Georgian Economic Trends

Quarterly Review

2003 No. 2-3

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APPENDIX III:
PROSPECTS FOR THE US DOLLAR AND THE EURO AND GEORGIA

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In an environment of world-wide globalisation, practically any individual country will to an increasing extent feel the impact of the ongoing economic processes in the international economy.This is the case even more so, with the world financial system based on electronic communications and on-line distribution and sharing of information as a factor of production.

In this paper, we discuss an opinion of the famous multi-millionaire and philanthropist, George Soros, stating that in the near future the US Dollar is likely to lose one third of its value [1]. In his opinion, confidence in the US Administration's economic management has been undermined throughout the world.

Merrill Lynch experts, who think that the rate of Euro by the end of 2003 will have reached 1.25, make almost a similar prognosis and their colleagues from Goldman Sachs go even further predicting EUR/USD 1.35 [2, p.13].

According to George Soros, depreciation of the US Dollar will affect the world economy and the scandals in regard to accounting and corporate frauds in certain major American companies will stimulate an outflow of capital from the USA.

This statement has given rise to a new wave of debates concerning future prospects of the US Dollar and the US economy, as a whole. About ten years ago Soros made a similar statement with regard to the British Pound Sterling as well. He conversed his assets in Pound Sterling to start purchasing when its rate had reached minimum value, thus gaining high profits [4, p.1].

Although we could perhaps partly share these forecasts, it seems less probable that events will develop in such a dramatic way and that the US Dollar will experience such a strong devaluation, otherwise it would create a threat to the international exchange system and hence, to normal functioning of the world economy.

It should be noted that the USA, Japan and the Euro zone produce 45.3 per cent of the world GDP and they also account for 42.8 per cent of the world imports and 40.9 per cent of exports [3, p.13]. Severe economic shocks in these countries might provoke an economic crisis all over the world and this is neither in the interests of the countries in question nor any other countries.

A successful peace operation in Iraq would have a positive impact on the ongoing economic processes both in the USA and the rest of the world. In particular, it would influence real earnings of the population and gains of corporations who will benefit from a steady fall in prices for energy resources. However, should partisan warfare persist on whatever scale, Iraq is likely to lose any attractiveness for investment.

There is no doubt that a wave of corporate crises that first occurred in Great Britain in 1995-1999, and which at the end of 2002 overtook the United States, has to a great extent destroyed the myth of the omnipotence of the American economy and weakened the position of the US Dollar on the international scene. Nevertheless, a look into history will convince us that it is too early for the US Dollar to be “written off”. However, at the first sight, a pure American problem has initiated formation of a three-pole exchange system in the world which, we believe, will become of paramount importance for establishing the subsequent exchange order in the world.

What are grounds for drawing such conclusions?

Our earlier prognosis that introduction of the common European currency (Euro - EUR) would somewhat shaken the leading positions of the US Dollar have come true [5]. As concerns the initial depreciation of the Euro, it was only temporary and the following economic developments have proved the validity of the above-referred assumptions.

In May 23 2003, the Euro was 1.1837 against the US Dollar, by 1 cent exceeding the value of 1.1747 in January 1, 1999 to which the history of the Euro dates back. However, it should be noted that the above-referred value is still slightly below the maximum quotation of the rate of Euro (1.1906) [2].

It is also worth noting, that a hypothetical rate of the Euro during the past decade, being calculated on the basis of the currencies comprising the Euro basket, is somewhat higher than the maximum quotation of the Euro.

As estimated by the vice-president of the European Central Bank Lukas Papademos, the maximum rate of the Euro is close to the average hypothetical rate of the Euro for the past 15 years [6]. This allows us to suppose that the Euro still has a potential for further appreciation. It should also be taken into account that transfer to the common European currency has entailed a significant reduction in transaction costs between the currencies of these countries while conversion costs are now zero, thereby to some extent increasing its potential for further appreciation. Moreover, free movement of goods and services, capital and labour will contribute to the more effective distribution of resources.

However, it is unclear on one hand whether a further devaluation of the US Dollar is reasonable and on the other hand, how acceptable a “cheap” dollar is for the economy of the European Community, Japan and other developed countries.

The answer will be definitely negative, as a significant devaluation of the US Dollar would set off a cascade of devaluation processes in its major trade partners, finally leading us to the increase of protectionism and downturn of economic activity in the world [5].

Proceeding from the above-said, an effective appreciation of the Euro is less acceptable and the parity against the US Dollar fixed at the time of introduction of the Euro will either be maintained or may slightly increase.

Although the economic situation in Europe is much better, a further strengthening of the Euro would diminish competitiveness of European goods both on home and foreign markets. Obviously, an “expensive” Euro will lead to weakening of exports, though this will be compensated with cheap imports.

Further rise of the Euro will endanger economic growth in the Euro zone. In the first quarter of 2003, there was no overall economic growth recorded in the Euro zone and an economic recession in Germany, whose economy is the largest in Europe, was reflected in a growth rate of 0.2 per cent [6].

In contrast to the Euro zone, in the United States the growth of GDP was 1.9 per cent, exceeding the preliminary projections by 0.3 per cent. According to “The Economist” estimates, during 2003-2004, economic growth in the United States will be at 5.6 per cent level and in Japan and Germany it is projected at 1.5 and 3.1 per cent, respectively [7, p.26].

Unlike the Federal Reserve System of the USA, the European Central Bank has a cushion (reduction of the interest rate) for maintaining stability of its currency and ensuring parity of terms of trade.

The session of the European Central Bank of 5 July decided upon a 0.5 per cent reduction of the rate to 2 per cent, which will stimulate economic activity in Europe on one hand and cause a capital outflow from the Euro zone and somewhat neutralize appreciation of the European currency.

Further enlargement of the Euro zone through involving Great Britain, would serve as an additional short-term influence for the stability of the Euro, as Great Britain is experiencing approximately twice the rate of economic growth of the Euro zone countries and the target is to attain 2.2 per cent growth in 2003 [8]. However, as recently underlined by the Chancellor of the Exchequer (Minister of Finance), Gordon Brown, five tests intended for Great Britain, which were supposed to ascertain its readiness to enter the Euro zone, have produced negative results, postponing its accession for an indefinite period of time [9].

It is reasonable to discuss those factors that will have various impacts on the economy of the USA and will in perspective influence probable dynamics of the US Dollar. Let us first consider circumstances accounting for the depreciation of the US Dollar.

The first is shrinking of confidence in the US economy, which will contribute to the weakening of the US Dollar position in the commodities markets and lessening of the share of the US Dollar in central bank reserves. Until recently, trading of oil and gold was carried out in US Dollars and approximately 50 per cent of the central bank reserves were held in US Dollars [10].

The effects of some of the circumstances which have encouraged us to draw such conclusions, still exist. This is the growing collision between the “old” and “new” economies. That is, the price of the shares of the “new economy” companies on stock exchanges is determined not on the basis of statement of current incomes and expenses but by future “virtual” profits. [11, p.19]. According to the authors, this situation is impeding stability of stock exchanges, as far as it is exhibiting some features of a financial pyramid and its stability is underpinned by psychology. Bankruptcy of such giant corporations as Enron Corp., , WorldCom Inc.and a catastrophic fall in the cost of the shares of others was a tremendous shock to the whole world. However, in addition to the initial accounting nature of the crisis, it has equally involved auditing service, stock market regulators, commercial banks, rating agencies and corporate management. It is also noteworthy that, owing to a high degree of openness of the USA economy it will have a great effect on the economic situation in other leading countries, as well.

Here we had a case of the so-called “Bubble Economy” explained by a famous Japanese Professor K. Kussak as a situation when there is an agitated demand, and prices for securities and real estate are boosted [12, p.178].

It is to be noted that the above-referred characteristics of the economy do not encompass a separate segment but rather have a macroeconomic effect and predetermine a significant impact on a monetary and fiscal system of the country.

Second, corporate scandals have significantly distorted balance of capital of the USA, which found its reflection both in increasing capital outflow and decreasing capital inflow.

During the recent period, the balance of payments of the USA has had a large deficit (5 per cent of the GDP). Until recently, the deficit was covered through net capital inflow. While in 1999, 91 per cent of the current account deficit was financed through FDI, by 2002 this indicator has fallen to 43 per cent [13, p.69]. The experts consider that this downtrend will persist. The above-referred downtrend has been pre-conditioned by a lack of confidence in the US economy on one part and by selling foreign assets on behalf of American investors (e.g. ordinary Euro zone shares), on the other.

Third, depreciation of the US Dollar persuades foreign investors to sell securities and shares which results in a decrease in their price. It is well known that foreigners possess 40 per cent of the T-Bills of the USA as well as one third of other securities and 13 per cent of real estate [13, p.70].

As concerns factors preventing devaluation of the USA Dollar, they are:

First, shrinking of the share of the US Dollar in international reserves would have been more sensible save for the behaviour of the major trade partners of America directed at preventing depreciation of the USA Dollar and hence, deterioration of the conditions of trade in foreign economic relations; no doubt that “expensive” Euro or Yen will cause a reduction in exports. Therefore, they are increasing the share of the US Dollar in their currency reserves. In particular, the Central Bank of Japan has purchased USD 43 billion (the largest currency operation in recent years), South Korea and Taiwan – USD 4.5 billion; in March, the same indicator for China was USD 7.8 billion [14].

However, recently in currency interventions targeted at attaining stability of currency rates, the priority has been given to collective interventions. The analysis made by the Professor of the University of Tokyo Mr. Takatoshi Itos, showed that joint interventions by central banks of various countries in the 1990s proved 20-50 times more effective than intervention made by the Central Bank of Japan alone [13, p.69].

Second, an insignificant depreciation of the US Dollar will stimulate exports of the United States, increase corporate profits and investment; at the same time facilitating implementation of structural reforms and corporate restructuring in the Euro zone and Japan, thus raising efficiency in the regions and benefiting the international economy as well. In particular, according to one of the estimates, 20 per cent depreciation of the US Dollar will cause a 1 per cent growth throughout the world [13, p.70]. However, as noted above, such depreciation is less expected.

Although until lately, there was a one-pole international exchange system, recent developments have established a basis for a three-pole system (USA Dollar, Euro and Yen). However, gold as an international reserve asset has become of paramount importance again. As underlined by Professor H. Tietmeyer – Ex-President of the Bundesbank of Germany, gold accounts for about EUR 40 billion of reserves (15 per cent) of the Central Bank of Europe and 10.5 per cent of international reserves of Russia [15]. This trend persists in other countries as well.

In addition, the positions of the countries of Latin America and Asia insist on increasing the role of the Euro in the framework of international exchange reform. For instance, in the MERCOSUR countries of Latin America and countries of ASEAN+3 (China, Japan and Korea), they attentively follow regional monetary integration, which in their opinion, has been so successfully implemented in the Euro zone.

Notwithstanding the above-said, the post-war organisation of Iraq will also largely influence the international economic order. This will be a key factor that will affect economic activity of the USA.After hostilities ended in Iraq, the Security Council has adopted a resolution on reversal of economic sanctions against Iraq, which fully authorizes the USA and Great Britain to attend to the post-war reorganization of the country and to manage its oil deliveries to the market [7, p.26].

It will take a definite time for this resolution to have effect on the USA. Before the war the deliveries of Iraq to the world market attained 2 million barrels per day. While there was severe damage to the oil industry infrastructure,the Chairman of the Consultation Council at the Ministry of Oil of Iraq, Phillip Korel, considers that in the second part of 2003, oil production will surpass the pre-war level; according to some experts the benchmark will be 1.5 million barrels per day [17, p. 9]. However, there are more optimistic forecasts that in case of intensive investment, Iraq will be in a position to increase production up to 6 million barrels per day, ranking fourth in the world by its oil production after Saudi Arabia (8.8 million barrels), the USA (7.2 million barrels) and Russia (7.1 million barrels) [18, p.21]. With this level of production, Iraq will be able to effect market fluctuations in oil prices in the world and in a way balance out monopoly of OPEC in price-formation on the oil market.

If, with the increased deliveries of Iraqi oil, the United States allows a significant reduction in oil prices on the world market, this might cause economic downturns afterwards growing into a global economic dislocation. Development of events according to this scenario is particularly dangerous for Russia with the lion's share of its budgetary incomes accounted for by those received from the oil exports. It also presents jeopardy for Georgia, as a possible devaluation of the Russian Rouble will considerably affect its trade with Russia, which will presently find reflection in balance of payments and endanger stability of the Lari that is actually the only "bright spot" of the monetary sphere.

When experts consider changes in the global exchange system acceptable (which as noted above, we think to be a bit exaggerated), this will naturally raise such questions as what will be Georgian monetary policy in the situation of "expensive" and "cheap" foreign currency and what will be positive and negative sides of maintaining the current rate of the Lari.

This time we will not linger on positive and negative effects of devaluation/revaluation of the major currencies (US Dollar, Euro and Yen) on Georgia as a detailed analysis of this has been made in the article [5]. However, it should be underlined that Georgia should adapt its monetary policy while taking account of new trends forming in the world.

Given that the monetary system of Georgia is undeveloped, control of the general price level is not less important for Georgia than that of the real exchange rate of the Lari.

Separate empirical and theoretical researches show that in transition economies, institutional and structural aspects are more important for stimulating export, than currency devaluation (see, for example, [19]).

Some Georgian economists (as well as those of other post-communist countries) often suggest that, for stimulating economic growth and exports, devaluation of the Lari can be justified, although theoretically it has been proved that given the technical lag and by placing uncompetitive products on the market, currency devaluation would only facilitate inflation rather than production or export [20; 21].

In January-May 2003, the Georgian foreign trade turnover with the EU members was USD 150 million, which compared to same indicator of the previous year is 65.6 per cent more. Of this imports account for USD 129.1 million (twice as much as during the relevant period of the previous year). Such growth of imports in the situation of a significant fall of the real rate of the Lari against Euro and improvement of trade conditions [22, p. 27] serves a good proof of the above-referred theoretical statement.

Introduction of Euro has essentially changed “world money”. It has become the second major currency in the world right after “birth”, constituting the third pillar of the “world money” together with the US Dollar and Yen. “The exchange rates among these three islands of stability will become the most important prices of the world economy” [23].

As proceeds from the above-mentioned reality, diversification of currency reserves by the National Bank of Georgia is given a priority. We have considered two models of diversification of currency reserves by which it would have been appropriate to include in these reserves all more or less stable currencies [5].

However, while analysing major monetary policies of Georgia in 2003 [24], we could outline several problems:

First, the extent of currency reserves diversification at the NBG level;

Second, the extent of diversification of deposits for commercial banks and private companies;

Third, enabling of mechanisms for option transactions (so-called “no-loss” operations”), which are supposed to provide for maintenance of real value of assets on the part of both commercial banks and economic agents.

For 2002, deposits in Euro made up just 2 per cent of total deposits (25, p.33). Should the Euro become strong while a large part of deposits is in US Dollars (83 per cent), the “losses” of economic agents will appear significant [26, p.12].

Diversification of currency reserves is also essential for retaining confidence among the population, which is marginally putting at risk the remaining stability of the banking system. In January-March 2003, national currency deposits have shrunk by GEL 8.9 million and foreign currency deposits have grown by GEL 9.4 million. As against the respective period of the past year, deposits in national currency have grown by GEL 3.4 million and those in foreign currency by GEL 17 million [26, p.12]. As we see, expectations of economic agents, as compared to the relevant period of the last year, in 2003 are much more pessimistic. This is a result of both the undeveloped fiscal environment in the country and ongoing economic developments in the world. In particular, economic agents have decided that the US Dollar is a currency to which depreciation is not new and, like other currencies it is a reflection of the economic situation of its own country.

And last but not least, it should be underlined that the biggest problem for the safety of the Georgian economy is presented not by forming a “new exchange order” in the world but rather by a lack of economic policy in the country hampering regulation of the budgetary sphere and depriving Georgia of attractiveness for investment. In addition, in the absence of an optimal size public sector, Georgia runs a serious risk in its attempt to achieve economic stability and security.

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