

## **Experts Expect Further Strengthening of Lari**

### ***“Georgia has a Classical Form of Dutch Disease” — economist Vladimer Papava***

Nothing in particular is happening in Georgia—the thing is that the country is suffering from Dutch Disease, MP Vladimer Papava of the ruling National Movement faction believes. In an interview with GBW, he argued that “along with the objective reasons, the monetary situation has been aggravated by the government’s spending policy.”

**Q: In the aftermath of the Rose Revolution, Georgia has seen an inexorable strengthening of its national currency, the lari, against the U.S. dollar. What are the accompanying risk factors for Georgia’s economy, and what should we blame for the trend—the National Bank’s monetary policy or the government?**

**A:** Regretfully, the population of Georgia has been misled into thinking that the blame must be put either on the authorities or the National Bank. The point is that Georgia’s post-revolution economy has been infected with Dutch Disease.

The phenomenon of Dutch Disease came about 40 years ago after the discovery of gas deposits in the North Sea. As a result of exporting those resources, the Netherlands witnessed a big inflow of foreign currency, strengthening its own currency. What are the accompanying syndromes and threats of Dutch Disease? The most negative outcome is that appreciation of the national currency destroys stimuli for exports, and makes export-focused business non-cost effective.

At the same time, strengthening of the national currency results in the devaluation of imports—but for importers and never for the consumers. There are a number of variations of Dutch Disease across the world. Among the states infected with Dutch Disease are Brazil and other Latin American countries as well as African countries and Middle East countries, which are all destinations of an enormous influx of foreign currency, be it from oil exports, coffee exports, remittances, foreign investments, or tourism development. So, the crux of this phenomenon is not the oil or the gas reserves, but the big inflow of foreign currency into the country.

As for Georgia, in the wake of the Rose Revolution we have seen an increased demand for lari, which has certain grounds. Firstly, the Rose Revolution was followed by a vigorous fight against corruption which meant the detention of former Shevardnadze allies—then the government accepted large sums as bail, transferring money directly to the state budget or extra-budgetary funds. But since Georgia the lari is legal tender, detainees paid in lari while they had savings in USD. So, large volumes of U.S. dollars were put into circulation to purchase lari.

Secondly, following the revolution, remittances from foreign countries have increased almost five-fold. The total volume of remittance transactions hit half a million already this year. While in 2000 remittances were 77 m USD, this figure climbed up to 410 m USD in 2006. And we have to take into account that these are only bank transfers; there must have been unofficial

transfers as well. These transfers have been converted into GEL, which further increased demand for lari.

Thirdly, we have had a number of grand projects in the country like the BTC [Baku–Tbilisi–Ceyhan] pipeline, the South Caucasus gas pipeline, and others which have flooded foreign investments into Georgia. Besides, the tax administration has been stricter in forcing businesses to pay taxes. Since taxes are collected in lari and, again, owners keep savings in USD, they were forced to exchange them for GEL.

In addition, we also should consider foreigners' engagement in the privatisation process, be it Russian, Kazakhstani or Czech businesspersons. Once foreigners come to a country they bring dollars along to purchase facilities and to invest in enterprises, and then they have to buy lari in order to pay taxes. All these resulted in increased volumes of US dollars and brought the lari rate upward.

This is the explanation for the Georgian variant of Dutch Disease. We have a justified trend of huge inflow of foreign currency and demand for lari.

**Q: How would you evaluate NBG's role in this process?**

**A:** The National Bank of Georgia is largely responsible for what's happened. Before the revolution, 1 USD was offered at 2.15 GEL. Ever since, the lari has grown stronger and stronger. If NBG hadn't intervened, the U.S. dollar would have dropped to as low as 1.40 GEL, which would have torn down Georgia's export capabilities. This is why NBG has no alternative but to purchase USD in large amounts, meaning that it has to sell lari. Pursuing this policy, NBG has achieved another goal—increasing its currency reserves.

However, withdrawing USD from circulation and releasing more lari stimulates inflation. So now, NBG has a choice between rising inflation and a devalued USD, which is perilous to [Georgia's] export potential. Therefore, nothing in particular is happening in Georgia—the thing is that the country is suffering from Dutch Disease.

Yet, along with the objective reasons, the monetary situation has been further aggravated by the spending policy of the government. Let's look at just [spending for] road reconstruction. Certainly, reconstruction works are an important factor for the country's economy, but the benefits are long-term. The same must be said about entertainment activities, fountain... Last year the government organized an employment program, allocating 22.5 m GEL. During a three-month period, private businesses were commissioned to hire personnel who would get state-provided salaries of 150 GEL a month. What happened was that many people provided falsified documents claiming to be unemployed. The money paid to them contributed to inflation.

The same should be said about the student employment program. The byproduct of the programs will be trivial compared to the spending, in my view. So the government has spent the sums earned from privatisation, and we have got a picture similar to that of the budget deficit—that is, inflationary. So, objective inflation processes in our country have been further intensified by the government's incorrect spending policy.

**Q: Do you think this 'Disease' is incurable? What is the way out?**

**A:** We have an influx of foreign investments into the country. For instance, the Arabs recently announced they would make an investment of over USD 1.5 billion in Tbilisi. Well, this is good news for Tbilisi's infrastructure development, but at the same time it means that demand for lari

will increase dramatically. Given the government's choice between a strong national currency and inflation, which is worse? The answer is, that both of these are not good, but high inflation is the worst choice. The government must find the golden point, and keep the lari at a level will not allow higher inflation. The goal is to stay below a double-digit rate.

We should expect that the lari will further strengthen until the year's end. This is an alarming signal for exports. The most important thing is that the government should move to a budget surplus model, so that the surplus is kept in reserve. Then we will be able to keep the lari strong and inflation under control. But the question is whether the government is going to follow this path. And the answer is no.

2008—election year—is drawing closer and the government is due to increase state pensions, which in moral terms is a just cause, but we have to consider that this will further step up the inflation process, making monetary policy even worse. In such a situation the International Monetary Fund has assumed an ineffectual role. In this situation, IMF is becoming a weak “audit” rather than a wise advisor and partner for the country's economic policy. IMF is in a position of a “peacock” taking pleasure by looking at his tail. This is why the advice provided for the Georgian authorities [by IMF] in most case is not helpful, though is theoretically sound and well-reasoned.

**Q: You've mentioned that the authorities should keep a golden point to evade inflation. Where are we now?**

**A:** Good question. In July 2006, the Statistics Department released figures claiming the annual inflation was 14.5%. In reality, inflation was even higher. Still, the then-chief of the Statistics Department might have missed the figures, or they wanted to show the real picture. Criticism from IMF followed. Yet, the criticism was mostly about NBG and not the government, which I have to say, was a big mistake of IMF. So what happened was that the chief of the department was fired. And that proved to be enough to “bring inflation down,” and we saw the annual inflation rate posted at 8.8%. But even a child would say the revised figures were nonsense.

In some ways, the government seems willing to play “ostrich.” And, what is most surprising to me, the IMF is following the example. Not only was the inflation at 8.8%, but Georgia no longer had the statistics agency. Having become a part of Ministry of Economic Development, the Statistics Department is part of the government and we have a clash of interests preventing us from seeing the real picture. In theory, while the government is responsible for making economic policy the statistics service is responsible for reflecting what is going on in the economy. But neither the IMF nor the World Bank expresses criticism for what is happening in this field. Nobody knows what the exact inflation rate is right now. Try to visit the department's web page and you'll fail to find the information. A foreign colleague of mine emailed me, saying that he is doing research of central Asian and Caucasian countries, and needed macroeconomic indicators. He said that previously they had a problem with obtaining information about Uzbekistan, since the information was not only false but not even available. ‘What is going on now in Georgia?’ he asked me... Thus I think it would be the best option if Georgia had an alternative statistical agency like many foreign countries. It would be very good if international donor organisations support this idea.

**Q: Has there been any suggestion from the IMF in this regard?**

**A:** I can't say. What is clear is that they're following the trend to see Georgia as a success story in all respects. Well, we have achieved real success in many fields, but we have some problems

remaining in certain areas. To conclude, I don't think the government will change spending policy any time soon. So, we are likely to have both inflation and a stronger lari at the same time.

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