

## PART III. ECONOMIC REFORM AGENDA

### MEDIUM-TERM PROSPECTS FOR THE GEORGIAN ECONOMY

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Analysing the medium-term (MT) prospects of the Georgian economy requires a concept for understanding the economic significance of what medium-term means. It is possible to have an institutional understanding of MT; that is, what is put on the MT agenda. For the Government's "Basic Data and Directions" (BDD) as well as the negotiated European Neighbourhood Policy Action Plan (ENP AP), medium-term covers the time range of four to five years. It would be misleading, however, to understand MT as just the time range which is located between the short-term and long-term. In the specific context of Georgia, MT has a very precise content because the country is in a process of post-communist transformation. What makes the transition specific is the fact that we are facing a process of systemic change from which new productive structures and new economic behaviours emerge and stabilise. In such a context, the start of the transition process is associated with relatively volatile structures and behaviours whereas the end of the transition is associated with the lost of their plasticity.

If we make a sequencing of the Georgian transition, we should consider that the country was put in a "transition trap" [1] until 2003 where the new economic interests legated from the communist past – oligarchs, rent-seekers and State-owned enterprises – managed to optimise their personal benefit and stop further reform that may have damaged their interests. After the Rose Revolution of November 2003, the first step of transition was restarted by launching the reform process. The main outputs of these short-term transformations are: the stabilisation of economic powers including the results of privatisation, the macroeconomic stabilisation and the definition of economic virtues it generated, as well as the social divide between the winners and the losers of the first step, and the setting-up of the main legal frames and regulations of economic activity.

These outputs of the end of transition first phase will become the constraints of the MT period which is the period we are now analysing. The outputs of the MT horizon will thus become the inputs of the last phase – the long-term prospects – where the structures of economic activity will stabilise definitively and become able to change only in the long run. That means that the period covered by MT prospects is associated for the last time (if there are no more crises) with a relative plasticity of economic and institutional structures. Afterwards, the transition process will become more or less achieved, economic structures will become stabilised and change will happen only very slowly in the long range except for in crises situations. After that moment, even the "medium-term" will have a new significance which will be very different from the current one. Today, the MT range is a situation when the constraints of the first phase are already built (pro-Western orientation, balance of economic powers, macroeconomic choices and mode of economic regulation) and when the main economic structures are being set up.

#### **The Pro-Western Strategic Orientation of Georgia**

Since the Rose Revolution, the new policy conducted by the head of the State and the Government was characterised by a strong reform process towards the Western standards of a market economy. Georgia is quickly integrating within the global economy with the clear strategic orientation towards the European Union (EU) and towards NATO and the USA. At the same time, increasing tensions with Russia, the main economic partner at the beginning of the process, accelerated the economic disintegration with this country. The building of the BTC oil route (Baku-Tbilisi-Ceyhan) by the British Petroleum consortium from Baku to the Mediterranean Sea crossing Georgia, the construction of the gas route Baku-Tbilisi-Erzurum by the three countries involved as well as the railway Kars-Akhalkalaki-Tbilisi-Baku (KATB) to connect Europe further with Kazakhstan and China confirm the strategic orientation of the country on the side of the Western and Turkish interests in the region.

The choices which Georgia has recently made on energy routes have high political significance. The oil route BTC and the gas route SCP connect the Caspian fields with Western Europe without loading the Bosphorus. These high capacity pipes provide Western markets whilst making a diversification from Russian deliveries and putting a final end to the Russian monopoly on transit from the Caspian Basin. For that reason, it is possible to say that these routes have a strategic orientation favourable to the inter-

ests of Europe and the USA, and not to Russia. These energy routes towards Europe and Asia help to increase the production capacities of the Caspian region.

On the other side, these routes make Turkmenistan, Kazakhstan, Azerbaijan and Turkey strategic partners of Georgia. This integration enables Georgia to become free from Russian energy deliveries and pressures within the medium-term. According to the IMF, however, Georgia can receive natural gas – the maximum capacity of which will reach 0.85 billion cubic meters per year by 2011 [2] – in the form of a gas transit price. Georgia has already asked Azerbaijan to buy additional 3 billion m<sup>3</sup> by the end of 2005 but this will only be possible in the second phase of the project. Consequently, the supply of natural gas from the Russian Federation will remain a concern in the short-term.

The energy dialogue is integrating into a single energy network consisting of Central Asia, the South Caucasus and Europe. With increasing regulatory convergence, this will originate in a single energy market between the three ensembles within the medium-term.

Azerbaijan, Turkey and Georgia decided recently to build the railway Kars-Akhalkalaki-Tbilisi-Baku (KATB) to connect Europe further with Kazakhstan and China. The project was signed in February 2007 in Tbilisi with the main initiative and funding coming from Azerbaijan. With the construction of the Kars-Tbilisi-Baku railway, originally brought to the agenda in 1960, Turkey will become a major transfer route between Asia and Europe. Kazakhstan and China have also joined the project which, when completed, will be a modern version of the former Silk Road, enabling a person in Kars to reach Shanghai or Hong Kong via Kazakhstan. The project, linked also to the Marmaray Project, will permit trains departing from Britain to reach China non-stop via Turkey. The railroad venture will be completed in two years and will transport 20 million tons of cargo annually.

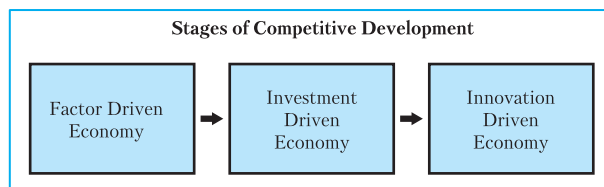
The increased freight traffic on TRACECA (Transport Corridor Europe – Caucasus – Asia) indicates the interest of transporters in this route as the shortest and potentially fastest and least expensive land connection in an east-west direction.

The Georgian telecommunications provider, Caucasus Online, and the US-based Tyco Telecommunications have signed a contract to construct a 1100-kilometer undersea fibre optic system which will connect Georgia's Black Sea port of Poti with the Bulgarian city of Varna [3]. The system will serve Georgian markets by providing direct access to Western Europe via a state-of-the-art undersea fibre optic link. The system will have an ultimate capacity to transmit 6410 GB wavelengths on each fibre pair for a total bandwidth of nearly 1.3 terabits and is expected to be operational by the end of 2008. Despite the fact that this information highway will impact basically Georgia, the effects could spread and increase the position of Georgia as a link between Europe and the Caspian region.

### **The Stabilisation of the Development Path of Georgia**

Four years after the Rose Revolution, a new economic pattern of the Georgian economy has appeared. The government managed to keep a stable macroeconomic framework according to the IMF and World Bank orthodoxy although this pattern is not yet stabilised and will change, even in the medium-term prospect. One should keep in mind that Georgia is still in a process of transition; that is, departing from the economic structure that was a component of the socialist division of labour within the former Soviet Union and reaching an economic structure adapted to an economy open to the global world and integrating both with economic partners of the South Caucasus and the Black Sea Region and with the European Union. This process will be completed in a medium range horizon when the whole economic structure becomes stabilised. Some features have already stabilised and will become the levers and the constraints of future economic growth. Some other sectors and regions are still in the phases of their restructuring with their future remaining relatively open in the same horizon. We will analyse herein the most significant of these components.

According to economic science, one should make the distinction between economic growth and economic development. Development is important because it creates the sources of sustainable economic growth. Economic growth is the increase of the GDP as a statistical aggregate built in the national accounts upon the basis of value-added production of reported activities. For Georgia, for example, it means that self-employment in agriculture, which occupies almost half of the labour force, is not fully included in the GDP measurement. On the other side, the process of fiscalisation of the economy, as a result of the legalisation of informal activities, for example, produces an artificial increase of the GDP without a real increase of production. Development is a deeper and more complex notion which refers to the efficiency of human productive activity and to human welfare as the result of economic activity.



As conceived by Michael Porter [4], from productive side, development can be represented as the process of shifting from one to another stage of competitive development; that is, from a factor-driven economy (based upon natural or external financial resources and upon inexpensive labour) to an investment-driven economy (based upon productive capital investment) and then to an innovation-driven economy (based upon the intelligence and innovative activity of human labour). From the side of consumption, development is well approached by the UNDP's Human Development Indicator which gathers individual income level and the efficiency of education and health systems or by the 1998 Nobel Prize winner, Amartya Sen's, "capabilities" and positive freedoms. In that respect, poverty reduction is a part of the development strategy which is, of course, very important from the social point of view but economic development cannot be reduced to only poverty issues.

How can we make progress towards economic development within that concept of understanding? From the most recent theories of other Nobel prize winners, such as Douglass North and Joseph Stiglitz, to those of economists like Paul Krugman, Allen Scott or Michael Storper as well as with the best outputs from international think tanks like the UNDP, the EU, the OECD or the World Bank, it is possible to consider economic development as a complex process of:

- State building;
- The institutionalisation of the economy; that is, the building up of the rules and habits framing economic activity;
- The building of material and social infrastructures;
- The emergence of productive firms and entrepreneurs instead of informal activities and the distribution of internal rent or external resources;
- The clusterisation of economic activities connected to global markets in large cities and productive territories.

For a country like Georgia, the transition towards a market economy is embedded in the process of economic development which gains peculiarities because of the specific legacy of history. The building of the state should take into account the legacy of hypertrophic, authoritarian and bureaucratic public administrations. The institutionalisation of the economy, which means the integration of shared rules of fair economic behaviour by economic players, should take into account the former lack of autonomy of the economic sphere. The emergence of productive firms should take into account the recent past of the absence of firms, of the quasi-disappearance of SMEs and the existence of rent-seeking behaviours. The territorial clustering of activities is suffering from the lack of a tradition of decentralised bottom-up economic and local government initiatives. In other words, the development processes and policies cannot be based upon universal receipts and should take care of the former economic system that is still present in economic structures and behaviours.

### **Georgia's Macroeconomic Performance**

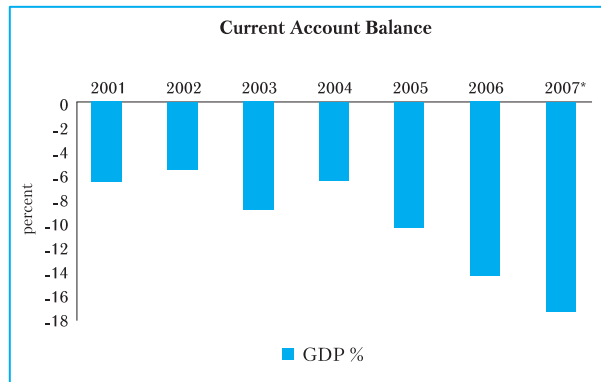
Georgia's macroeconomic performance is characterised by a strong dynamics accompanied by a huge restructuring of the economy. The imbalances that appear are quite often connected with this adjustment process. Some of them, however, may reflect more structural phenomena and should receive more attention.

#### ***Monetary environment and contrasted state balances***

Since the beginning of 2004, during the almost three years, the authorities have managed to keep a stable monetary framework. Inflation measured by the consumer price index (CPI) was relatively stable: 2004 – 7.5 percent, 2005 – 6.2 percent and 2006 – 8.7 percent. From the end of 2006, inflation pressure was strengthened with the annual growth of consumer prices exceeding 10 percent in 2007.

The lending rates are decreasing (21.6 percent in 2003, 18.7 percent in 2006), making credit more accessible to investors. This process has not stabilised, however, as lending rates in the short-term have slightly increased at the end of 2007.

The real effective exchange rate of the lari has been increasing slowly since 2003 with a total increase of 15.3 percent in the medium-term. The explanation is the constant nominal appreciation of the lari from 2003: 24 percent against the US-dollar in 2006. The increase of the nominal exchange rates of the lari potentially brings a loss of price competitiveness of Georgian goods and services.

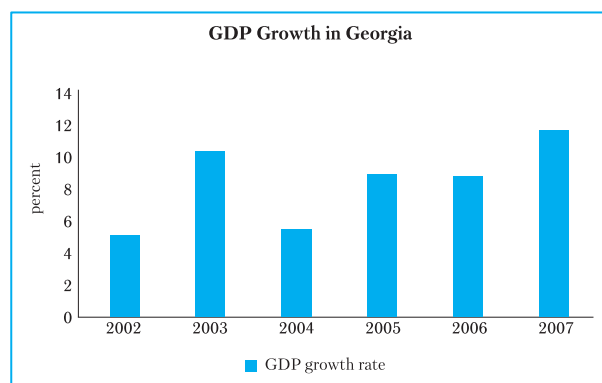


Source: Department for Statistics, Ministry of Economic Development  
 Note: \* Six month data

The good situation of the state internal balance is a factor that explains the stable and improving monetary situation. State budget deficits figures, as percentages of the GDP, are 2004: – 2.9 percent, 2005: – 0.2 percent and 2006: – 0.3 percent with the first half of 2007 showing a slight budget surplus. This result is explained by a strict budgetary policy and by the revenues of privatisation and increasing grants from international organisations. On the other side, the current account balance is strongly deteriorating from a – 6.8 percent of the GDP in 2004 to a – 15 percent of the GDP in 2006 and more in 2007. This important issue will be discussed below although in the short range, however, this situation creates tensions towards the nominal depreciation of the lari which is not an issue because the problem with the national currency is, in fact, the opposite.

#### ***A solid growth hosting strong structural change***

Since 2004, GDP annual growth was 8.3 percent on average which is a high rate in international comparisons. One should keep in mind, however, that Georgia and Moldova both had the sharpest drop with a GDP level of only 38 percent in 2002 as compared to that of 1990. For equalising the EU nominal GDP per capita of today, Georgia needs 35 years with 8.3 percent growth. Ten years of such a growth rate would bring Georgia’s per capita GDP to 12 percent of the current EU level. Twenty years would set it at 27 percent.



Source: Department for Statistics, Ministry of Economic Development

Strong structural changes are taking place within these aggregate figures. Between 2003 and 2006, the shares of agriculture and industry are decreasing whilst those of construction and trade are increasing (see Table 1). One should notice, however, that even if the share of agriculture keeps decreasing or stabilises, the share of industry is likely to increase again after restructuring as a result of FDI and following a J curve profile.

If we consider the structural changes during the last reported year (2006) in more detail, we see very dynamic sectors in services (growth in financial intermediation: 39.4 percent, trade – 19.8, communication – 11.9, hotels and restaurants also – 11.9) and also in material production (manufacturing – 22.2 percent, electricity generation – 14.2 and construction – almost 10 percent). If one weights these trends

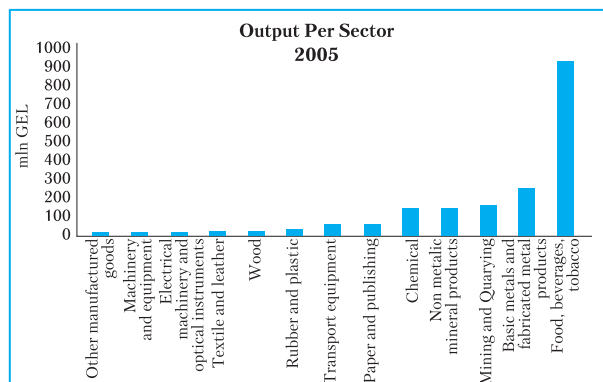
by a sector's importance in the GDP, the biggest contributions to GDP growth come from trade – 2.1 percentage points, manufacturing – 1.2, electricity generation – 1, communications – 0.8, agriculture – 0.6, hotels and restaurants, financial intermediation and public administration 0.5. The activities that drive economic growth are market services (5 percent), material production (3.3 percent) and public infrastructures (2.6 percent).

**Table1: Georgia's GDP Structure (%)**

	2003	2004	2005	2006	2007*
Industry	17.7	16.1	15.7	14.9	13.3
Agriculture	19.3	16.4	14.8	11.3	10.2
Transport/Communication	13.9	13.4	12.4	11.5	11.5
Construction	6.4	8.1	8.1	6.9	6.1
Trade	13.3	12.7	11.9	13.6	13.5
Hotels and Restaurants	2.9	2.7	2.8	2.2	2.1
Other Services	26.5	30.6	34.3	39.6	43.3

Source: Department for Statistics, Ministry of Economic Development  
 Note: \* Six month data

This production profile is typical of transition countries within processes of deep restructuring: market services are growing quickly in order to fill their gap and because growth is being led by final consumer demand, material production is significant because of the construction which is driven by both private consumers and public bodies and because agriculture and industry in change start bringing some results and, finally, public investment in infrastructures (energy, administration, transport, education and health) show that the state is changing and focusing upon its new functions in order to provide public goods.



Source: Department for Statistics, Ministry of Economic Development

Within industry, the largest sub-sector is food processing and beverages which focuses upon the part of the economic legacy that relies upon real comparative advantages. Other significant sub-sectors are not really new – metal scrap, copper concentrates and fertilisers – with other new industry sectors having not yet appeared. This chart shows that industry restructuring has not been completed but it is a process which will continue in the medium range horizon.

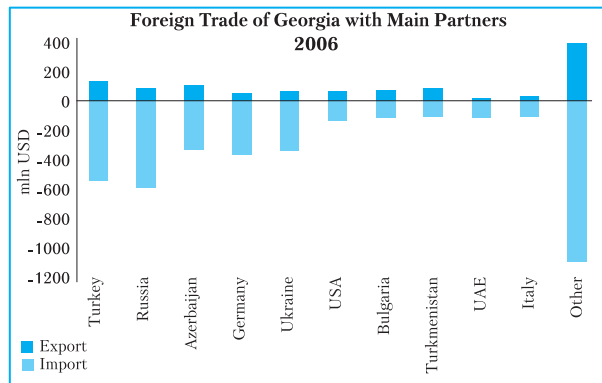
***The weak current account balance***

The macroeconomic landscape is characterised by a huge imbalance in the external sector. This imbalance comes from the trade deficit which then shapes the negative current account balance.

This trade deficit was already important in 2003 when imports were three times higher than exports. Since then, however, exports have doubled when imports became multiplied by three. The trade deficit is reaching 25 percent of the GDP in 2007.

This deficit is proportionally distributed amongst the trade partners which shows that it is a general feature of Georgia's economy, whether it be with traditional partners, such as Russia, Azerbaijan, Ukraine or Turkmenistan, with a new key partner, such as Turkey, or with Western countries. The origin of this deficit is in the extreme dynamics of imports which makes the macroeconomic situation of the country fragile and reveals a structural weakness that should be explained. Economic growth is linked with the standing opening and deepening of a huge hole in the economy which seems impossible to

stop without halting the growth. Moreover, this deficit may bring direct imbalances because it should be financed and has a downward impact upon the exchange rate of the lari.



Source: Department for Statistics, Ministry of Economic Development

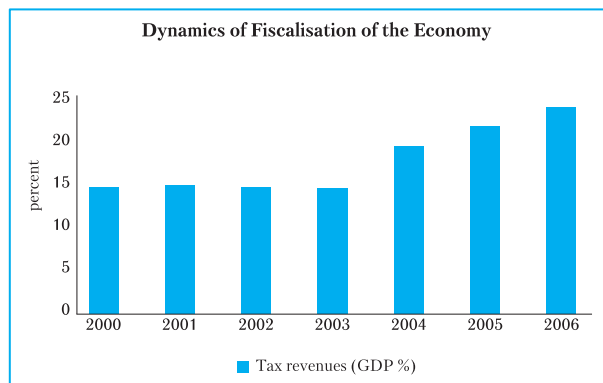
### A Medium-Term Focus upon Successes and Weaknesses of Georgia's Economy

If we consider the economic landscape of Georgia, we can see that the country is at a half-way point in its transformation with some interesting and promising performances but also some severe weaknesses. This allows us to consider that the medium-term prospects should consolidate the performances hitherto reached whilst at the same time tackling the existing weaknesses that prevent a sustainable growth.

#### The success stories of Georgia since 2003

It is possible to identify four macroeconomic performances with high significance.

The first one is the increased fiscalisation of the economy with total tax revenues jumping from 14 percent of the GDP in 2003 to 23 percent in 2006. This trend is still moving in an upwards direction with the first half of 2007 showing a figure of almost 27 percent and reflecting not only the financial basis of the state's action but also the success of an anti-corruption policy, both of which have been well reported. This further reflects the expansion of the economy and the reduction of the informal sector, as a success of tax reform, laying the bases for a pro-business policy.

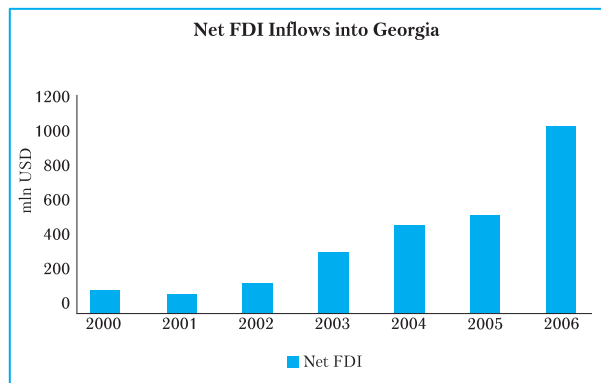


Source: Department for Statistics, Ministry of Economic Development

The decrease in interest rates on loans is an evolution which is welcomed by enterprises. The rates on loans in foreign currency dropped from 23 percent to 18 percent for short-term and from 19 percent to 16 percent for long-term loans between 2003 and 2006. The long term loans in the lari, however, remain expensive and did not change significantly since 2003 with a figure of 20 percent. This situation makes the financial sphere quite profitable but this high level means that investments in the production of good or services could not rely upon credit or it would cause losses in competitiveness. As for agriculture, one can say that most of the farmers do not have access to finance.

A very positive evolution is shown on the side of FDI. After 2005 and the end of the building of the oil and gas pipelines, one could expect a drop in FDI flows. The opposite is taking place, however, with a two-fold increase in 2006 and most likely a higher level in 2007. If 36 percent of these investments are devoted to the modernisation of the energy sector, the large share of other investments reveals an increase in the attractiveness of the country. The country analysis of the origin of FDI inflows shows that one third of the FDI comes from Georgia's richer neighbours: Kazakhstan, Turkey and Russia (the latter including Cyprus and the Virgin Islands). This trend is very promising and shows that the opening

and deregulation policy of the Government has created a high profitability of the country which is often higher than in these countries. If one considers the economic size of these three investors for Georgia in relative terms, then the potential for fostering the economic development of the country is high.



Source: Department for Statistics, Ministry of Economic Development

Fifty-four percent of investment activity in Georgia was driven by FDI in 2006. This amount is still increasing with USD10 billion of foreign direct and portfolio investments expected in the next five years according to the new programme of the Government for 2008-2012, “United Georgia without Poverty.” This huge entry of capital is already causing some trouble for the monetary stability and the risk is increasing.

Another issue is that the FDI are hitherto mainly directed towards infrastructure (energy, pipelines, transport) which is good for the business environment but not for an increase in productivity and competitiveness. The trade deficit requires FDI in the tradable goods such as agriculture, manufacturing and services.

An interesting fact is the way in which Georgia managed the Russian embargo which was imposed upon its products, such as wine, mineral water, fruits and vegetables, in spring 2006. Despite this pressure which made Georgia lose the Russian share of its export market – 14 percent of its exports – its overall export figures continue to grow slightly. Both the EU and CIS countries, such as Azerbaijan and Kazakhstan, absorbed the export increase. This lesson reveals the ability of the Georgian economy in diversifying its markets – if not yet its goods – and the end of the export dependency from Russia.

**Table 2: Georgia’s Foreign Trade (thousand USD)**

	2005	%	2006	%	2007-jan/feb	%
Total Imports	2490913	100	3681230	100	662419	100
CIS countries	997691	40.1	1404526	38.2	264805	40.0
Russian Federation	384350	15.4	561724	15.3	116625	17.6
EU countries	671387	27.0	953097	25.9	190411	28.7
Turkey	283007	11.4	522982	14.2	81177	12.3
Total Exports	866241	100	993051	100	136815	100
CIS countries	407952	47.1	394925	39.8	53261	38.9
Russian Federation	153925	17.8	75664	7.6	5480	4.0
EU countries	165216	19.1	188760	19.0	42597	31.1
Turkey	121809	14.1	124960	12.6	20575	15.0

Source: Department for Statistics, Ministry of Economic Development

Increased fiscalisation, high FDI attractiveness and a diversification of the markets are outputs which are not only feeding economic growth but carrying real medium-term development potential. The ability to attract FDI was one of the keys of the development success stories in South-East Asia and China since the 1980s. The two other sources of success for these countries are the building of material and social infrastructures by the state and the learning capacity of the economy. Let us consider how these two other challenges are managed by Georgia.

### ***The obstacles to sustainable economic development***

Three issues bring concerns for the future. The first one is the increasing trade deficit of Georgia and it is important to understand to what extent this situation is a problem. We will argue below that such a situation is connected to the structural orientation of the country as an income-driven economy. By itself, such a deficit has a monetary and a real dimension. The monetary side of the question is the impact

of the deficit upon the exchange rate. In theory, self-adjustments by the exchange rate tend to balance trade performance: a surplus of import increases the demand for foreign currency and tends to depreciate the national currency which brings increased exchange rate competitiveness to products and a return to trade balance. Stable deficit may appear in different situations. In the USA, the national currency is also the international currency which prevents the action of the regulatory effect of the exchange rate. It appears in other countries where the exchange rate fluctuation is frozen because of rigid exchange rate policies conducted by authorities, because of a currency board or because of monetary integration like in the EU. It also appears in countries such as Georgia where capital inflows compensate the impact of the trade deficit upon the exchange rate and keep the national currency at a high level.

The real dimension of the issue is that it reflects a lack of competitiveness of the national economy and a too narrow economic basis of the country that can be measured by the real labour input per inhabitant. This input could be too low for different reasons: an under-developed economy, an informal sector, a low potential activity rate provided by the demography, a low employment rate or a low annual labour input of the working population. As a matter of fact, the monetary and real dimensions of the trade deficit should be analysed by considering the priorities of the economic policy.

It is interesting to see that such a situation is that of the French economy today, with a trade deficit for the fourth year rocketing at 39 billion Euro (about 2 percent of the French GDP). This deficit comes from import prices for energy, the strong Euro, low salaries in Germany and insufficient labour inputs and which fuels a controversy amongst economists about its interpretation.

What are the priorities of the Georgian economy? If priorities are its modernisation through FDI and the fight against poverty, then we can answer this question as follows. The monetary effect of the deficit is neutralised and Georgia still has a high and stable exchange rate. This rate is good for attracting FDI and for the purchasing power of the population as long as it has incomes. The real effect is that this rate is not good for the competitiveness of domestic firms and, thus, for generating employment and domestic incomes. The country is locking in a situation of narrow economic basis.

One should add that the current balance between the pressures in favour and against the national currency make a situation which remains fragile in the medium-term. Given the huge dimension of the trade deficit (over 24 percent of the GDP; that is, 12 times higher than in France), any change in these two variables would generate high economic instability. Already today, the huge amounts of lari injected by the NBG for preventing the nominal appreciation due to FDI inflows create dangerous inflationary trends.

The second concern is the difficulty to improve the business climate in Georgia. Despite the lack of proper monitoring tools of the business climate, the interviews with businessmen provide convergent evidence. Since 2003, there have been huge reforms of the regulatory environment aiming at making business entry and business life easier and the rules more transparent. As well, major successful reforms were made with the tax, customs and labour codes (albeit with concerns about the protection of workers' rights) and licensing issues. The fight against small and large corruption was efficient and the fear of tax inspection is dominating in the behaviours. This made Georgia the country of the region wherein business is very easy to start and it has attracted significant Russian and Kazakh capital given the realities of difficult investment climates in these countries. This paves the way for a possible Georgian specialisation in banking and finance.

Despite these good successes, it seems that business is still complaining about some problems. The first is that reforms are taking place too quickly for both firms and the state administration and they need time for digesting and understanding the changes. Moreover, business suffers from an environment which is not competitive enough and complains against the unequal treatment in regulatory issues, procurement and privatisation markets.

The low level of competitiveness is typical of post-Soviet economies and is reflected by the difficulties in the creation of small businesses despite a favourable regulatory and banking environment. We are not facing the explosion of SMEs that usually accompanies booming development processes.

In addition, business suffers from the still authoritarian behaviours of the state. This interventionism takes the form of arbitrary tax inspection and court decisions. Another example is the suspension of the judiciary institution of arbitration which, for the first time, might have given the right to business against the state. The Economist Intelligence Unit also reports recent criticisms from business against the uncertainty caused by unjustified state interventions (tax, courts) in Georgia. Two important issues

are still pending. Several companies reported the “voluntary contributions” they had to provide to the state which is perceived as a hidden tax or corruption. The second weakness is the judiciary system which has difficulties to ensure equal rights. The authorities intervene in the decisions taken with these interventions being mostly not in favour of business.

For all the above reasons, the adaptation process of the Georgian economy is hampered by the slow demography of firms. The economy has difficulties to react to an internal demand that generates more import than local business.

The third major medium-term issue – and perhaps the largest one – is poverty with the topic currently having become a focus in political life. So far, however, there is no deep analysis and monitoring of the phenomenon. The quantitative assessment was made impossible because of a discontinuity in the poverty data series reported by State Department of Statistics (SDS).

**Table 3: Level of Poverty in Georgia (%)**

	Q1, 2005	Q1, 2006
Urban	38.1	36.0
Rural	41.1	31.2
Georgia	39.7	33.6

Source: Department for Statistics, Ministry of Economic Development

Current figures show a decreasing trend with higher poverty in the cities which is an appraisal that is quite questionable when one takes into account the importance of remittances in the urban centres. What seems better established is that poverty is connected to under-employment both in the urban and rural areas. The main form of under-employment in the countryside is what is called “self-employment” by international organisations. The reality of this fact seems to be mainly survival subsistence agriculture or rural poverty.

Self-employed persons represent about 50 percent of the economically active population. The number of hired persons is hitherto not increasing and represents only 30 percent of the active population or 35 percent of the total employment. Currently, there are no regional analyses of labour markets, remittances and poverty which could help in identifying poverty traps in cities and rural areas.

As said before, this is the issue with the highest shortage in figures, reports, monographs and qualitative studies. It can be said, however, that the main medium-term impact – besides the social and political consequences of this situation – is the overall under-employment that is associated with a reduced economic basis of the country. That made the Fitch rating agency cautious in its assessment, addressing more precisely Georgia’s moderate income level and narrow economic base.

### **Regulation, Deregulation and the ENP [5]**

Georgia has developed a strong programme of economic deregulation which made the country attractive for foreign investors. On the other side, Georgia is strongly involved in economic integration with the EU within the European Neighbourhood Policy (ENP) that leads to another regulatory approach. The consistency and the stabilisation of the regulatory framework is also a medium-term challenge for the economy. We will discuss herein the issues of consistency between the two approaches and of the required ENP strategy to be developed from Georgian side.

Some voices expressed the idea that the ENP Action Plan (AP) could lack consistency with the policy orientations of the Government of Georgia as expressed in the BDD. In fact, there is no opposition between them, either in substance or in approach.

Both the BDD and the ENP AP approaches are based upon the assumptions that economic opening and FDI attractiveness are the key factors of the economic development of Georgia and of the improvement of the living standards of its population. On the one side, it is possible to say that the BDD puts a strong accent on economic opening and liberalisation whereas the ENP AP has a focus upon improving the institutional framework of investment and of economic activity which is the ground of FDI flows. Moreover, economic opening as a result of FDI seems to be the favourite way of Europe which realises two-thirds of productive capital exports from developed countries. It should be noticed that the two approaches – trade opening and FDI opening – are complementary. The important and increasing trade deficit of Georgia shows that the benefits of trade opening do not come automatically if the business and

investment climate do not create the conditions and incentives for the responses of entrepreneurs to new opportunities. Experience has shown that FDI inflows are quite often a precondition for obtaining the full benefits of economic opening, especially in post-Communist countries.

The most important difference is that the two approaches address different issues and, thus, have different priorities in the areas of regulation. The BDD is focused upon the current need of the Government to continue the reform of the country. Georgia is still suffering from its Soviet past whose legacy it has to remove. For this reason, one of the biggest concerns remains the inefficient and corrupted state bureaucracy whereas the administration, on the contrary, should be the instrument of state reformism. A concern of the authors of the BDD document is that some regulatory orientations of the reform process may express a focus upon legal approximation in itself instead of a focus upon business initiative and economic development. The major concern, however, is that even when the regulatory orientation of the reform is focused in the right direction, the concrete conditions of correct implementation and efficiency of the measures are some times not met. There is a risk that a new regulation, due to administrative controls and sanctions which are connected, might increase the opportunities for corruption and bribery. The key criterion herein is the overall situation of the state administration and of the mentalities in the country regarding corruption and the concrete state of any particular administration and its civil servants and the levels of their salaries, their competencies and their professional ethics.

On the other side, the aim of the ENP is to foster Georgia's economic development by giving access to the EU internal market and making it possible for the country to be in a situation wherein it can benefit from the four fundamental freedoms; namely, the free movement of goods, services, capitals and persons [6]. Why is EU integration important for Georgia? Major economies, such as the USA or the EU, expand their institutional environment to neighbouring areas both for providing reference in institutional development and for building an economic space familiar to their companies and investors. The building of *institutional areas* is an important form of economic integration and will significantly foster trade and FDI flows within this area. It makes sense to orient part of the legal development of Georgia towards EU practice. So far, the institutional environment of Georgia has still been close to that of Russia but political factors prevent Georgia from benefitting from this situation. Moreover, thanks to Common Economic Spaces between Russia and the EU, this Russian environment has already started getting closer to that of the EU. Turkey has a customs union with the EU for some time. Bulgaria and Romania are at the end of their accession processes and Ukraine, Moldova, Azerbaijan and Armenia are also involved in the ENP plan. It is, therefore, urgent for Georgia to orient its institutional environment towards the EU so as to foster economic integration in this direction; that is, to benefit from trade opening and FDI flows. Because of its low development level, a mere trade integration of Georgia with the EU may play against the country. Current trade deficits reflect this situation. Only more complete integration measures, with movements of capital and institutional convergence, are likely to bring Georgia the benefits of its economic opening towards the EU and this is exactly what the EU is able to provide to Georgia within the European Neighbourhood Policy. This will also help Georgia to better integrate with countries coming closer to the EU, such as Russia, Turkey and all of the countries of the Black Sea region.

For these reasons, the ENP AP documents puts the emphasis upon the measures for making the economic spaces homogenous and so for this reason it focuses upon regulatory and standard issues. The Ministry of Economic Development, for example, insisted upon the inclusion of measures which could help Georgian firms reach EU standards for specific goods within the priorities of the BDD. The ENP AP is exactly oriented towards helping Georgia adapt its standards and regulation for a better access to the EU single market.

Under these conditions, Georgia needs to have its own strategy connected to the ENP in order not to lose its ownership in this process. This is the regulatory medium-term challenge of the country. The main issue is for the country to prioritise what will best help its economic development and the attraction of FDI within the ENP AP. That means that the country has to set its economic development strategy more precisely. It would be useful for Georgia to benefit more from the multi-country tools and programmes and the regional integrating dimension of the ENP. In addition, Georgia needs the production of its own policy ideas focusing upon the best ways to use the ENP for its economic development

within all important economic sectors, such as transport, energy, agriculture, environment, trade, social policy or tourism.

### **Georgia is Bearing the Medium-Term Constraints of Income-Driven Economies**

It is useful to consider Georgia as an income-driven economy in order to summarise the above analyses. This will help to understand what is possible and impossible for the country and to identify the most efficient development strategies to conduct.

#### ***What is an income-driven economy?***

An income-driven economy is an economy wherein an important share of public and private incomes has autonomous origin and is disconnected from productive activities like agriculture, manufacturing or services. We say that the economy is driven by the incomes insofar that this money is recycled within the economy: the incomes are spent mostly on public consumption by the state and private consumption by households. This makes the difference from so-called fiscal paradises wherein most of the capital is not spent in the country.

We consider here the most common type of income-driven economies wherein:

- The incomes are coming from factors external to the country;
- The size of the economy is small and, therefore, autonomous incomes play a relatively important role in the macroeconomic equilibria and in the economic growth.

This makes a difference with several developing countries wherein the incomes are generated by a huge domestic informal (non-reported according to OECD definition) sector. This also makes a difference with several large countries like China, Brazil or Russia wherein the incomes from outside have a relatively lower weight in the economy and where the dimension of the domestic markets makes the country attractive for foreign investors. In that case, an important share of external means go to investment and not consumption. Georgia as an income-driven economy could be compared to Moldova, Kyrgyzstan, Albania, Croatia and Bulgaria and, in some respects, to Morocco or Portugal.

One may compare the income-driven economy with the rent economy living from oil and gas revenues, such as Kazakhstan, for example. There are similarities because both are economies of a distribution of resources instead of a production of goods and services. Moreover, both may suffer from high capital inflows which push the real exchange rate upwards and erode the competitiveness of tradable sectors. There are, however, two significant differences. The rent economy is not over-consumption and deficit oriented because the capital inflows are not simple transfers but they have counterparts in strong exports of commodities. This shows the weakness of the income-driven economy which is threatened by the so-called monetary Dutch disease but without having oil or gas for balancing current accounts. On the other side, the revenues from the commodities in the rent economy are highly concentrated and difficult to recycle within the economy whereas the revenues from income economies are mostly channelling through households. They are easy to recycle in the economy and to generate growth when the rent economy is infected by the real Dutch disease which causes a dualisation of the economy and which may finally stop growth. The growth generated by external revenues, however, bears special features that may become a concern in the medium- or long-range.

#### ***What are the main features of income-driven economies?***

An analysis of the overall features of income-driven economies will help to better understand the Georgian economy.

- *Over-consumption*: It means that the consumption is partly disconnected from production, according to quantities and according to dynamics. It can be measured by the fact that private and public consumption have an important share in the GDP which was over 90 percent in 2006 [7]. From the dynamic point of view, it is the fact that the evolution of consumption is not in relation with that of production. The same share was 82.1 percent in 2003. In other words, the economy is increasingly guided by consumption instead of production and the share of consumption is too high as compared to production potential. Moreover, this expansion of consumption is accelerated by the dynamic banking sector wherein the banks are in the best position for recycling external financial means and Georgia is living a boom of retail and housing credits. One may argue that the final aim of economic activity is consumption and this is absolutely true. The point, however, is that there are laws of good economic governance and this over-consumption, as we shall see below, is associated with some problems and prospects;

- *Foreign trade deficit*: This is the other side of over-consumption, like a shadow. If the country is consuming over its production capacities, a share of the consumed goods should be imported. As seen above, the trade deficit has been regularly growing since 2003 up to a peak of 25 percent of the GDP in 2007. Even if we correct this figure from conjuncture difficulties (the Russian embargo on some goods), the trend of the deficit is moving upwards since 2003. This means that the income-driven economy is generating more imports than exports wherein the winners are the traders, importers of consumer goods, second-hand cars and food as well as activities connected with real estate and construction for higher and middle classes. The losers are in the tradable sector hit by the nominal appreciation of the lari as well as in the poverty niches wherein remittances are not coming;
- *Under-employment*: As the production dynamics lags behind consumption, one can say that the productive basis in the country is too narrow. This is the employment side of over-consumption. Of course, one should take into account the differentiated labour intensity of selected production branches and the fact that some in the non-tradable sector, like construction, create a lot of jobs but this is not the case, however, for other booming sectors like finance or communication. This structural under-employment is only partly reflected in unemployment rates and one should take into account the non-reported under-employment in the countryside as well as in the larger cities and the numbers of working age population who have emigrated;
- *Emigration*: Emigration is a complex phenomenon which is explained both by economic (the *push* movement of poverty and the *pull* forces of wealth and high living standards of other countries), sociological (the networks of already emigrated diasporas) and cultural (the symbolic attractive power of some countries) factors. It appears that for small countries like Georgia, high emigration is a traditional response to under-employment. It is reported that Georgia has a net migration loss of more than one million persons (20 percent of the population), two-thirds of whom are in Russia (other countries are the USA, Greece, Turkey, Spain and Ukraine). These Georgian living and working abroad officially sent USD 546 million as remittances (4 percent of GDP) in 2006 with the actual amount close to USD 800 million [8]. Official figures estimate that remittances represented 15 percent of the monetary incomes of the population in 2006. Emigration is the first factor fueling the over-consumption with other factors including foreign grants to public bodies and private capital (FDI and privatisation). The circle of emigration and over-consumption makes the income-driven economy typically self-enforcing. Of course, there also exists the opposite trend of productive investment but it is currently still weak. This shows that an income-driven economy is stable and sustainable even with strong risks of lock-in.

The official figures confirm that *Georgia is an income-driven economy*. These incomes are 2006: remittances (USD 800 million) [8], FDI (USD 1100 million), international grants (USD 187 million), capital revenues from privatisation (USD 312 million) and approximately USD 100 million from pipelines royalties. The total of incomes from outside in 2006 represents approximately USD 2.5 billion; that is, almost 32.5 percent of the GDP and 114 percent of total budget revenues (163 percent of the tax revenues). This total amount of external resources increased sharply in 2006 as compared to 2005 with an addition of about USD 500 million for FDI, USD 100 million for capital revenues, USD 150 million for remittances (official), USD 70 million for grants and an estimated USD 50 million from the opening of pipelines. These external incomes, therefore, represent a total increase of USD 870 million by themselves or 13.5 percent of the 2005 GDP which is more than official reported growth for 2006 (9.4 percent). In other words, the 2006 growth was, in fact, totally caused by that of external revenues.

This income-driven situation of Georgia is itself driven by three engines:

- the self-enforcing mechanism of reduced economic basis, emigration and over-consumption;
- the external support of Western donors having long-term strategic interests in the country;
- FDI flows if conditions are met.

#### ***What are the medium-term consequences for Georgia?***

- *Macroeconomic medium-term risks*: Herein, we have a paradox with a current balanced situation that bears medium-term risks. In fact, it is reasonable to consider that the severe trade deficit is not a problem by itself because there are incoming means to simultaneously finance it and soften the imbalance it causes. Reversely, the negative potential impacts of almost USD 3 billion of capital inflows upon the real exchange rate is neutralised by the foreign deficit. Like a bicycle, the Georgian economy is rolling ahead between these two imbalances. The problem is that this equilibrium is not stable and that either the reduction of the external incomes (one may expect the comeback of a part

of the emigration in the medium-term) or the reduction of the trade deficit (which is expected thanks to an increase of exports) will open up a period of macroeconomic turbulences. In addition, in a context of a quasi fixed exchange rate, the high capital inflows cause the corresponding emission of the lari and, therefore, expanding money aggregates: M2 increased by 26 percent in 2005 and by 30 percent in 2006 whereas the demand for money did not increase equally. This inflationary pressure has already appeared and the average prices index for 2006 was 8.7 percent against 6.2 percent in 2005. It is already a sensitive problem for the population because the price increase is almost totally concentrated upon final consumer goods. The high share of imports controlled by a small number of traders may decrease the competition level in those markets and add non-monetary inflation. A rebound of inflation would decrease the export potential and strengthen the over-consumption.

- *Reduced standard comparative advantages and competitiveness:* Another phenomenon is currently taking place that brings heavy medium-term consequences. If we consider the increasing trade deficit, standard textbook economics would immediately show the diagnosis: the exchange rate level of the domestic currency is not optimal and is far from equilibrium. The receipt would be a devaluation of the lari which is, therefore, considered over-valued. This policy, however, is not recommended and is not suggested by monetary institutions like the IMF or the World Bank for several reasons: the structure of exports, the doubtful ability of domestic agriculture and business to benefit from an exchange rate adjustment and the asset structure of banks as well as social issues. These reasons, however, make Georgia condemned to live with a strong lari. This is a serious challenge in the medium term; that is, to adjust the economy instead of adjusting the lari exchange rate. So far, the increasing FDI inflows will not change the situation because they are not really oriented towards productivity increases and will not ease the external constraint.
- *Sustainable growth of the country cannot rely upon cheap labour and price competitiveness.* Basic tourism supply, for example, is not competitive with Turkey. Even some Georgian agricultural products, given the very low tariffs, can hardly compete on the domestic market with goods from Turkey and other countries. Small light industry goods face the same problem with Chinese imports. To meet this challenge, Georgia must build new comparative advantages based upon quality and high added-value products. Georgia should build its competitiveness upon its specific origin for agri-food production and its specific resources for tourism. As for transport, transit and logistic services, Georgia already benefits from its specific location and has to reach the already high international standards with the use of FDI.
- *External vulnerability:* The current account deficit and the situation of an income-driven economy creates a situation of high financial dependence from abroad. The incomes coming from donors are more or less long-term ensured because of the strategic investments in transport routes across Georgia. This situation close to huge western interests bears the risks of instrumentalisation of the country by the USA or the EU. Moreover, the incomes coming from remittances are subject to political risks that are not negligible as in the case of Russia [8].
- *The narrow economic basis:* The major constraint upon the economic development of the country is its narrow economic basis. This is connected with long lasting diasporas abroad and is a standard feature of income-driven economies. This situation is worsened by the huge under-employment in the country, especially in rural areas. The point, therefore, is to manage the development of a formal market economy in the countryside and to manage the new potential rural exodus generated by expected productivity increases in the rural economy. If a narrow economic basis is compatible with medium-term sustainable development, then, there is both a need to eliminate the under-employment and to expand production by improving the export potential thanks to FDI and the introduction of European norms and standards.

### **The Ways for Good Prospects for the Georgian Economy**

The above analysis enables the drafting of guidelines for a successful medium- and long-term scenario. The long-term development strategy is the precondition for a sound medium-term policy. There are political and social conditions for starting this development path which have not been discussed herein. Political stability and, even more, the consistency of the economic policy, as has been the case for Ireland in the 1980s, is the precondition for the taking-off of the economy. It is also possible to draft scenarios of failure with increasing inflation, social disorders and the exodus of foreign investors.

Given its location between two huge neighbours – Turkey, with a GDP 50 times larger, and Russia, with a GDP a hundred times bigger, and integrating the EU single market which is 2000 times bigger – it is quite possible for a small country like Georgia to anchor its growth on these markets. If sound poli-

cies are conducted, Georgia is able to become amongst the richest economies of the region. It is quite possible for Georgia to become richer than Russia and Turkey in terms of GDP per capita and to emerge as a country like Switzerland in the Caucasus.

### ***The right inventory of the resources***

By destination, it is possible to identify three traditional resources of the country:

- the main resource, as developed above, is the location of the country on West-East routes and, later on, on South-North axes;
- the second resource is agriculture and food industries with the unusual combination of good soils, water and sun;
- the country's third resource is its broad tourist potential from sea-side to alpine tourism and also using green, trekking and cultural tourisms. Tourism is based upon people-to-people relations and hospitality which are two skills belonging to the ancient culture of Georgia.

Identifying these resources means taking care of them. The location of the resource is optimised with a good political climate with neighbours and strong investment policies. Agriculture needs a structural reform and foreign investments together with a regional policy. Tourism requires huge vocational education, infrastructure investments and a living SME population.

A fourth resource is provided by the emigration and the diasporas. They bring remittances that provide incomes, reduce poverty, increase consumption, provide some investment in the education of children and some productive investment. Experience shows that when overall conditions for business are better, the productive use of remittances increases. The biggest resource connected to emigration, however, is that it is a strong tool for integrating the global economy and bringing modernity and new behaviours coming from more developed countries. Adapted policies should focus upon the best use of this resource and include visa policies, for example.

### ***Georgia has to build its comparative advantages***

As explained before, Georgia has to live with the strong domestic currency. No competitive advantage is given by itself and no competitiveness could be gained in the standard production of goods or services.

The first competitive advantages have already been built by the authorities which is the installation of energy routes on the territory which correspond to the strategic interests. The next and urgent steps are the building of the motorway between Poti and Turkey and that with Baku whilst also including efficient railways.

The second competitive advantage has to be created in agriculture and tourism upon the basis of the theory of specific resources developed by G. Colletis and B. Pecqueur [9]. In two words, it is the building of high-added value production upon the basis of unique and high-quality goods and services.

The third competitive advantage to build is increased human capital as a result of strong vocational and general education policies. The current levels are very low and the changes within are much too slow. Like in Ireland as well, education should become the first priority of the current authorities.

### ***Georgia has to learn from transit economies***

The impact of transport infrastructures and the use of transport for economic development depend upon the side-policies that are developed. Singapore, Dubai, Estonia and others have success stories in what is called "smart development." These experiences should be investigated for getting the lessons for Georgia.

### ***Georgia needs to broaden its economic basis***

A too narrow economic basis is typical for income-driven economies and this trend should be contradicted by efforts to reach higher competitiveness. In addition, Georgia has another source of a narrow economic basis which is the rural under-employment.

Agricultural reform and policies should be implemented in rural areas, combining the restructuring of the property, the access to markets and the access to credit. The migratory potential produced by this reform should be anticipated and managed.

Strong policies in favour of SMEs will help reduce the informal sector and regain the domestic market by better ability to respond to demand. The abovementioned obstacles to a healthy business climate should be eliminated as quickly as possible.

In addition, transport infrastructure policies and education policies will contribute to the broadening of the economic basis and to the modernisation of the agriculture and tourism sectors.

A question to be further investigated is to know to what extent the new programme of the Government of Georgia for 2008-2012, “United Georgia without Poverty,” bears the right answers to these requirements.

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