, the significant increase of national budget revenues and the overcoming of the energy crises should be emphasized, both of which were achieved by the fight against domestic internal corruption. At the same time, mistakes in terms of both the building of a democratic state and economic policy were made. Making the judiciary an appendage to the General Prosecutor's Office and the executive branch, the government's control of the media and its defiance of property rights, including extra-judicial decisions to demolish privately owned residential houses, are among the most serious errors of Georgia's post-revolutionary development. Despite its anti-Russian rhetoric, the new government has openly welcomed Russian investments into Georgia's economy. After the Russian aggression and under the impact of the global financial crisis, Georgia finds itself in a more complicated situation. International financial aid of US\$4.55 billion, which was pledged at the international donors' conference held in Brussels in October 2008 for the reconstruction of post-war Georgia, may enable the country to avoid the banking and currency crisis.

Keywords: post-communist Georgia; combat of corruption; extra-budgetary accounts; deprivatization; Liberal Empire; Free Trade Agreement with EU

Introduction

The collapse of the Soviet system and the beginning of the transition to capitalism may be interpreted as a revolution (Bunce 1999a, pp. 152–156). 'Coloured revolutions' in the post-Soviet space raised the question as to whether they were really revolutions, and how much the expectations of their supporters could or would be realized. There are already scholarly papers addressing these issues, yet, arguably, more time is needed to arrive at any generalized conclusions about the results of the 'coloured revolutions'.

The Rose Revolution of November 2003 was the outcome of the Georgian people's desire for a more democratic society, the reduction of corruption and improvement in the national economy and social conditions (Fairbanks 2004, King 2004, Miller 2004, Welt 2004, Coppieters and Legvold 2005, Karumidze and Wertsch 2005, Khutsishvili 2008). It is no surprise that the Rose Revolution and its heroes, led by the current president of Georgia, Mikheil Saakashvili, have been supported by the US administration, and the leadership of the EU.

However, within two years of the Rose Revolution, quite naturally, the euphoria that followed it, both inside and outside the country, diminished. It has been replaced by a more sober assessment and a more realistic evaluation of the results of post-revolutionary change. This 'sobering up' took place in Georgia rather more quickly than overseas as Georgian citizens experience the discomforts of revolution on the ground. Georgia's international friends, on the other hand, often mistook what they would like to happen for what is actually happening (Mitchell 2006, Papava 2006c).

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Nevertheless, even those analysts who have been a priori supportive of Georgia's revolutionary leaders cannot turn a blind eye to some recent antidemocratic developments in Georgia, such as the executive's domination of the judiciary (Jones 2006).

From the outset, the post-revolution political regime in Georgia was represented as a mixture of democratic and authoritarian elements (Nodia 2005, p. 44–45). Such hybrids are not new and are characteristic of many post-Communist countries (Bunce 1999b) that avoided 'coloured revolutions'. To many Western observers, the crushing of peaceful demonstrations in the Georgian capital of Tbilisi in November 2007, appeared to be totally unexpected and, consequently, shocking. However, for many local analysts these events were more or less predictable (Areshidze 2007, Lansky and Areshidze 2008, Mitchell 2008, Papava 2008c). For Georgians, it was relatively easy to see official Tbilisi's undemocratic nature, although not all agree, even after November 2007, that the post-revolutionary regime should be described as authoritarian (Jones 2008b).

In 2008, a new crisis developed: war with Russia. This five-day Russian–Georgian war in August 2008, together with the global financial crisis, has presented Georgia with new economic challenges (Papava 2008f). These include, in particular, overcoming economic damage caused by the war, avoiding a crisis in the banking sector, preventing high inflation and preserving the stability of the exchange rate of the national currency, the lari. In spite of Georgia's WTO membership, it is equally important for post-war Georgia to continue its successful transition to a free trade regime promoted by the US and the EU. To understand these major problems in Georgia's development and the coming post-war challenges, it would be useful to analyse all the key tendencies that emerged after the Rose Revolution which have contributed to the current situation.

Starting points

The young Rose Revolutionaries – in terms of age and experience – inherited numerous unresolved problems from the Shevardnadze administration. The most important included an energy crisis, which meant whole winters without electricity and heating, and a budgetary crisis created by the inability and unwillingness of public servants to collect taxes. The government accumulated huge arrears of pensions and salaries in the public sector. These problems were conditioned primarily by a high degree of corruption. The key challenge of the new post-revolution government, therefore, was to combat sleaze and dishonesty. In order to do this, the government, which had come to power by means of revolution, was tempted to strengthen the vertical axis of power and minimize any decentralized foci of resistance. It justified its actions by the need to reinstate the country's territorial integrity.

From the moment of his accession to power, President Saakashvili set about concentrating power in presidential hands. As early as February 2004, a number of amendments were made to the Georgian Constitution, which gave the president the power to dismiss the government or, alternatively, to disband the parliament and order extraordinary parliamentary elections, should the parliament and the government be in conflict with one another. The consequence of this type of constitutional innovation was the growth of parliament's loyalty not only to the president, but also to his government, which, in turn, led to the significant weakening of parliament as an independent political institution. From 2006 onwards, under pressure from the Council of Europe, and later from the opposition, President Saakashvili gradually proposed some democratic reforms (Areshidze 2007, Lansky and Areshidze 2008).

Positive reforms

The strengthening of presidential powers in Georgia had some positive results in terms of establishing financial order. Significant increases in tax revenues led to the neutralization

of the budgetary crises (Areshidze 2007, pp. 191–195). The post-revolution government succeeded in paying off all accumulated debts to pensioners and public sector employees. In the summer of 2004, this led to the renewal of the International Monetary Fund (IMF) agreement, which had been terminated in 2003 due to the incompetent and corrupt nature of the Shevardnadze administration. Among some other accomplishments of the post-revolution government, the qualitative improvement of the criminality in the country should be emphasized (Kupatadze 2007).

The strengthening of presidential powers enabled the government to start an effective fight against corruption. The abolition of the old Soviet traffic police and the creation of a Western-style patrol police were accomplished in a short 'revolutionary' period of time. As a consequence, the shameful practice of bribery across the country's roads and highways was abolished. The fight against corruption in the energy sector resulted in overcoming the energy crisis and, as of the winter of 2006–2007, the whole of Georgia has been enjoying an uninterrupted supply of electricity. Among the post-revolution government's accomplishments, the introduction of national entrance examinations for admission to universities replaced the old corrupt system of separate admission exams in individual universities that had existed since Soviet times.

A fourfold growth of the national budget revenues was achieved as a result of these anti-corruption measures, including the arrest and release of former government officials and their relatives for what might be called a 'liberty price'. Officially, the price officials were forced to pay to secure their release was described as paying back the state monies and properties that had been stolen (McDonald 2005). However, such revenues cannot be raised on a regular basis. At best, they can be collected once, but thereafter with diminished effect. The government established extra-budgetary 'law-enforcement development accounts' specifically for this purpose, where those suspected of corrupt practices were compelled to transfer payments to buy their liberty.

Deregulation measures, such as reducing the number of licenses and permits, has limited the legal grounds for the government's interference with businesses. Cutting tax rates significantly eased the tax burden (Khaduri 2006). Reducing the import-tax base for agricultural produce and construction materials, as well as the annulment of the import taxes for other goods, has made Georgia much more competitive. The new Labour Code was revolutionary. By limiting the rights of employees, it has substantially broadened those of employers. However, although this may encourage businesses to develop, it leaves employees unprotected.

These types of reforms resemble the Southeast Asian (Hong Kong, Singapore) and Anglo-Pacific (Australian, New Zealand, US and Canada) economic models. Therefore, it should come as no surprise that the Georgian reform model looks toward the East. Georgia is moving towards the American–Canadian model along a path that passes through Southeast Asia and Australia–New Zealand.

After the publication of the World Bank's rating list in 2006 entitled 'Doing Business', according to which Georgia had made an impressive jump from 112th to 37th place amongst the world's nations in terms of hospitality to business, the Georgian government announced that its objective was to push the country forward, and to ensure that Georgia would be found amongst the 20 best nations of the world in the World Bank's rating list. In 2007 it reached 18th place.¹

Hollow reforms

Many of the Georgian government's actions defy both economic theory and common sense. Chief amongst these was the President's generous summer 2006 initiative to add 50,000 people to a national employment programme (*Civil Georgia* 2006c). The idea was to require private entrepreneurs to give jobs lasting three-months to unemployed persons. For this, the

latter were to be paid US\$85 a month out of the national budget. (In the summer of 2006, after the enactment of the new Labour Code, unemployment allowances [US\$12.40 per month] were abolished.) The programme cost the national budget US\$12.7 million. In principle, no business that wishes to expand needs any direct assistance from the national budget. All the government needs to do is to provide for the development of professional training or retraining programmes, and the Georgian government has rightly assumed this duty.

However, this programme re-employed only a few people. In most cases, a simple deal was made. Businessmen agreed to subscribe to any contract under which they could pretend that they employed some people who did a job. Such a deal made an unemployed person happy because he made US\$255 in three months for doing nothing. However, there were more perverse results. Some businessmen agreed to subscribe to such contracts on the condition that new 'employees' shared half of the total amount with them. The average share of salaries in the costs of production is typically 20%. Thus, in theory, US\$12.7 million spent on salaries should produce goods and services worth about US\$60 million. Although there are no official statistics of employment under this programme, it is expected that approximately 10% of the targeted number of beneficiaries were actually employed. This means that US\$12.7 million was spent out of the national budget for the production of goods and services with an aggregate value of perhaps US\$6 million (10% of \$60 million).

In essence, it can be said that US\$12.7 million allocated from the national budget was nothing but an allowance for the unemployed. This amount went to the market ostensibly with the purpose of producing consumer goods, but because no actual goods and services were produced, the only contribution was to the growth of inflation. Consequently, any measures of this type, however generous their objectives might be, cannot, in fact, produce the desired results. On the contrary, all they can do, together with other similar measures, is to contribute to macro-economic destabilization (*Civil Georgia* 2006a). The same type of national employment programme covering 100,000 people was started in December 2007.

Errors and offences

Among the negative consequences of the strengthened presidential and weakened parliamentary powers is an intensified feeling of impunity among government officials, which manifested itself in a gross disrespect for the rule of law. The significantly weakened parliament is often called the 'Government's Notary'. With regard to the judiciary, it has become an appendage to the General Prosecutor's Office and the whole executive branch (Anjaparidze 2006a). The government's control of media and, most of all, of TV channels has become overwhelming. Some independent TV channels ('Channel 9', 'Iberia' and later '202') and popular newspapers ('*dilis gazeti*', '*mtavari gazeti*') were closed shortly after the Rose Revolution. Other popular private TV stations have fallen under complete government control (*Civil Georgia* 2005, HRIDC 2008a).

Redundancies in the government were combined with gross mistakes in staffing and institutional policies. In all government agencies the most experienced employees were simply dismissed (in most cases in violation of the law). All governmental institutions were staffed by youth with some international training but with little 'institutional memory'. The government's mistakes in the radical reorganization of the ministries and departments were compounded with non-professionalism among many post-revolution ministers. The most blatant example of non-professionalism was in the spring of 2006, when the Minister of Defence was charged with the marketing of Georgian wines abroad. A further example of this type of inexperience was the abolition of the state anti-monopoly service in late 2004 and its replacement at President Saakashvili's initiative in the fall of 2007 with the Ministry of the Interior (which in Georgia combines the police and the national security forces). Its new function

was to deal with anti-monopoly regulation in the domestic market. Later, after the Russian-Georgian war in August 2008, President Saakashvili added to the Ministry of Interior's responsibilities by charging it with the supervision of the construction of houses for internally displaced persons (IDPs).

The revolutionary wave of 2003 and its aftermath led the government to reorganize other ministries and departments. In particular, the State Department of Statistics, which before the revolution had been an independent agency accountable to the president, fell victim to revolutionary reorganizations. It was incorporated into the Ministry of Economic Development, which is perhaps the most palpable example of a conflict of interests. As a consequence, in Georgia today statistics play the same role as they did in Soviet times when they were assigned a political function. A clear example of statistical manipulation for political purposes was an accidental 'leak' of information in August 2006. In July 2006 the Department of Statistics declared that the annual inflation rate in Georgia had reached 14.5%, which led the IMF to criticize the Georgian government. The government found an 'ideal' remedy: the head of the State Department for Statistics was dismissed and his successor, following the government's instructions, started a gradual reduction of the inflation rate until it dropped to 9.2% in December 2006.

Corruption has diminished in Georgia, but it has also been transformed. For example, the extra-budgetary accounts, which were used to accumulate income from individuals accused of corruption, were outside budgetary control. There was no transparency in spending from these funds. The problem worsened as the government started replenishing these accounts by means of so-called 'voluntary contributions' of businesses (Anjaparidze 2006b). If pre-revolutionary functionaries had their pockets open for bribes, their post-revolutionary successors have transformed open pockets into bank accounts. Initially the IMF turned a blind eye to the existence of such accounts due to the erroneous assumption that all means should be used to fight corruption. Obviously, the IMF had forgotten a simple truth – that it is futile to beat corruption by means of further corruption. Later, in the spring of 2006, under IMF pressure the 'extra-budgetary' accounts were abolished.

A process of 'de-privatization' was launched after the Rose Revolution. De-privatization in the post-revolutionary Georgian context means that certain assets that had been privatized before the revolution were forcibly taken back by the government, which then offered them for re-sale as privatization. There is no guarantee that sometime in the future another de-privatization will not be considered necessary (Papava 2006b).

Additional examples of the post-revolution government's defiance of property rights include extra-judicial decisions to demolish privately owned residential houses built before 2003. This was despite the possession by owners of all the relevant documents certifying both ownership and the legality of construction. The only argument presented by the government justifying such demolitions was a desire to improve the city's 'image'. That property rights were grossly violated (Christiansen 2006) did not generate much concern in government circles (HRIDC 2008b). Paradoxically, the Georgian government's obvious disrespect for property rights never became the focus of Western criticism. In the World Bank's rating for Year 2007, *Doing Business*, Georgia, a country where private ownership is not protected in any way, was in 18th place.

Against the background of a relatively successful fight with mass corruption, there remains the problem of elite corruption involving high-level government officials who, in defiance of public procurement regulations and with total impunity, have used budgetary resources for their own benefit, or used their official status to protect and favour certain companies. The most palpable example was the case of the former defence minister, Irakli Okruashvili, who was charged with corruption. While Okruashvili remained a cabinet member, he was an ideal minister and an example to others (*Civil Georgia* 2006b). After he left office, the presidential

team chose not to press any criminal charges until he publicly announced his political ambitions and his alliance with the opposition.

The Russian trail in Georgia's post-revolutionary economy

In post-revolution Georgia, the so-called 'Northern Way', or Georgia's integration into Russia's economic (and political) domain, has become a frequently aired topic (Papava 2006c, 2008g). In 2003, Anatoly Chubais, the President of the Management Board of RAO EES (Unified Energy Systems) Russia, and a prominent Russian statesman and political figure, wrote that Russia should establish a 'liberal empire' in the post-Soviet world (Chubais 2003, Torbakov 2003, Simons 2008, pp. 70–81). By calling it 'liberal', he meant that the new empire should be based on economics rather than coercion. Russian companies (public and private) should take over the ownership of strategic companies in the former Soviet republics, which, in the long run, would lead to the re-establishment of Moscow's political influence over those countries.²

Russia started fulfilling its master plan in Armenia, its strategic partner in the region. In late 2002, on the eve of the presidential election in Armenia, a Russian-Armenian treaty called a 'debt-for-equity' swap was established.³ In early 2006, Russia obtained new assets in exchange for not raising Armenia's price for natural gas. As Russia and Armenia do not share a border, and in view of the frozen conflict between Armenia and Azerbaijan, Georgia is the lynchpin in the Caucasian economic space for Russia and Armenia. If Georgia is dragged into the liberal empire, the fate of Azerbaijan will be affected given that all of its strategic economic projects are linked with Georgia (Papava 2006a, 2008e).

The first step towards snaring Georgia in the liberal empire's net was the summer 2003 take-over of the shares of the US-based company AES Silk Road by RAO EES. RAO EES, after the 1998 privatization of the Tbilisi electricity distribution company, owned the controlling shares in the company (Gularidze 2003).⁴ The Georgian government fully supported the entry of Russian capital into the Georgian economy during the large-scale privatization of government-owned enterprises after the Rose Revolution. The best example was the sale of Georgian gold and copper mining and processing companies to Stanton Equities, a subsidiary of the Russian holding group, Industrial Investors.

Encouraged by the government's affinity for Russian capital, the owners of the United Georgian Bank (privatized in 1995) sold it to Russia's Vneshtorgbank, 99% of which is owned by the Russian government.⁵ In effect, this sale was the nationalization of the United Georgian Bank by the *Russian* government. This takeover came on the tails of Vneshtorgbank's acquisition of Armenia's Armsberbank.⁶

Gazprom is especially aggressive. It has made several attempts to take over the gas pipeline connecting Armenia with Russia. In late 2005 and early 2006, the Georgian government negotiated with Gazprom, ostensibly to sell the gas pipeline. However, it is not clear why selling the pipeline to the Russian government-owned gas company should be considered 'privatization'. After America's intervention, the Georgian government's talks with Gazprom came to an end,⁷ which dealt a heavy blow to Russia's plans. In late 2006, in the context of doubling the price for Russian gas, Gazprom once again tried to take over some of Georgia's energy assets (Socor 2006).

It is evident that Georgia is being pulled into Russia's liberal empire (Papava and Starr 2006).

Why the West supports Georgia's post-revolutionary government

While leaders of Western nations and various international organizations enthusiastically commended the post-revolutionary government's achievements, the mistakes were subject to moderate criticism at best. Naturally, the following questions arise: why did the West choose

to turn a blind eye to such mistakes and why was it only after 7 November 2007 that significant criticism began of Mikheil Saakashvili along with his government and the parliamentary majority?

The West's captivation with Mikheil Saakashvili resulted, first of all, from his role as a successful post-Soviet leader with a Western university education. In his numerous passionate speeches and interviews, he advocated Western democratic values, human rights and the market economy. But it is important to note that in contrast to his speeches for Western audiences, his public appearances in Georgia, especially after the Rose Revolution, were aggressive and disrespectful toward his own citizens. (For example, he declared on Georgian TV that the senior generation of Georgian scholars and public figures should be 'flushed out'.) This type of belligerence was combined with centralization of power, a weakened Parliament, and a subdued judiciary.

Official statements by the Georgian leadership regarding Georgia's desire to join NATO and the EU, Georgian military groups' participation in the anti-terrorist coalition in Iraq and peacekeeping forces in Kosovo and Afghanistan were considered proof of the post-revolutionary government's pro-Western orientation. However, similar statements had been made before the Rose Revolution. The first military missions to Kosovo and Iraq were dispatched before the revolution, so the new government's pro-Western stance is nothing new.

The West appreciated President Saakashvili's anti-Russian rhetoric, which was directed at Russia's top political leadership. However, very little attention was paid to the 'open door' policy towards Russian capital after the Rose Revolution. These Russian economic interests have by no means diminished, despite Russia's declared embargo on Georgian exports from spring 2006 (e.g. Anjaparidze 2006c, Parsons 2006, Tsereteli 2006). At the same time, the Kremlin's intense dislike for Georgia's post-revolutionary government (Papava 2007a) and its personal dislike of President Saakashvili (at times combined with open aggression against Georgia, such as the *de facto* annexation of the Georgian provinces of Abkhazia and South Ossetia) contributed to increased Western support of Georgia and its leadership.

Georgia's pro-Western and anti-Russian course was, in part, the reason why the Bush administration turned a blind eye to the negative consequences of the post-revolutionary government's activities. Apparently, the Georgian government was the first to realize this. After President George W. Bush's visit to Georgia in May 2005, the Georgian leadership's behaviour started to show symptoms of a certain 'The USA will always support us' syndrome. It was believed that the visit of the American president to Georgia secured future exoneration by the West for any suspiciously undemocratic actions of the post-revolutionary government, not only for those already committed. However, Georgia's experience shows that a pro-Western and anti-Russian orientation is by no means an adequate guarantee of democracy (Papava 2008c).

The economic aspect of the 2008 elections

In November 2007, after the disastrous repression of mass public demonstrations, President Saakashvili resigned and called for an extraordinary presidential election for 5 January 2008. On 21 May 2008, a parliamentary election followed. During both campaigns, it was apparent that President Saakashvili and his party were using administrative resources for their own interests. The elections were competitive, considering the circumstances, and polling was mostly uneventful. In the final accounting, President Saakashvili received slightly more than the 50% required to avert a runoff whilst his Party, the 'National Movement', now controls 80% of the seats in the Parliament. International observers gave qualified approval to the campaign environment and electoral conduct, but also mentioned serious reservations about the use of administrative resources and the transparency and fairness of the ballot count (OSCE 2008a, 2008b).

During both election campaigns the emphasis was on social problems, especially on overcoming poverty in the country. Mikheil Saakashvili and his political party declared their pre-election slogan to be: 'Unified Georgia without Poverty!' Having won both of the elections, the government embarked on fulfilling its promises with a five-year poverty eradication programme. The programme calls for the reduction of poverty by half (*Civil Georgia* 2008d). It should be emphasized that relative poverty cannot be eradicated, because as the level of economic development increases the poverty line also rises. There will always be a certain segment of the population below the poverty line. However, the government avoided the concept of the poverty line in its programme.

Within the framework of the five-year governmental programme, the government created a 50-Day Action Plan (*Civil Georgia* 2008f, 2008h) which was scheduled for implementation within the first five months of 2008, that is, from January to May for a total of 152 days. Some projects in the Plan are directed towards economic development and, consequently, reducing the level of poverty; others are more questionable. Thus, within the framework of the government's 50-Day Action Plan, a so-called 'revolutionary' economic package of laws was developed (*Civil Georgia* 2008e) with the aim of turning Georgia into a global financial centre by offering tax exemptions on income to large financial companies whose activity in Georgia does not exceed 10% of their financial turnover. This 'revolutionary' package also provided for a significant reorganization of the National Bank of Georgia (NBG), the country's central bank, by subordinating it to the government. This meant that exceeding a threshold level of annual inflation would allow the government to demand the resignation of the President of the NBG through Parliament (*Civil Georgia* 2008a).

Amongst the projects stimulating economic development, one of the potentially most important was the creation of financing facilities in the form of 'cheap credits' for small business development. Unfortunately, this project, which was attractive for many businessmen, was carried out without sufficient transparency. Surprisingly, the decisions about credits for each concrete project were taken not by a credit agency hired by the government for this purpose, but by the government itself. The government's 50-Day Action Plan also included increased pensions – the amount of a monthly pension increased by 27% in April 2008 – and the raising of the minimum pension up to US\$100 was promised by 2009. Given the current exchange rate, this implies a more than double increase.

The government's 50-Day Action Plan includes the creation of a free economic zone (FEZ) in the proximity of the port city of Poti. The idea of opening a FEZ in Georgia is not a new one. It was first linked with the province of Achara when its former leader, Aslan Abashidze, 15 years before the Rose Revolution, raised the issue of creating a zone around the port city of Batumi (e.g. Khutsidze 2003). Given that Georgia embarked on liberalizing its foreign trade more than 10 years ago, and that business registration procedures were significantly liberalized during the post-revolutionary period, the economic viability of an FEZ is doubtful (Papava 2007b). International experience of FEZ's in countries that lack investment or experience 'investment hunger' suggests that both foreign and domestic entrepreneurs will prefer to run their businesses within the zone because of the tax exemptions. Outside the zone, as a result, the economy withers. Thus, the economic development of the country outside the FEZ is hampered. This danger is very real in the case of the Georgian economy (Patsuria 2008), but arguments against establishing the FEZ (Khutsidze 2007) were not shared by the government. It signed an agreement of Investment Authority with the UAE's Ras al Khaimah for development of this economic zone near Poti. The company purchased 51% of the shares of the Poti sea port (*Civil Georgia* 2008g).

Within the framework of the government's 50-Day Action Plan was the issuance of Eurobonds of US\$500 million, with a maturity of five years and with a coupon set at 7.5% in

April 2008 (*Civil Georgia* 2008b, 2008c). Unfortunately, the government did not make clear public announcements on the purposes of increasing the foreign debt of Georgia by US\$500 million. First, it claimed that the money was needed to implement new energy power projects, but afterwards the plans were changed, and it was stated that all the money would be channelled to the Fund of Future Generations (the Fund is mainly set up for the economic rehabilitation of Abkhazia and South Ossetia after they are reintegrated in Georgia) and the Fund for Stable Development (this Fund was set up specifically for preventing economic crises). Finally, it was stated that these Funds would get only half of the money received from the Eurobonds, and a decision would be taken at a later date with respect to the purpose for the other half of the amount. Thus, the government either does not know what the purpose is of the increase of the country's foreign debt by US\$500 million, or it is concealing its intention from the taxpayers who will pay this debt with interest. Thus, during and after the 2008 Presidential and Parliamentary elections, the government implemented several large-scale projects whose economic viability is doubtful or certainly poorly thought out (Lashkhi *et al.* 2008).

Economic challenges for post-war Georgia

In general, the Georgian economy stood the test of the five-day Russian–Georgian war in August 2008 (Antonenko 2008, Cornell 2008, Jones 2008a, King 2008), even though it has to deal with considerable difficulties in the aftermath of the conflict (Kakulia 2008). The country suffered huge direct economic damage consisting of ruined towns, villages and infrastructure, along with considerable environmental damage (Grigoriev *et al.* 2008, pp. 92–95, Westley 2008).

At the aid conference held in Brussels under the aegis of the World Bank in October 2008, US\$4.55 billion was committed for the reconstruction of post-war Georgia. US\$2 billion was grant money, the remainder a loan. Georgia will receive these funds during 2008–2010, and a major part of it will be spent on the reversal of economic damage caused by Russian military aggression. In the process of remedying the damage, particular stress should be placed upon monitoring how these funds are spent, with maximum transparency. It must be as transparent as possible. Particular attention should be paid to the stability of Georgia's banking system and the national currency's exchange rate. 11 August 2008 was the most difficult day for the country's banking sector. The threat of extensive Russian occupation led individuals and corporate entities to start withdrawing their savings and deposits from banks. In a few days, some US\$0.5 billion were withdrawn from the Georgian banking sector. By the end of September, only 30% of this amount was returned to the banks.

To avoid a banking crisis, the NBG, the country's central bank, correctly renewed commercial bank refunding operations to ensure relatively cheap credit resources for the country's commercial banks. At the same time, the interest rate for one-week deposit certificates was reduced from 12% to 10% (to discourage commercial banks from buying NBG securities), and the required reserves for commercial banks was reduced from 15% to 5%. In this way the NBG safeguarded Georgia from a major banking crisis. However, it contributed to the growth of the overall amount of money in circulation, which results in inflationary pressures. In other words, in choosing between bad and worse, the NBG opted for the former. Otherwise the banking crisis might have resulted in the destruction of the whole economy.

Significant social problems resulted from the conflict, especially the increase in internally displaced persons (IDPs). The government had to build temporary homes for newly displaced people. These efforts, on the one hand, create additional demand for construction materials and jobs, but on the other hand, government expenses in the construction sector will stimulate a further growth of inflation in a short period of time because it is the government, not

private individuals and entities, who are buying those homes. The government's laudable plan to distribute vouchers to the new IDPs to pay gas and electricity bills will also contribute to inflation. The government has limited choice, which is exactly what makes the growth of inflation so inevitable.

The inflow of foreign direct investments to Georgia has dropped significantly. Investors try to invest in relatively safe countries rather than ones such as Georgia, which was seriously affected by the Russian aggression. In addition, the global financial crisis drove Georgians living abroad to reduce their remittances to their relatives living in Georgia. The country's huge foreign trade imbalance must be added to this mix. Imports exceed exports by four times, so it came as no surprise that the stability of the lari exchange rate was shattered.

After the war, the IMF, acting within the terms of its stand-by arrangement, extended Georgia US\$750 million in support of the country's macro-economic stability, of which US\$250 million had already been transferred to the NBG reserves in the fall of 2008. Instead of allowing a gradual devaluation of the Georgian lari, the NBG attempted to ensure an almost imperceptible devaluation by implementing regular interventions with its currency reserves into the currency market. During a one-month period, the NBG spent some US\$300 million of its hard currency reserves. As a result, the Georgian lari was devalued by only 2.5% against the US dollar. However, on the unfortunate day of Friday 7 November 2008, the commercial banks' demand for US dollars soared to more than US\$31 million against a zero supply on the part in the Inter-Bank Currency Exchange (IBCE). The NBG offered just US\$270,000 for sale and then quit transactions ostensibly for technical reasons. What followed was a general panic: in a flash all cash machines were emptied of their reserves, and the currency exchange outlets drastically raised the dollar exchange rate. Many simply refused to sell dollars and so the NBG arranged for a 'Green Friday' – an artificial 'victory' of the green US dollar over the Georgian lari (Papava 2008b). The panic in the currency market continued on Saturday 8 and Sunday 9 November. On Monday 10 November, when the IBCE renewed operations, the NBG offered US\$47 million for sale, thereby setting a new exchange rate for the Georgian lari to the US dollar. Compared to the morning of the 'Green Friday', the lari was devalued by 15% against the US dollar. It was only on Monday 10 November 2008 that the NBG leadership announced that the events of 7 November had been planned in advance. Whatever the truth, after 'Green Friday' people have been trying to get rid of their lari, the commercial banks have been reluctant to extend loans in lari, and the overall level of dollarization of the Georgian economy has grown dramatically. Given that imported goods occupy 80% of Georgia's consumer market, prices soared, causing inflation to be one of the most serious economic problems in post-war Georgia.

After the war, devaluation of the lari was inevitable. To maintain the country's macro-economic stability, the devaluation should happen gradually so that any panic in the currency markets, such as the one which took place on 'Green Friday', can be avoided. International financial aid of US\$4.5 billion, which Georgia is due to receive in 2008–2010, is a solid foundation for preventing further dramatic drops in the lari's value. But unless the organizers of 'Green Friday' are held politically responsible for their decisions and replaced, the repetition of similar experiments cannot be excluded (Papava 2008a). The restoration of public confidence in the Georgian national currency depends upon good management and gradual devaluation of the lari.

After the Russian-Georgian war in August 2008, Brussels offered Tbilisi negotiations on a free trade agreement. The proposed transition to a free trade regime with the EU is a very important factor for encouraging the continued flow of foreign investments into Georgia. Negotiations on this issue between the US and Georgia are still at an embryonic stage, but the EU decided at an Extraordinary European Council meeting in Brussels on 1 September 2008 (CEU 2008), that

such an agreement should go ahead, provided that Georgia meets economic conditions set by Brussels within the format of the EU Neighbourhood Policy. These include the adoption of a new labour code, which would secure the same rights for employees as in the EU itself and the creation of a European-style anti-monopoly and consumer rights protective legislation. A new EU Eastern Partnership Plan, unveiled on 3 December 2008 in Brussels (CEC 2008), proposed further generous financial assistance programmes and free trade deals to Georgia and four other former Soviet states (e.g. Jowiak 2008).

The Georgian government has generally welcomed the EU's initiative on proposals for a free trade regime, but so far, the EU's conditions have been ignored by the Georgian government. Neither the Letter of Intent sent by the Georgian government to the IMF on 9 September 2008, nor the Memorandum of Economic and Financial Policies for 2008–2009 (IMF 2008) suggest the Georgian government plans to amend the Labour Code or adopt a new European-standard anti-monopoly and consumer rights legislation. In short, the Georgian government is in no hurry to implement a transition to the free trade regime with the EU. This is despite the fact that a free trade regime with the EU (Papava 2008d) is of vital importance to Georgia. The US and the EU should take this opportunity to co-ordinate their efforts to push the Georgian government to take more consistent steps toward Western standards, otherwise Georgia will diminish its chances of economic integration with the EU.

Conclusion

In the sphere of economic transformation, the post-revolutionary government initially showed the political will to establish financial order and eradicate corruption. This allowed the country to overcome budgetary and energy crises. At the same time, the government made numerous mistakes along the revolutionary road to market democracy, including repeated violations of property rights.

The government's authoritarian style and isolation at the top prevents the ruling party from recognizing and correcting its mistakes. Economic measures taken since the Presidential and Parliamentary elections in 2008 suggest these mistakes will be repeated. The challenges of the post-war period must be taken into account. The question now is whether Georgia will continue its slide toward the Russian model of 'controlled' or 'sovereign' democracy or meet the new economic challenges with a more transparent and legally consistent approach. The West's role in this respect is crucial. It should no longer simply blindly trust Georgia's president and its parliament but monitor both strictly (Applebaum 2008).

Notes

1. See: *Doing Business. Economy Rankings*. Washington, DC: The World Bank Group, 2007. Available from: <http://www.doingbusiness.org/EconomyRankings/>.
2. According to its architects, a liberal empire should be created not by forced armed occupation of the former Soviet republics, but by gaining control over the main economic facilities (by acquiring and developing assets) located on their territory. An analysis of Russian investments in the CIS countries is presented in an article by Crane *et al.* (2005). In the Russian idea of a liberal empire, its developers and executors imply non-military methods of empire creation, but not of its functioning. Here, the word 'liberal' should not apply (which is not surprising if the far from liberal nature of the Russian regime is remembered) (Åslund 2005, Trenin 2005). Note should be taken of the interrelation in Russian policy in the post-Soviet space between energy dependence and political independence (Balzer 2005). For an ex-Soviet state, when the former increases the latter weakens (Smith 2004, pp. 5–8). It is no accident that for Russia, together with the formation of a liberal empire, advance towards an energy empire is of particular importance (Hill 2004).

3. See: *Armenia: Economic Hai-Lights*, July 2002. Available from: <http://www.bisnis.doc.gov/bisnis/bisdoc/020809ARHaiLights.htm>
4. Later in 2008 RAO EES was split up into several companies (Chubais 2008).
5. See: Vneshtorgbank priobriol kontrolnyi paket aktsii Ob'edinionnogo banka Gruzii (Vneshtorgbank Purchases the Control Packet of Shares of the United Georgian Bank). *News.ru*, 18 January 2005. Available from: <http://www.newsru.com/finance/18jan2005/vnesh.html>
6. See: Russian Vneshtorgbank continues Transcaucasian expansion. *Armenian Diaspora.com*, 31 May 2004. Available from: <http://www.armeniandiaspora.com/forum/showthread.php?p=4560>
7. See: Millennium Challenge Corporation Board approves \$295.3 million compact with Georgia. *Georgian Business Week*, 16 August 2005. Available from: <http://mca.gov/press/releases/2005/release-081605-boardapprovesgeorgiacompact.php>

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