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Georgia

A Brief Survey of Macroeconomic Problems and Policies

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1. Introduction

During the first three years of independence (1991-1994) Georgia suffered serious economic decline. The difficulties associated with the transition from soviet-type planning to free enterprise and with the collapse of the CMEA trade system were aggravated by civil strife and especially by the 1992-1993 war in Abkhazia which obstructed one of Georgia's main transport links to the outside world, and caused an influx of 270,000 refugees into Tbilisi and other cities[1]. Banditism rose throughout the country, disrupting normal economic relations. Government policies lacked consistency: sporadic attempts at liberalization alternated with measures of direct control. Price controlled goods disappeared from the legitimate market; the economy went underground[2]. Unable to collect taxes, the government resorted to widespread foreign borrowing, which saddled the country with a heavy debt, and to the printing of “empty” money. Accelerating inflation led to a flight from currency and an increased reliance on the U.S. dollar as a store of value and to the ruble as a means of payment.

With the end of hostilities, the restoration of law and order in most of the country, and with the emergence of a government strongly committed to liberalization and to stabilization the situation turned sharply for the better. A series of energetic steps taken in the last quarter of 1994 stabilized the economy. The adaptation on December 1, 1994, of a comprehensive liberalization-stabilization program designed in consultation with the International Monetary Fund solidified the gains. Virtually all price controls were removed[3]. The Ministry of Finance came to exercise effective control over government spending (the system is soon to be further strengthened by the creation of an Office of the Treasury). The National Bank of Georgia (NBG), the country's central bank, obtained a high degree of autonomy. It exercises judiciously its right and duty to impose sound standards on the commercial banking sector. Currency stability was restored, and the new national currency, the lari, won general acceptance as a means of payments. Private domestic and foreign investment receives favorable treatment. Taxes are moderate by international standards; the current account convertibility of the lari facilitates trade, and profits may readily be repatriated.

Despite the remarkable progress Georgia continues to face serious economic difficulties. As part of the Soviet Union the country benefited from artificially low fuel import prices and from artificially high prices of many of the products exported to the other Republics. The withdrawal of these benefits rendered useless much of the Georgia's industrial capacity[4]. New investment is needed to recover the lost ground

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[1] Republic of Georgia, Ministry of Economy (1995).

[2] Papava (1995). It should be noted, however, that under Soviet rule desirable items (priced at less than market level) were sold from “under the counter”. The breakdown of law merely aggravated the situation.

[3] Direct price control is now limited to community services and municipal transport. The State also exercises influence over the price of petroleum, imported by a joint-stock company with a monopoly position, and over wheat, most of which is imported by a state monopoly.

[4] Most of Georgia's heavy industry is now at a standstill; there is urgent need of a study to determine conversion possibilities.

and to grow. But the favorable institutional setting notwithstanding, there are severe barriers to private economic activity. The country's infrastructure was heavily damaged by war and by the civil disorders. Further deterioration was brought about by the deep cuts in public expenditure made in 1994-1995 to stem the hyperinflation. There is now clear need to increase spending on infrastructure, on health, on education, on the social safety net and on other public services. To maintain the fiscal balance it will be necessary to increase the government revenues. But, recent progress notwithstanding, the Government's tax and customs duty capability remains very limited, and the low tax yield creates a barrier to public investment. The banking system is another problem area. Georgian banks are small and weak. Their activities are largely limited to the provision of short-term commercial capital. They play a minor role as financial intermediators, and they are incapable of mobilizing household savings. Under NBG prodding the banks have taken steps to better serve the community, but there is still much room for improvement. A third macroeconomic problem area is the foreign debt. The burden of debt service payments has been lightened through restructuring, but even so the Government meets its obligations by drawing on IMF-provided funds. In the future it will have to be self-reliant. This calls for a radical improvement in the current account balance — to be accomplished in large part by export growth — and/or for a major increase in private capital inflows. Whether, and how fast this can be accomplished depends, largely, on external factors, e.g. on the unblocking of the railway link through Abkhazia and the normalization of the economic situation in Russia — Georgia's traditional major trade partner.

2. Economic collapse

Prior to independence, the economy of Georgia was closely integrated with that of the Soviet Union. Trade accounted for 43 per cent of the estimated GDP, with 96 per cent of the exports directed to, and 72 per cent of the imports originating from the Soviet republics. But planning, as much as comparative advantage, determined the structure of production and of trade. Agriculture which, traditionally, has been an important activity; accounted in 1989-1991 for 33 per cent of the Net Material Product (NMP)[5] Georgia, with its favorable climate and soil, exported to the other republics fruits, wine, tea, and vegetables. But the horticulture and the viticulture were extended to areas more suited to growing wheat, making the country excessively dependent on wheat and flour imports.[6] The disregard of comparative advantage was even more glaringly obvious in industry which, in total, accounted for 37 per cent of the NMP. Though Georgia lacks cheap sources of energy, it produced for export steel pipes, locomotives, and other energy-intensive products. The financial profitability of the heavy industry was critically dependent on the supply of natural gas from

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[5] Source: Ministry of the Economy (1995). Sectoral GDP breakdown figures are not available for the pre-independence period.

[6] Thus, according to World Bank experts, "Many vineyards are sited in eastern and central Georgia in areas with flat, arable land, and fertile soils best suited for field crop production. Many tea plantations are located clearly beyond the ecological limits of quality tea production." World Bank (1996), p. 4.

Turkmenistan at artificially low prices, and on the artificially high prices of the products.

The dissolution of the CMEA and the consequent "dollarization" of trade dealt a serious blow to the Georgian economy. The price of gas and oil rose among 1990 and 1993 by 500 per cent making Georgia's heavy industry non-competitive, and bringing to a stop production in Rustavi and in other centers of heavy industry. Russia's economic difficulties led to a collapse of demand for agricultural goods in which Georgia has a comparative advantage. Tourism, once an important income source disappeared[7]. The difficulties were compounded by the 1992-1993 conflict in Abkhazia which cut of the only rail link between Georgia and Russia. 270,000 Georgians (some 5 per cent of Georgia's total population) fled Abkhazia, crowding Georgian cities. Civil strife and Banditism completed the process of disruption.

The decline in Georgia's real GDP in the 1990-1994 period is officially estimated at close to 80 per cent. These figures are, of necessity, only approximate. The decline of some sectors, such as organized industry and construction was even more drastic (Table 1). But some sectors, including small private plot agricultural production for household use, and the small-scale legal or "gray zone" businesses have suffered less. Such activities do not seem to be adequately taken into account by the official sources. The IMF estimates that the GDP, inclusive of the value added by the informal sector, decline by 50 per cent[8]. But even by this reckoning the economic situation verged on disaster (Table 1).

During the period of decline the budget fell into disarray. In 1994 the revenues of the general government (net of foreign grants), amounted to only 3 to 4 per cent of GDP, and covered only 17 per cent of the fiscal expenditures. Efforts to keep down the price of "essential" products and services contributed to the inflation: in 1993-1994 bread, household gas, electricity and transport subsidies accounted for more than half of the total fiscal expenditure. The government borrowed from the National Bank of Georgia and from the State Commercial Banks, and it accumulated vast payment arrears. Foreign debt mounted, surpassing US$ 1 billion by 1994. Local governments and extra budgetary funds also borrowed from banks and ran up payment arrears. The national currency, the coupon, quickly lost the credibility it gained at the time of its introduction in 1993[9]. By September, 1994 most of the transactions were carried out in rubles or in U.S. dollars, the latter also serving as a store of value. By September, 1994 foreign currency deposits amounted to 70 per cent of broad money, while foreign currency loans extended by Georgian banks amounted to 75 per cent of all credit to the economy[10]. The flight of currency aggravated the inflation (Table 2) and caused the coupon depreciation to outpace the loss of its domestic purchasing power. The free

[7] Prior to independence more than 3 million tourists per year visited Georgia, of whom about 80 per cent from the Soviet block. Source: Ministry of the Economy (1995).

[8] See IMF (1995).

[9] For the first two to three weeks following introduction the coupon was favored by the private sector over the ruble. The coupon bought at the black market 2 to 3 rubles (the par value was set at 1:1). Confidence in the coupon was soon undermined, however, by government and National Bank of Georgia officials' statement about the impossibility of maintaining the par value and by the subsequent growth in the supply of coupons.

[10] IMF estimates as given in IMF (1994).

market price of the coupon declined from about 700/USD in mid-March, 1993 to close to 5 million coupons/US in mid-1994[11].

3. The recovery program

March 1994 saw the formation of a stable government with the will and authority to restore law and order and to reform the economy. The reform strategy, developed in cooperation with the IMF, was to qualify Georgia for its and the World Bank's support. On April 1 energy prices were raised in an effort to cut the fiscal subsidies. To eliminate Government payment arrears and to convert bank overdrafts into long term debt, Parliament authorized in June a 10 trillion NBG loan to the Government, the amount of loan being three times higher than the total amount of reserve money. The government's inability to meet its current expenditures, and the consequent inflation largely wiped out the salutary effects of such moves. Government arrears continued to accumulate, surpassing, by September 18 trillion coupons — equivalent to the entire coupon broad money stock[12].

The Fall of 1994 witnessed a series of effective moves to tighten the money supply. All bank borrowing by local governments was prohibited effective August 1. Between July and October the commercial banks' overdrafts were transformed into NBG claim on the government. Effective October 1, 1994, the commercial banks' automatic access to NBG overdrafts was terminated, and the correspondent accounts of banks with overdrawn positions were blocked. The NBG also began seriously to exercise its bank control prerogatives, insisting that banks exercise prudential norms and, in some cases, withdrawing licenses (see section 7). The budget was “hardened”: on September 1 all subsidies and transfers to enterprises, including interest subsidies on directed credit, were eliminated. To improve monitoring and control all budget accounts of the Republican government were centralized as of August 31 at the NBG. Effective November 10, the Cabinet of Ministers authorized the Minister of Finance to limit, monitor, and control all expenditure commitments at the level of the Republican government.[13]

To reduce the budgetary drain caused by subsidies the Government ordered drastic increases in administrative prices. Counting the April 1 and September 7 raises, the price of household electricity was increased in 1994 from 100 coupons/kWh to 60,000, and that of natural gas for households from 200 coupons /cubic meter to 200,000 coupons/cubic meter. The latter date witnessed the adoption of a full-cost recovery pricing policy. Bread prices were raised in September 17 from 700 to

[11] *Ibid.*

[12] IMF staff estimates are twice as high. See IMF (1994).

[13] Republic of Georgia (n.d.).

200,000 coupons/kg.[14] The local transportation subsidy was cut drastically. The administered price increases and the cuts in subsidies, combined with a tighter monetary policy had immediate positive effects. Money demand rose sharply, and the free market value of coupons rose to 2.1 million per US by mid-November 1994 and to 1.8 million per US by year end[15]

On December 1, 1994, the Government of Georgia, in cooperation with the IMF, launched a 12-month comprehensive liberalization and stabilization program calling for the continuation and extension of the measures adopted since August. The scheme gave Georgia access to the IMF System Transformation Facility (STF) and opened the door to greater World Bank support[16]. The program's proximate goals were:

– to reduce the monthly inflation to 1 per cent by the end of the period,

– to strengthen the reserve position of the NBG,

– to arrest the decline in output,

– to normalize Georgia's relations with its creditors and trade partners, and

– to put in place a modest social safety net compatible with the government financial possibilities[17].

A key role was assigned to the reduction of fiscal deficit. Calculated on an accrual basis the deficit was to decline from 18 per cent of the GDP in 1994 (as then estimated)[18] to 6 per cent in 1995[19]. On a cash basis the deficit amounted to almost 26 per cent of the GDP in 1993 and to 9 per cent of the GDP in 1994 and it was targeted to decline to 7 per cent in 1995[20].

The improvement in the fiscal balance called for a decrease of the total expenditure/GDP ratio from 24.5 per cent in 1994 to 14.9 per cent in 1995. The remaining bread, gas and electricity subsidies were to be eliminated by April 1, at which time the price of bread was to be freed. Transport subsidies were to be phased out by mid-1995. But given the extreme erosion of public sector wages and social payments, modest in-

[14] The coupon prices of a kg. of bread and the dollar equivalents at the free exchange rate were adjusted as follows:

Prices /kg	Coupons	US dollars
Prior to September 1994	200	0.0003
September 94	280,000	0.22
July 95	300,000	0.23

The State monopolist, the Bread Corporation was broken up; privatization was 2/3 complete by end of 1995. In June 1996 price controls on bread were abolished, with virtually no effect on the market price.

[15] *Ibid.*

[16] The negotiations between the Government of Georgia and the International Monetary Fund were finalized in early November. The World Bank approved an Institution Building Credit to Georgia in July 1994. The granting of a Rehabilitation Credit to support structural reform was approved by the Bank's Executive Board in February, 1995. The granting of the latter credit was closely coordinated with the Fund's extension of the STF.

[17] Republic of Georgia, *op. cit. supra.*

[18] IMF (1994). More recent estimates show the 1994 deficit to have equaled 16.5 per cent of the GDP. See *Georgian Economic Trends*, Quarterly Review, First Quarter 1996.

[19] The above figures include foreign grants as part of the government's revenue. Excluding grants, the deficit was to decline from 22 per cent to 8 per cent of the GDP as estimated on the basis of Table 2, IMF (1994)

[20] *Ibid.*

creases were to be granted in partial compensation for the cost of living increases resulting from price decontrol[21].

The revenue (inclusive of grants)/GDP ratio was to rise from 6.5 per cent to 8.5 per cent of the GDP. To compensate for an expected decline in grants the ratio of the government's other revenues was to increase from 3.7 per cent to 6.1 per cent of the GDP. For this purpose, the Value Added Tax was raised on December 1, 1994, from 14 to 20 per cent. Numerous tax exemptions were eliminated, and a 10 per cent VAT was imposed on bread which till then was tax exempt. The customs duty went up from 2 to 12 per cent, and the excise tax on gasoline from 10 to 15 per cent. Steps were to be taken to improve the tax execution by providing training to tax officers and through the imposition of stiff penalties for non-compliance.

Among other measures to restore sound fiscal management the government undertook not to accumulate any new expenditure arrears during the STF-supported program period. The outstanding tax arrears were to be monetized, in accordance with a schedule designed in cooperation with the IMF, at a rate compatible with the maintenance of price stability.

The NBG was called upon to stringently control the expansion of money supply. It was recognized, however, that the NBG would have to accommodate the growing real demand for coupons resulting from the price adjustment moves and from currency substitution expected to occur as a consequence of the increasing confidence in the coupon.

4. The fiscal budget

The greatest accomplishment of the 1994-1995 fiscal reform lies in the reduction of deficit from 16.5 per cent of the estimated GDP in 1994 to 4.7 per cent in 1995 (Table 3). The target set by the stabilization program launched in December 1994 was met or possibly even bettered[22]. This achievement was primarily due to a 50 per cent cut in expenditure relative to the GDP. The expenditure reduction, in turn, reflects the cuts of subsidies and transfers from 39 per cent of GDP during the first half of 1994[23] to 11.8 per cent for 1994 as a whole, and to 1.1 per cent of GDP in 1995. Wage and salary payments remained unchanged at a modest 0.8 per cent of the GDP; the number of employees was reduced by 33 per cent but their salaries were raised, though they remain at an extremely low level[24].

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[21] Computed at the prevailing exchange rate, the minimum and the average monthly civil services wages equaled, respectively, $0.50 and $1.80. Though the purchasing power was, perhaps, ten times greater, the wages were not sufficient to pay for a minimum survival diet.

[22] As indicated in footnote 11 above, the 6 per cent 1995 deficit target was set prior to the downward revision of the 1994 fiscal deficit/GDP ratio.

[23] The half-yearly estimates are given by IMF (1995); they may not be comparable with the annual figures based on Ministry of Finance data.

[24] According to IMF (1995) the number of government employees was cut by one third. The same source gives the following minimum and average monthly wages following the September 1994 and the July, 1995 raises (in parentheses: U.S. dollar equivalents at the current rate):

– September 1994: minimum 1 million coupons ($0.43), average 3.6 million coupons ($1.55);

– July 1995: minimum 3.5 million coupons (2.70), average 9.7 million coupons ($7.50).

Total revenues and grants remained unchanged at 7.7 per cent of the GDP. Fiscal revenues increased from 5.0 per cent of the GDP to 8.9 per cent of the GDP — just enough to offset the decline in grants. Tax revenues amounted to a bare 3.8 per cent of the GDP, the low tax yield reflecting the government's limited ability to collect taxes.

The 1996 budget calls for a further narrowing of the fiscal gap, and sets the deficit target at 4 per cent of the GDP. This target is to be reached through a sharp increase in revenues (from 7.7 per cent to 9.8 per cent of the GDP) The budget allows for a modest growth in government expenditures (from 12.4 to 13.8 per cent of the GDP). The 1994-1995 expenditure cuts, dictated by the need to stop the hyperinflation, reduced the government expenditures below the minimum requirements of organized society. Unless maintenance is improved, Georgian highways will soon be unusable. Education, health, and social services are in a dire state. To improve the efficiency public services it is also essential to raise public salaries. Regrettably, there is still a shortage of means for public investment. In 1996 as in 1995 capital expenditure is to amount to just 0.8 per cent of the GDP.

To meet the revenue target will require a serious tax collection effort. Foreign grants, which, in previous years played a major role in helping the government meet its expenses, are scheduled to decline from 2.0 per cent of the GDP in 1995 to 0.9 per cent in 1996. The net-of grants government revenue should, therefore rise from 5.8 per cent to 8.9 per cent of the GDP. In 1995 such revenues covered 46 per cent of fiscal expenditures; in 1996 they are to cover 64.5 per cent. Can this target be reached? During the first quarter of 1996 expenditures amounted to 22.5 of the total budgeted for the year, and revenues, including grants, to 24.3 per cent. Though tax revenues rose markedly, they lag behind the budgeted amount (table 3).

5. Taxation

In 1995 taxes and other domestic income sources accounted for 97 per cent and customs duties for 3 per cent of the total 1995 net of grants fiscal revenues. Taxes are the most important source of domestic fiscal revenue. In 1995 the Value Added Tax (VAT) accounted for 46 per cent of domestic tax yield, the Profit Tax for 23 per cent, the Personal Income Tax for 17 per cent, excise taxes for 2 per cent, while all other taxes (including a 1 per cent tax on the estimated value of enterprise property, a 0.1 per cent tax on buildings and structures owned by physical persons, a motor vehicle tax and various other) brought the remaining 13 per cent of tax revenue[25].

A 20 per cent Value Added Tax is payable by all producers of goods and services whose value added exceeds 500 times the minimum annual wage rate. Bread and flour

In September, 1994, the social security benefits were brought in line with the increase in wage; but a review of the beneficiaries reduced their number from 1.4 million in mid-95 to 1 million m mid 95. Spending on social security rose from 0.2% of GDP in the first half of 1994 to 1.3% of the GDP in the first half of 1995.

[25] Calculated on the basis of data given by the *Georgian Economic Trends*, Quarterly Review, First Quarter 1996.

are subject to a 10 per cent VAT. A number of goods and services are VAT-exempt. Of these the most important are[26]:

– wheat,
– infant foods,
– educational products,
– medicines,
– goods manufactured for export[27].

The profit tax is differentiated according to the type of activity:

– industrial enterprise profits are subject to a 10 per cent tax,
– banks and other financial institutions are subject to a 35 per cent profit tax,
– all other enterprises are to pay a 20 per cent profit tax.

Personal incomes are subject to a flat 20 per cent tax[28]. The rate is reduced by 50 per cent for invalids of the first and second disability categories.

The most important excise tax is that level on gasoline. Effective December 1, 1994, the gasoline tax was raised from 10 to 15 per cent[29]. Other excise taxes currently in force include[30]:

– 15 per cent: on wine,

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[26] The information presented in this and the following paragraphs is drawn from Techniformi, *Legal Acts of Georgia* Vol. 5.

[27] Techniformi (*loc. cit. supra)* lists the following VAT exempt goods and services:

– products exported by the enterprises that manufacture them,
– goods and services for official use of foreign diplomats,
– housing rents,
– payments of lease of former State-owned enterprises,
– sums realized from the sale of property inherited or confiscated by the State,
– urban and state interregional state-regulated passenger service,
– manufacture, import and sale of agricultural raw materials, sugar beets, oil, milk, powdered milk for feeding children, school textbooks and literature for children under school age,
– insurance and reinsurance,
– financial services,
– postage stamps (other than stamps for collectors),
– state-tax supported services,
– hospital services, care for old and for disabled persons, construction of sports facilities, payment for the participation in study or hobby groups, expenses for care of under-school-age children, incl. the purchase of baby carriages,
– transfer of patents and of copyrights,
– burial expenses,
– medicines,
– medical equipment,
– re-exports,
– goods in transit,
– re-imports,
– goods in bonded storage
– imports of foreign currency and of foreign securities,
– goods in temporary storage on the Republic's territory,
– goods given to the Government in humanitarian aid,
– educational products and materials,
– import of non-material assets,
– TV, radio and press services.

[28] Lower rates apply to the first 30 lari.

[29] IMF (1994).

[30] *Georgian Business News*, no 142, June 29-July 5, 1996

– 30 per cent: on machine made carpets,
– 50 per cent: on car tires and jewelry,
– 100 per cent: on beer, tobacco products, liquors, and vodka.

In addition to the taxes levied to provide fiscal revenue, there is a 35 per cent social security payroll tax the proceeds of which are paid into a fund to finance retirement and disability benefits.

Import goods are subject to the payment of the VAT and of excises and to the following border charges:

– all imports are subject to a 0.3 per cent customs charge,
– imports from outside the CIS are subject to a 12 per cent uniform customs duty.

In analyzing Georgia's tax system, exception may be taken to the differentiation of the profit tax by type of economic activity: there is no a priory reason to discriminate against banking and commerce. The wisdom of an employment tax may also be questioned. On the whole, however, Georgia's tax system is simpler than that of most of the developing countries' and the tax rates are relatively moderate. Tax avoidance is, however, extremely widespread (see section 4). The inadequate pay of tax and customs officers are part of the problem. But even an incorruptible officer finds it hard to carry out his duties. Georgia is a cash economy where payment by check is unknown. Transactions are therefore easy to hide or to misrepresent, especially in view of the lax accounting standards and the absence of public audits. The borders are very porous and smuggling is hard to detect. Perhaps most important of all, there is a strongly negative perception of the government as a parasite, and not as a purveyor of important goods and services. At the same time there is a sentiment that the government should continue to provide goods, such as electricity, for which under the Soviet regime there were no user charges. Such charges are often regarded as yet another tax to be avoided.

The past two years showed marked increase in tax compliance. Some further steps, such as the introduction of compulsory cigarette banding could be taken to reduce customs and excise duty payment avoidance. As the economy develops — and as the borders become more secure — the tax collection problem is bound to ease. Objective determination of tax liabilities will become easier with the general adoption of Western accounting and auditing standards. Better-paid tax officials are bound to be less venal, while the citizens' tax resistance will lessen once it becomes clear that the government puts their money to good use. Yet the message of tax resistance should not be ignored: it is possible that the minimalist government of Hong Kong rather than the all-embracing high-tax Welfare State is the right “model” for Georgia.

6. Money and foreign exchange management

The National Bank of Georgia (NBG) was established in 1991 as a successor of the regional branch of the Soviet monobank. For the next two years Georgia remained in the ruble zone, but with the progressive disruption of trade and of financial settlements within the former Soviet Union, the supply of rubles became increasingly erratic. On April 5, 1993, to remedy the growing currency shortage, the NBG issued coupons, at par with the ruble, to serve as a supplementary currency. On August 3, 1993, the coupon was declared the only legal tender.

Under the 1991 law the NBG was independent *de jure*, but *de facto* it was subordinate to the Executive and to Parliament. The Bank President and the members of the Board of Directors were appointed by the President of the Republic and could be removed at will. The NBG yielded readily to political pressure. It lent, without limit, to the government and it gave unlimited overdraft facilities to the State Commercial Banks, thus failing to exercise control over the currency.

In mid-1994 the Government and the NBG joined forces to re-establish, with IMF backing, the country's monetary stability. The June 1995 Law of the National Bank of the Republic of Georgia gave the NBG full authority over monetary management. Henceforth the NBG to have the sole right and duty to "work out, approve and pursue" the monetary and the foreign exchange policy of the Republic of Georgia so as to "achieve and maintain the purchasing power of the national currency ... and the stability of prices"[31]. The law explicitly bars parliamentary or executive interference with NBG policies[32], while the long (7 year) terms of office of the Bank President and of the members of the Governing Board fosters the independence and personal integrity of the members of the governing body[33].

To establish confidence in the coupon, the NBG maintained a fixed coupon/dollar exchange rate from February till September 1995. The policy was crowned with success. The ratio of domestic-denominated to foreign currency-denominated deposits in commercial banks rose from 0.8 in February, 1995 and to 1.5 in September. Inflation subsided (Table 1). The coupon rapidly appreciated against the dollar in real as well as in nominal terms. The gap between the price at which the dollar was made available for commercial purposes and the curb price narrowed, and, in some months, the latter was even the lower.

In accordance with the 1994 IMF agreement, the NBG introduced in September 1995 Georgia's permanent currency, the lari (abbreviated as GEL). Conversion, at 1 million coupons per lari, was carried out without difficulty, and the new currency gained immediate acceptance as a means o payment. During the first week of the introduction of the new currency the population converted 37.9 million U.S. dollars and 70.6 billion rubles into laris[34]. This figure is arrived at by converting dollars and rubles into laris at the average September FXG rates of 1.2750 lari/$ and 5000 lari/ruble as given by *Georgian Economic Trends* Quarterly Review, First Quarter 1996. NBG's net

[31] Law of the National Bank of the Republic of Georgia No. 764-IIs of June 23,1955, Article 2.

[32] Under Article 3, "The NBG shall be independent in its activity in the framework of rights granted to it by the law" and "The legislative and executive bodies shall have no right to interfere in the activity of the NBG, except in cases provided by this Law". The law is quite specific on the scope of parliamentary control. Under Article 69 NBG is to present for Parliamentary approval a report on monetary policy. Under Article 11 Parliament is empowered to remove a Board member if he assumes a governmental post which bars him (under Art. 10) from serving as a Board member, for criminal behavior or for dereliction of duties.

[33] The President of the Republic nominates the President of the Bank who also serves as Chairman of the Board of Governors, which exercises overall management and supervises the Bank's activities. The Board's three vice-presidents are nominated by the Parliamentary fiscal commission, and the other 5 members are elected by Parliament *Ibid.*, Articles 6 and 7.

[34] Papava (1996). These sums, converted at the September free market rates amount to some 62.4 million laris, i.e. to two-thirds of NBG net foreign asset increase.

foreign assets rose from –26.8 million lari in September to +58.6 million lari. The NBG allowed the lari to float. In October, 1995, the commercial rate of the lari declined from 1.3000 lari/$ to 1.2500 lari/$ (on the Tbilisi Interbank Foreign Exchange Market, abbreviated as TICEX) and the curb price from 1.2750 lari/$ to 1.2500 lari/$. Since then the lari has fluctuated within a narrow range, with a slight tendency toward appreciation against the dollar.

During the month that followed currency conversion the consumer price index rose by 23 per cent. A seasonal rise in agricultural products (which have a weight of over 70 per cent in the CPI) provides the most plausible explanation of this phenomenon. The replacement of rubles and dollars by laris as a means of payment led to an equal increase in lari-demand for goods and in the supply of lari-denominated goods, hence it had no price effects. Other popular explanations linking the price rise to conversion also lack plausibility[35]. At any rate, the price jump proved to single short-lived event (Table 4).

To maintain monetary stability in the face of continuing fiscal deficits the NBG draws heavily on IMF support. The supply of laris increases when the Government borrows from the NBG; the NBG sterilizes the money increase by drawing on IMF credit to buy back the domestic currency, consequent expansion of reserves by drawing on IMF-supplied foreign funds to repurchase domestic currency. For purposes of fine tuning the NBG sells, but it also occasionally buys foreign exchange on the TICEX, on which authorized banks also trade.

The conduct of a monetary policy dispensing of IMF support is contingent on the availability of tradeable government obligations which can be used as open-market operation instruments. The issue of such obligations was included in the economic plan for 1996 prepared in cooperation with the IMF. The policy was reversed under pressure from Georgia's Ministry of Finance which argued that before contracting new public loans the Government should restructure the debt contracted between 1990 and 1994. Preparatory steps to loan restructuring are now taking place[36], and there is possibility that new obligations will be issued in 1997.

An effective monetary policy requires that the number of instruments should match the number of targets. At present the NBG uses a single instrument (the use of IMF provided foreign exchange) to achieve two related but nevertheless distinct goals. The purchase domestic currency reduces the monetary mass, thus exercising a downward pressure on domestic prices and, simultaneously, it increases the supply of foreign currency exercising a downward pressure on its price thus strengthening the

[35] One such explanation is that the merchants, taking advantage of the conversion, rounded upward their prices; another that the introduction of the lari meant that an agio had to be added to the ruble price. Even if true the cumulative effects would have accounted for only a fraction of the price rise. One also hears the opinion that the Government's pre-election pledge that public sector wages would rise by 40 per cent effective. November fed inflationary expectations and caused anticipatory price increases. But a rise in inflationary expectations would have caused a flight from the lari, while, in fact, there was a rise in lari holdings at the expense of foreign exchange holdings.

[36] In 1990 the government of Soviet Georgia organized a consumer durable pre-payment scheme. Many participants never received the products they paid for. In 1992 the Government of Georgia floated a 10-year 5 billion ruble lottery-type loan. Most of the purchasers saw their investment wiped out by inflation. Registration of claims for the 1990 prepayments was scheduled to take place in September, 1996, with the amount of compensation to be determined at a late date. The Government also allocated 200.000 laris for the repurchase the outstanding 1992 loan certificates, but no payment has been made as yet.

lari. A foreign exchange purchase has the opposite effect. Open market operations with use of government securities would have a similar effect. Most of the world's monetary authorities conduct open market operations, but they also, as a second instrument, pursue an active discount rate policy. But, as discussed below (see section 7) in Georgia the credit market plays a very minor role. The NBG tends, therefore to maintain a stable discount rate, arguing that changes in the discount rate are unlikely to have any significant effect on the aggregate supply of money. Thus until the credit sector matures, the NBG will have to rely on the single-instrument approach. In the long run it may, of course, be to Georgia's advantage to join a major currency block, but whether and when this is to take place depends, of course, on the stability of Georgia's major trading partners, and also (perhaps most of all) on political considerations.

7. The Commercial Banking Sector

Georgia's commercial banking system consists of three large publicly held Commercial Banks and of numerous private banks. The commercial banks are successors of five Soviet-era specialized banks which operated in Georgia, and which, in 1991, were transformed into State Commercial Banks[37]. In 1995 the commercial banks were privatized (three of the banks were subsequently amalgamated) with the State retaining a minority stake[38]. The private banks are new entities, licensed by the NBG under the 1991 banking law.

At Independence the Commercial Banks entirely dominated the credit market, but they found it difficult to adapt to the institutional changes taking place in the country. Under the Soviet system banks automatically extended predetermined credits to designated customers. Under free enterprise they must compete for credit-worthy customers. By continuing to lend to their established clients, many of whom became insolvent, the Commercial Banks accumulated bad debt, while timidity and lack of experience prevented them from seeking out new customers. Their position was gradually eroded. In 1994 they still held close to 80 per cent of total banking assets, in August; 1995 their share amounted to 67 per cent and in July, 1996 to 54 per cent[39].

The private banks proliferated in the 1991-1994 period during which the NBG readily granted licenses, and exercised no control over banking activities. A minimum own capital requirement constituted, at first, a barrier to entry, but this was quickly eroded by inflation[40]. At the eve of the reforms there were 229 banking license holders. Most of the banks were formed by groups of close associates as an adjunct to their commercial or other small-scale enterprises. There were also some scams that

37 See the law “On Banks and Banking Activity in the Republic of Georgia”, Records of the Supreme Council of the Republic of Georgia, Art. 562 No. 8, 1991.

38 Under Soviet rule five specialized banks operated in Georgia, namely an Industrial Bank, a Savings Bank, an Export-Import Bank, a Housing Bank and an Agricultural Bank. Under Georgian rule the first three were amalgamated to form the Joint Georgian Bank.

39 Data provided by the NBG Banking Supervision Department.

40 Under the original rules a bank had to have a charter capital of 500 million coupons (ca. $700,000). By 1994 inflation reduced this requirement to $300 to $500.

promised the depositors a quick profit and disappeared with their money. These played an especially pernicious role, giving banking a bad name among the population.

To put the banking industry on a sounder footing, the NBG created in mid-1994 a Banking Supervision Department[41] which, as a first step weeded out the small-scale banking sector by withdrawing (in October) 42 licenses, mostly from inactive operations. The remaining banks were to be subject to regulations inducing them to evolve into viable units, giving a broad range of services to a diversity of customers. In line with this strategy the Banking Supervision Department issued in January, 1995, its first prudential standards regulations. On November 1995 it introduced a certification procedure under which the banks were required to present (by March 1996) a three year business plan specifying the strategy to conform (a) with the new prudential guidelines issued by the NBG and (b) with new charter capital requirements (at least $100,000 in June, 1996, rising to no less than $500,000 by June 1998). The requirements were met by 91 banks; the others had their charters withdrawn. In February 1996 the NBG established a certification commission which holds monthly meetings to review the commercial banks' position. New prudential regulations were issued in May, 1996. To conform to the new regulations the banks will have to reduce the concentration of ownership and to diversify their portfolio, hence further mergers and acquisitions are very likely to come[42]. By July 1997 all banks are required to adopt West European accounting practices, and to undergo an external audit by a certified auditing firm[43]. These regulations also apply to the commercial banks. The latter agreed in June, 1996 to adopt a restructuring strategy calling for bad debt write off, sale of fixed a part of assets to cover the liabilities, and for the streamlining of the operations. During the restructuring period they are not allowed to increase the volume of credits. Starting May 1995, to increase the efficiency of bank intermediation, the NBG has been holding interbank credit auctions. The NBG itself participates in these auctions, and offers loans against the banks' required reserve deposits, up to 75 per cent (later increased to 90 per cent) of the reserves. Originally only for 7-day credit was being auctioned, by the system was later extended to 30 and 90 day credit. At first

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[41] NBG's powers were strengthened by the Law of Georgia on the Activity of Commercial Banks of 23 February 1996, which under Article 19 states that all commercial banks have to comply with "resolutions, regulations and instructions" issued by the NBG. In case of non-compliance the National Bank of Georgia may issue an admonition, impose fines, designate a temporary administrator, and, in extreme cases suspend or revoke the bank's license *(*Article 30).

[42] The May, 1996 directive establishes the following compulsory standards:

1. The Primary Capital/Total Assets ratio > or = 8%.
2. The Total Capital/Total Assets ratio > or = 10%.
3. Total Credits and Obligations Extended to a Single Insider/Total Capital < or = 5%.
4. Total Credits and Obligations Extended to All Insiders/Total Capital < or = 50%.
5. Total Credits and Obligations Extended to a Single Outsider < or = 15%.
6. A Single Depositor/Total Liabilities < or = 20%.
7. Ten Largest Creditors/Total Loans < or = 50%.
8. Liquid Assets/Total Liabilities > or = 30%.
9. Deposits/Total Capital = 200% (the ratio will not be compulsory after January 1, 1997).

The directive also recommends the adoption of the following:

1. Fixed Assets/(Primary Capital + Total Liabilities) < or = 20%.
2. Current Assets/Current Liabilities = 100%.
3. Long Term Assets/Long Term Liabilities = 100%.

[43] The NBG, with the help of a World Bank loan, covers half the cost of the audit.

the auctions met with limited interest; total 1995 transaction volume amounted to 2.7 million lari. In 1996, however, the volume quadrupled.

Progress notwithstanding, the banking sector role in the economy is very limited, and the Georgian banks are very weak. In 1995 the sum total of the net domestic assets of the entire commercial banking sector amounted to 109 million lari (July figure) that is to 4 per cent of the GDP. The domestic bank asset total includes non-performing loans held by the Big Three as well as their office buildings, many of which are of dubious value. It is, indeed, far from clear whether the Big Three are solvent. Most of the other banks are seriously undercapitalized. As of June 1, 1996, the assets of only three of them exceeded $4 million; those of fifteen others $1 to $4 million, while the next sixteen had assets of $500,000 to $1 million. Virtually all bank credit consists of fully secured commercial loans, mostly for periods of 3 months or less, and never exceeding 1 year. Investment lending is virtually unknown. As of May, 1996, the lari deposit/money in circulation ratio was less than 0.3. In 1995 the total amount of deposits in all commercial banks amounted to only 17 per cent of the GDP if one includes, and to only 9 per cent of the GDP if one excludes foreign currency deposits[44].

The weakness of the banking sector has multiple root causes. Depositors lost trust in banks as a result of losses suffered during the hyperinflation period and of the 1992-1993 banking scams. Businesses shun the use of checks, because cash transactions are harder to trace, hence easier to hide from the tax authorities. Banks make no investment because they have little capability to appraise the customers' creditworthiness. But given the murkiness of the Soviet accounting system, still in general practice, and the laxness of standards, even very capable bankers would find great difficulty in risk appraisal.

The proximate future is likely to bring to the banking system new challenges and new opportunities. The World Bank and the European Union have identified a group of 12 to 14 banks through which to channel their loan allocations for agriculture and for small business. The banks selected as conduits will have to identify and appraise their prospective customers, and they will bear full responsibility toward the supplier of the funds. Another stimulus will be provided by the construction of a projected pipeline the cost of the Georgian sector of which is estimated at $240 million. The construction will inject purchasing power into the economy, and generate demand for local credit. Other (more distant) foreign projects are also bound to create the need for complementary local finance. The local banks are not likely to be able to satisfy the needs of the growing market. Foreign banks, despite the legal ease of entry, have, as yet, shunned Georgia. Political risks and the difficulties in the appraisal of the creditworthiness of Georgian businesses explain, no doubt, their reluctance. But with continued political stability, this is bound to change. There is thus the possibility of evolution of banking into a two-tier system, with foreign-based or foreign-connected banks that have the advantage of economies of scale providing low-cost services to internationally connected business, and the small, high-cost native banks, with the

[44] These ratios were calculated by dividing the July, 1995 commercial bank deposits by the GDP on the basis of data reported in the *Georgian Economic Trends, Quarterly Review*, First Quarter, 1996. Between May, 1995 and May, 1996 lari deposits grew by 118.5 per cent, which, in real terms means a 77 per cent increase. Most of the growth is accounted, however, by the conversion of foreign exchange deposits into lari deposits. Total deposits rose, in constant lari terms, by 15 per cent.

advantage of knowledge of the local conditions continuing to serve small and medium business ventures.

8. Trade, aid, and the foreign debt

From the beginning of its independent existence Georgia was faced by foreign trade difficulties. The recession in the former Soviet Union countries resulted in a drastic reduction in demand for Georgian luxury exports (wines, brandy, fresh fruit and vegetables and processed foods). It also had a strongly negative effect on the demand for Georgian capital goods. Geography, and the lack of connections, made it difficult to find other markets. Besides, the quality of some major products (including most of the wine and tea) was not acceptable in the West. Georgia's imports, on the other hand, could not so easily be reduced. Bread is a staple food in Georgia, and cutbacks in the imported wheat and flour from which the bread is baked could have meant starvation. Georgia is heavily dependent on energy imports. At the time of independence 80 per cent of the imported energy consisted of natural gas from Turkmenistan, which was used for power generation, for space heating and for other household purposes. Cutbacks in energy imports would thus have had strongly adverse consequences on production and/or on the standard of living.

The crisis deepened when the prices of fuel supplied by Turkmenistan and by Russia were raised to world level prices. Though Georgia began to cut back its energy imports as early as 1990, the 1992 energy import bill amounted to $114 million, and accounted for 17 per cent of total imports. In 1993 the volume of energy imports decreased, but, because of price increases, the import bill soared to $401 million (45 per cent of the total import bill). In 1994 energy imports declined further, but they still accounted for close to 40 per cent of the total. Throughout this period exports stagnated, and the proceeds covered only half of the total import bill.

The government attempted to cope with the accumulating trade deficit by borrowing abroad. At independence Georgia, having opted for the “zero option” involving the cancellation of all inter-republican claims, had no external debt. By mid-1994 it accumulated a foreign debt in excess of $1 billion (nearly 80 per cent of the GDP), most of it on commercial terms with maturities of less than four tears. Debt service charges falling due in 1995 amounted to $280 million[45] — about equal to the total 1995 commodity exports![46] Clearly, the obligations were beyond the country's payment capability.

In 1995 Georgia, with IMF backing, initiated debt rescheduling negotiations. Turkmenistan, the largest debt holder (32.2 per cent of total indebtedness) forgave Georgia $55 million in accumulated interest payments. The balance was converted into instruments with an 8 year maturity, and a three year grace period. Agreements

[45] IMF 1994.

[46] According to the figures on the direction of trade 1995 exports amounted to $151.7 million. This figure is much lower than those given in the balance of payments' statistics. According to the latter exports during the first three quarters of the year equaled $193 million. For the entire year the figure is likely to fall within the $240 million to $280 million range. Data source: *Georgian Economic Trends* Quarterly Review, First Quarter 1996.

with other creditors have either or are about to be concluded; they call for conversion into ten year maturity instruments with a five year grace period. Interest (also payable during the grace period) is set at 4 per cent. Earlier on radical steps were taken to reduce energy imports — the prime cause of the deficit. The supply of household gas to Tbilisi was discontinued in January 1995; that to other cities in April. The generation of electricity from gas was stopped in May. In June the government declared invalid the agreement under which it imported gas: henceforth enterprises had to negotiate their own contracts[47]. Natural gas imports declined dramatically, as did the total energy bill which, for the whole year may be estimated at $70 to $90 million.[48]

Debt reduction notwithstanding, the Government continues to rely on the IMF to meet its international obligations. The interest due to creditors who have signed a re-structuring agreement is paid from an account in the Netherlands Bank into which the Government deposits every quarter the sum of $8 million obtained by drawing upon IMF credit. Thus, at present, Georgia relies on the IMF facilities to control inflation, to maintain the exchange value of the lari, and to meet its international obligations. Concessionary loans and aid are also instrumental in the maintenance of macroeconomic equilibrium. For lack of appropriate data it is not possible to present a reliable quantitative appraisal of the volume of foreign exchange supplied by aid activities, or of the contribution of such activities to Georgia's national product. The balance of payments data shows that in 1994 humanitarian aid imports (mostly wheat and flour) were valued at $68 million and filled 22 per cent of the trade gap. In 1995 such imports were valued $113.9 million filling 27 per cent of the gap. But the humanitarian aid import data do not take into account the foreign exchange spent by the donors on Georgian goods and services. A preliminary and incomplete listing appraises the completed aid projects at $163 million, and the ongoing and proposed projects at $529 million[49]. The complete listing will provide an upper bound estimate, since not all the aid expenditure reaches Georgia in the form of foreign exchange or of counterpart goods and services[50]. It is clear, however, that the foreign exchange contribution of aid is far from negligible[51].

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[47] Such a radical solution was prompted by the government's inability of recouping the cost of gas by imposing consumer charges. Household gas is not metered in Georgia. Enterprises simply refused to pay; in 1994 the collection rate was equal to 7 per cent (IMF 1995).

[48] In 1995 net imports of natural gas amounted to $36.6 million, and net imports of electricity to $17.2 million (State Department for Social and Economic Information (1996) *Balance of payments of Georgia 1995*) In 1993 (later estimates are fragmentary) imports of other sources of energy amounted to $ 16.7 million (IMF, 1994). If, as is likely, the latter remained at approximately the same level for the last two years, the 1995 energy bill would have come to $70.5 million. By assuming that the non-gas, non-electricity energy import bill doubled, we obtain the figure of $87 million.

[49] See Georgia (1996) *Donor Activities.*

[50] The appraisal of the value of advisory services presents an especially vexing problem. Should they be valued at (an often exorbitant) donor cost, or at cost to the recipient, which is zero? A similar problem, in a more attenuated form, pertains to aid in kind: the cost to the donor often substantially exceeds the recipient's valuation.

[51] According to the IMF estimates the value of humanitarian wheat and flour imports amounted in 1993 to 7.4 per cent of the GDP and to 3.5 per cent in 1994. In the latter year the value of such aid amounted to 45.2% of the total fiscal revenue, including grants (IMF, 1995).

In the future the support of the international organizations, the concessionary loans, and the humanitarian aid are bound to be phased out and Georgia will have to face the problem of meeting its own obligations. A sudden discontinuation of support would spell extreme economic hardship. In the absence of IMF backing and of aid Georgia would have had to generate a trade surplus of over $32 million per year to meet interest payments on the restructured debt. This would have required a reduction of national expenditure on the order of 18.5 per cent[52]. The formal sectors of the economy would be likely to be more deeply affected than the informal gray zone activities. But Georgia's wages do not even cover the cost of a minimum adequate diet[53], and any further reduction could have dire economic, social, and political consequences.

Macroeconomic policy should therefore aim at the promotion of stability and of growth and at the gradual emancipation from foreign support. The feasibility of such an approach is demonstrated in a well-regarded government document which sets an 8 per cent growth target for 1996, followed by a 10 per cent growth in the next three years, after which growth would gradually decline to 5 per cent by the year 2004[54]. Assuming the continuation of a tight fiscal policy the debt service/export ratio would be kept under 30 per cent throughout the period. Toward the end, Georgia would be able to meet the service charges without foreign aid. The predictions of the “framework” will not necessarily come true. But the value of the exercise is to show that recovery within the next eight years is feasible and plausible[55].

Georgia's legal framework lays the foundations of outward-oriented policies which, as experience shows, are conducive to self-sustained growth. There are no significant export restrictions, and no quantitative import barriers. Imports from the CIS countries are duty-free. Other imports (humanitarian aid excepted) are subject to a 12 per cent customs duty; this relatively high rate may, perhaps, be justified in view of the severity of the fiscal crisis (a lower rate accompanied by excise duties would have been preferable). But since the rate is uniform it is does not lead to major allocative distortions. Negotiations are in course for admission to the WTO, thus completing the institutional foundations for orderly international trade. Nevertheless, Georgia's export performance depends to a substantial extent on the economic situation of the former Soviet Union members who still constitute a “natural” market for Georgia's products. In the West Georgia would have to compete with better established suppliers (such as

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[52] This (rough) estimate was derived by dividing the sum of the trade surplus and of the required foreign debt service payment by the sum of the GDP and the foreign trade current account deficit. The calculation is based on the 1995 State Department for Socio-Economic Information figures, as reported in TACIS (1996) with the lari figures converted into U.S. dollars at 1.3000 lari/$. For the sake of consistency the 1995 deficit figure was takes as reported in the above source, rather than a later, revised figure.

[53] The GMS Financial Information Agency calculated that as of July 1, 1996 the cost of a minimum adequate food basket amounted to 58 laris, while the gross average monthly wage was equal to 20.5 laris. Source: *Georgia Business* News no. 142, June 29-July 5 1996.

[54] See Republic of Georgia, *Public Expenditure Review* April, 1996. The study appears to have been conducted by World Bank consultants.

[55] The “framework's” growth target for 1996 is likely to be surpassed. The projection for the entire 1995-2004 period is imbued with a probably unwarranted deep trade pessimism. In 1995 exports amounted to 17 per cent of the GDP only. As Georgia's economy recovers exports are likely to grow substantially faster than the GDP, yet the “framework” assumes that they will decline to 10 per cent of the GDP in 1997 and to remain at approximately that relative level until 2004. Faster export growth would facilitate the closing of the trade gap, hence faster progress toward self-reliance.

Turkey, Greece, Cyprus and with the Maghreb nations for fresh and processed fruit; Italy, Spain and Slovenia for wines; Sri Lanka and India for tea). To do so, it would have to modernize production and marketing which can be most expeditiously achieved by attracting foreign investment.

Foreign investors in Georgia enjoy all the rights and prerogatives of domestic investors. There are no restrictions on acquisition of property, or on the scope of activities. The right to transfer after-tax profits is guaranteed, and the nationalization of foreign investments is prohibited[56]. As yet, possibly because Georgia is perceived as a country where political risk is high, total foreign investment has been limited to a mere $30 million. But continued stability politico-economic stability is bound to improve the country's image, and though it would not be wise to bank heavily on foreign investment, the world's business community's interest in Georgia is certain to grow.

9. Concluding remarks

Since 1994 Georgia, with the help and cooperation of the IMF, has stopped a hyperinflation, liberalized the economy, established a stable, freely convertible currency, and constructed a well-designed macroeconomic institutional framework. The Central Bank has a clear mandate to conduct a sound monetary policy, and it enjoys a high degree of autonomy. The Ministry of Finance controls the budget. Public expenditures have been pared down — too deeply, indeed, for the long run. The tax system is relatively simple and taxes are far from being onerous. There are no restrictions on foreign investment, and no quantitative trade barriers. The credit market is the one weak link: the banks are small, undercapitalized, and they play an insignificant role.

The reforms stemmed the economic decline and fostered recovery. The real GDP increased in 1995 by about 2.5 per cent. The six months of 1996 were a period of vigorous growth. Compared with the first half of 1995 industrial output rose by 4 per cent, agricultural output by 13 per cent, and wholesale and retail trade activity by 22 per cent (Department of Statistics estimates). There has also been a clear revival of the construction industry. It is generally expected that GDP growth for the year as a whole will surpass 8 per cent (the Department of Statistics expects 14 to 15 per cent growth). The tempo of growth is spectacular, though it should not be forgotten that the start is from a very low base, and that virtually all of it results from better utilization of unused capacity.

Georgia continues to face, nevertheless, serious economic problems. The greater part of the heavy industry, once the mainstay of the socialist economy, has lost its *raison d'etre*. Much of the capital has to be written off. Enterprises that are still potentially viable have lost the assured position they once held in the Soviet market. They now have to match the quality and the price of international competitors. The inadequacy of the infrastructure hampers recovery. The main rail link to Russia is still cut. The highways are in disrepair, the telecommunications in shambles, the supply of electricity is erratic. The conditions are not those to attract foreign investment.

[56] Law of the Republic of Georgia on Foreign Investments of June 30, 1995, Chapters 2 and 3.

The human factor constitutes, perhaps, the greatest problem. The strong ethic of loyalty toward family and friends saved many people from starvation during the years of troubles, but it is inimical to the establishment of an efficient administrative system, and to the “downsizing” of public enterprises. From an efficiency point of view job assignments all too often bear little relation to the qualifications of the job holder. The application of government rules is sometimes arbitrary and inept. In the past people had to defy authority in order to survive and they continue to mistrust the government, and fail to perceive its positive functions. Tax avoidance is considered something of a virtue. Much of the economy is “underground” creating an almost insoluble problem to the fiscal authorities.

Since the onset of reforms the Government has relied on the IMF to help fill the fiscal gap, to support the currency, and to service the debt. But IMF support is a temporary expedient. Over the next few years the Government — and the country — will have to become more self-reliant. The task ahead is difficult. But, since 1994 the country has overcome enormous difficulties. There is now a sound institutional framework for growth, and a stable government which pursues a steady course. These accomplishments give ground for cautious optimism toward the future.

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Tables

Table 1
Indices of economic performance 1990-1994

	1990	1991	1992	1993	1994
Real GDP	100	80	44	30	21
Agricultural output	100	64	53	33	26
Industrial output	100	77	42	31	19
Electricity generated	100	94	81	71	48
Freight transport	100	71	21	10	6
Construction	100	67	38	3	3

Source: Statistical Office of Georgia as reported in TACIS (1995).

Table 2
Inflation in Georgia 1990-1995

Year	Annual rate of increase of the CPI
1990	5%
1991	175%
1992	1,340%
1993	9,040%
1994	8,340%
1995	163%
1996 (forecast)	29%

Note: During the 1993-1995 period many goods (e.g. consumer durables) were traded in U.S. dollars or in rubles. In calculating the CPI the foreign currencies were converted into coupons at the average free (i.e. black) market exchange rate.

Source: 1990-1995 State Department for Socio-Economic Information; 1996 forecast IMF.

Table 3
Budget execution 1994-1995 and 1996 planned expenditures and revenues as percentage of the GDP

	1994	1995	1996
REVENUE			
Total revenues and grants	7.7	7.7	9.8
Total revenues	4.2	5.8	8.9
Tax revenues	3.0	3.8	6.6
Other revenues	1.2	2.0	2.3
Grants	3.5	2.0	0.9
EXPENDITURE			
Total expenditure & net lending	24.2	12.4	13.8
Current expenditure	21.6	8.0	N.A.
Capital expenditure	0.3	0.8	0.8
Local government expenditure	1.6	2.4	2.4
Net lending	0.7	1.3	N.A.
DEFICIT (accrual)	16.5	4.7	4.0

N.A. = not available.

Note: The percentage of GDP calculations for 1994 and 1995 are based on Ministry of Finance GDP estimates. The 1996 calculation is based on an IMF GDP projection, which assumes an 8 per cent growth in the real GDP and a 29 per cent increase in the CPI.

Source: 1994 IMF; 1995 and 1996 Ministry of Finance, as reported in *Georgian Economic Trends*, Quarterly Review, First Quarter, 1996.

Table 4
Monetary aggregates and prices, selected months, December 1994 – May 1995 in million of lari

	Net foreign assets	Net domestic assets	Reserve money	Currency in circulation	M2	M3	CPI
XII.1994	6.4	36.6	43.1	21.1	40.6	79.8	100
I.1995	6.3	36.5	42.8	20.2	37.1	58.6	113
II.1995	4.8	42.5	47.2	19	34.3	53.6	114
IX.1995	-26.8	76	49.1	17.3	52.4	76.1	123
X.1995	64.4	55.8	120.3	95	126.6	148.4	152
XI.1995	80.9	52.7	133.7	107.5	141	162.2	152
V.1996	21.4	142.7	164.1	134	171.6	200.2	175

Note: M3 is defined as the sum of M2 and of foreign currency deposits. The CPI is rebased to December 1994 = 100.

Source: National Bank of Georgia as reported in *Georgian Economic Trends.*