The Global Financial Crisis

and the Difficulties of Economic Development in the Central Caucasian Countries

The contemporary global financial crisis has created complex problems the world over. The first signs of the crisis appeared in the US financial system in the summer of 2007. Later it expanded to Western Europe and Japan and reached all the developing countries and economies in transition by the end of 2008. Financial globalization is accelerating the spread of the crisis worldwide. The progression of today's financial crisis may be described in the simplest way by means of the following chain of transformations: first there was a mortgage crisis which, as should be expected, grew into a banking crisis, which led in turn to an industrial crisis. The current financial crisis is also labelled as a demand crisis. Therefore, today's financial crisis has transformed into an economic crisis or a financial-cum-economic crisis, which is very important for understanding the current economic difficulties.

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In numerous instances, overproduction of goods and services was a key characteristic feature of the economic crises of the 20th century. With respect to the nature of the current crisis, however, there is hitherto no universally shared opinion. Some believe that unlike the preceding crises, the cause of which rested upon the overproduction of goods and services, the root of the present one (which is labelled a "credit crisis") should be related to the overproduction of debts. Others suggest that the current crisis is nothing unique, but is actually the result of the previous situation of an overproduction of goods and services fuelled by the expansion of "fiduciary money" and resulting in excessive supply which eventually led to the current level of consumption of goods and services at the expense of future incomes, which sometimes were not received at all.

It appears that, with respect to the present economic crisis, both of those views are correct and by no means contradict each other. It simply depends upon the length of time in which the given phenomenon of the crisis is to be considered. Specifically, in the short-term perspective, the existence of debt overproduction is apparent. In other words, the crisis was preceded by the continued financing of growing current consumption. This financing was carried out by means of loans which were issued on the basis of some future, although not always realistic and reasonable, income. Moreover, due to it being tied up with consumption in the past, future income can hardly be used for consumption in the corresponding period of time. As a result, the cost of goods and services to be produced in the future is higher than the buying capacity of the income generated in the corresponding period. Consequently, in the long-term perspective, the effect of the overproduction of goods and services also becomes apparent.

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The post-communist countries shared common starting conditions and similar challenges twenty years ago, and they are currently encountering common problems in the conditions of the global crisis. The key objectives, however, and the ways in which to achieve them differ according to the extent they have overcome the communist past (as "leader" countries) or the extent to which they are enslaved by their communist heritage (as "outsider" countries).

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The transition period in the "outsider" post-communist countries has ended but, unfortunately, the economic (and not only economic) system of some of them is far from European-style capitalism. The phenomenon of the "outsider" post-communist countries can be explained by the human factor.

The dead enterprises which the "outsider" countries inherited from the command economy have proven to be quite tenacious. As a consequence, the market economies of the "outsider" countries have been hampered by the burden of a necroeconomy.

The occurrence of financial crises has encouraged the emergence of a kind of routine which guarantees the stability of a government's bailout programmes implemented throughout the banking sector in support of de-facto bankrupt firms. As a result, a network of zombie-banks and zombie-firms develops, upon which the entire system of the zombie-economy rests.

This threat of an economy's zombie-ing is even greater in the "outsider" countries, given that this zombie-ing also has a great deal to do with the necroeconomy, which is a factor that will make it rather difficult to improve an economy's health after the end of the financial crisis.

Certainly, there are more frequent cases of companies and banks becoming insolvent during an economic crisis, although it is very difficult for a government to make a political decision and put bankruptcy legislation into effect by initiating its activation. As a rule, governments are so interested in even artificially maintaining the employment level that, in order to achieve their political goals, they try to make a decision which will facilitate keeping insolvent companies and banks in business in the circumstances of an economic crisis. Therefore, the extent to which a government will go to continue supporting insolvent companies and banks in the post-crisis period, as well as the extent to which it will facilitate simplifying the bankruptcy procedures, is of great importance.

In the conditions of the current financial and economic crisis, the anti-crisis measures of all the post-communist countries contain the threat of zombie-ing the economy, whilst those of the "outsider" countries also contain the threat of zombie-ing the necroeconomy, which is a much worse phenomenon.

The countries without a communist past and the leading post-communist countries are likely to have better economic conditions in the post-crisis period. This optimism is founded on the relatively higher effectiveness of the bankruptcy legislation. Despite the challenges arising from the current financial and economic crisis, the bankruptcy processes in these countries are more dynamic compared to the other countries.

Although the financial markets in the countries of the Central Caucasus – Armenia, Azerbaijan and Georgia – are not well-developed, it was also expected that these countries too could not escape the negative implications of the global financial crisis. Further, this is not at all unusual if one bears in mind the fact that the economies of these "outsider" countries depend largely upon the economic situation in Russia, the EU, and the US.

In the absence of any serious deposits of natural resources, the global financial crisis has had a very serious impact on Armenia. This country was also gravely affected by the Russian-Georgian war. In particular, according to official sources, the direct and indirect damage inflicted on Armenia by the war is estimated at USD 700 million. In 2009, the GDP accounted for just 85.8 percent of its volume in 2008.[1] National budget revenues in the first quarter of 2009 fell by almost 10 percent against the level of the previous year.

As was expected, the crisis primarily hit the country's industrial sector where the enterprises of the necroeconomy are concentrated. In 2008, the production rate in the metallurgical and chemical industries fell to 9.6 and 14.8 percent, respectively, compared to 2007. In this regard, it must be noted that only

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[1] Armenian statistical information is available from the web-page of the National Statistical Service of the Republic of Armenia – http://www.armstat.am/en/.

98.7 percent of the total industrial production volume was sold in 2008 and, more remarkably, some 70 percent of those sales took place in the domestic market, which is a clear indication of the necroeconomic nature of some key sectors of the Armenian economy. So, the main problems in the Armenian economy are concentrated in the real sector.

In November 2008, the Armenian Government came up with an anti-crisis programme which, inter alia, provides for support of the local industries by means of subsidising or issuing governmental guarantees to companies experiencing certain difficulties and even purchasing a share in some of them. Within the framework of this approach, more than twenty companies have already received governmental assistance totaling USD 67 million.

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The significant role played by the Armenian diaspora in essentially all the spheres of Armenia's development should be particularly emphasised, primarily in rendering economic aid and in investments in the national economy. The main goal of the anti-crisis programme is to attract the funds of non-residents, particularly diaspora Armenians, into Armenian banking and, finally, the government's launching of the All-Armenian Bank, which will also act as a major shareholder (aimed at attracting the funds of diaspora Armenians for investments in Armenia).

Presently, there is a broad consensus over the fact that Azerbaijan has suffered the least damage from the global financial crisis compared to the other countries of the post-Soviet world. In 2008, in the conditions of an annual inflation rate of 20.8 percent, the GDP growth rate in Azerbaijan amounted to 10.8 percent. In this regard, it must be noted that economic growth in Azerbaijan in 2008 was basically conditioned by a 7-percent increase in the oil sector and a 15.7-percent increase in the non-oil sector.[2]

Azerbaijan's ability to cope better with the global financial crisis than any other post-Soviet country is fuelled by the following two factors: the underdevelopment of its financial sector and the domination of the oil and gas sector in the national economy.

At the same time, it is noteworthy that the loans attracted from foreign financial markets did not exceed 25 percent of all banking liabilities in Azerbaijan's banking sector.

Although the price of oil has significantly dropped in the context of the global financial crisis, the country's foreign currency reserves make it possible to alleviate the negative impact of the crisis. It is important to note that Azerbaijan has enough strategic currency reserves at present to finance the country's imports for 27 consecutive months.

In late 2008, Azerbaijani banks had to pay off approximately USD 1 billion in external debts. Furthermore, due to the scarcity of lending resources in the world markets, all of those banks reduced their lending programmes and some of them completely stopped providing loans to Azerbaijani households and enterprises. To maintain the stability of the exchange rate of the national currency, the National Bank of Azerbaijan, as the country's central bank, spent some USD 1.2 billion to buy manats in the first four months of 2009.

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As was to be expected, particular hardships have been suffered by necroeconomic enterprises; specifically, the steel, aluminum, and chemical industries. Pursuant to official statistics, whilst the overall growth of industrial output in Azerbaijan amounted to 103.9 percent during the first eight months of 2009 compared to the same period in 2008, the non-oil sector has demonstrated some decline; that is, the production rate for the same period of 2009 comprised only 94.3 percent of the similar indicator for the same period in 2008. Sumgayit, which is Azerbaijan's third largest city in terms of population and was famous during the Soviet period for its military-industrial complex, presently represents a classic example of a necroeconomic centre. Almost all of its enterprises – namely the plants of the state-owned Azerkimya chemical company, the state-owned Azerboru pipe factory, and Azeraluminum – remain either completely idle or work at extremely low capacities.

Also inoperative (or close to that status) are all the steel and metal-rolling factories that were created in the years of Azerbaijan's independence; namely, the Baku Steel Company, Baki Poladtekme JSC, and DHT Metal JSC.

One has to bear in mind that Azerbaijan's economic management system still retains some of the old-fashioned institutional schemes, such as

[2] Azerbaijani statistical information is available from the web-page of the State Statistical Committee of the Republic of Azerbaijan – http://www.azstat.org/indexen.php.

the independent disposition by almost all state-owned large industrial and infrastructure companies of their material and financial resources, the availability for many of those companies of some large budget assignations, and their privilege of enjoying some "tax holidays."

The summary economic indicators for 2008 clearly reflect the implications of both the global financial crisis and the Russian military aggression against Georgia.

In early 2009, the Government of Azerbaijan came up with a package of anti-crisis measures. It includes some preventive steps against the artificial growth of prices in the consumer market, the depositing of foreign currency reserves kept abroad in the most reliable local banks, ensuring reliable governmental control over the investment of these resources in the real sector of economy, enhancing assistance to export-oriented enterprises, increasing the volume of privileged loans to businessmen, intensifying the government's support of agriculture, etc.

The existence of the large necroeconomic sector, as well as the practice of financing businesses using public resources as one of the methods for combating the crisis, is a clear indication of the exposure of Azerbaijan's economy (including necroeconomy) to the danger of zombie-ing, which was discussed above in the general context of post-communist countries.

Generally speaking, the Georgian economy stood the test of the five-day Russian-Georgian war in August 2008, even though it has to deal with a considerable number of difficulties in the aftermath of the conflict.

In the course of 2008, all doubts regarding the negative impact of the global financial crisis on Georgia's economy disappeared. It must be noted that the summary economic indicators for 2008 clearly reflect the implications of both the global financial crisis and the Russian military aggression against Georgia.

As far as Georgia's economic crisis is concerned, it must be noted that the crisis also has its own domestic roots. The latter consist of the economic policy mistakes that the post-revolution government made in the aftermath of the Rose Revolution. Other factors which have contributed directly to the rise of the economic crisis in Georgia should also be mentioned, which include the following:

1. Huge amounts of FDI siphoned into the privatisation and acquisition of real estate which led to an obvious imbalance in which the inflow of financial resources into the country substantially exceeded the real sector's growth rates.

2. The government's relaxed control over the developments in the construction sector led to industry becoming dominated by "financial pyramids."

3. Banks incremented their lending resources basically by accumulating cheap resources from European financial markets with most of these resources being lent for construction and the acquisition of consumer goods, 100 percent of which are imported in Georgia. Almost all of the imported lending resources, therefore, were used to finance the construction businesses infected by "financial pyramids" and the import of consumer goods. Obviously, such developments could not have a positive influence on the country's economy.

In response to the Russian aggression, the international community extended significant financial assistance to Georgia as a victim of the aggression. At the conference held in Brussels under the aegis of the World Bank in October 2008, it was decided to allocate USD 4.55 billion in financial aid to post-war Georgia, USD 2 billion of which is a grant and the remainder a loan. Georgia will receive these funds during 2008-2010 and a major part of them will be spent on liquidating the economic damage inflicted on Georgia by the Russian military aggression.

The crisis has also badly affected the national budget. In June 2009, the Parliament of Georgia approved a USD 300 million cutting of tax revenues of the national budget, which accounts for 10.5 percent of all tax revenues previously planned for the fiscal year of 2009. At the same time, the national budget grew, the lion's share belonging to the abovementioned international donor assistance.

The negative effects of the Georgian economic crisis might have been far more distressing had the international community not extended a helping hand in response to the Russian military aggression.

2009 has hitherto been marked by an apparent decline in the Georgian economy. The year's GDP rate accounted for only 96.1 percent of its own level in 2008.[3]

In these circumstances, the ten largest companies of Georgia significantly reduced their production capacities and some stopped operating entirely, thereby creating favourable conditions for the

[3] Georgian statistical information is available from the web-page of the National Statistics office of Georgia – http://www.geostat.ge/index.php?action=0&lang=eng.

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succession of a necroeconomy. Although the government periodically buys large amounts of fertilisers from Georgia's largest chemical factory, Azot, even this enterprise has had to stop its production. Most surprisingly, however, these enterprises continued manufacturing their products during the first months of 2009, in the "best" tradition of a necroeconomy and despite the obvious crisis in the Georgian economy, even though there was no demand for their output. They simply stopped their activities in April and May when the warehouses were completely filled with unwanted products.

To help the country overcome the economic crisis, the Government of Georgia developed a so-called new financial package which is basically targeted at strengthening the banking and construction sectors. The package envisages Tbilisi City Hall issuing some financial guarantees to construction companies as a means of encouraging banks to lend money to the construction companies which will then be spent on renovation of the old districts of the capital.

The global financial crisis has created some general threats for all the post-communist countries of the world.

As one can see, although the problem of a necroeconomy in times of economic crisis is still very pertinent, fortunately, the government's anti-crisis plans have hitherto not given any indication that the government is going to finance necroeconomic facilities. On the other hand, it must be remembered that no official bankruptcy proceedings have been initiated to this point with respect to any of the necroeconomic enterprises of Georgia. Furthermore, as was noted above, the Government of Georgia is going to provide financial assistance to construction companies, many of which represent "financial pyramids." This is nothing but a step towards the zombieing of those construction companies and also of those banks that will extend loans to such construction companies owing to the financial guarantees from Tbilisi's City Hall.

The Central Caucasian economies suffer from the same basic problems as all the other post-communist countries, with the global financial crisis having created some general threats for all the post-communist countries of the world.

The only effective way to get rid of both the necroeconomy and zombie-economy is to adopt a sound bankruptcy law which, in turn, requires the strong political will of the ruling elite.

IMF recommends Azerbaijani government to continue increase of adequacy of tax regime to fundamentals of region.

On May 13, head of IMF Mission to Azerbaijan Nienke Oomes said in video conference between Washington and Baku, reduction of rate of tax on profits made from January 1 from 22 to 20 % made it adequate to rates of corporate income taxes, existing in the region.

"The government also lowered the maximum rate of income tax from 35 to 30%, but rate of individuals' income tax still remains inadequate to situation in the region. We recommended the government opportunity to reduce it to the level existing in Russia, Ukraine or Georgia," N. Oomes said.

IMF recognizes investment policy and practice of SOFAZ perfect

The IMF is impressed over operational results of the State Oil Fund of Azerbaijan (SOFAZ), received at the height of the global economic crisis in 2008 and 2009.

N. Oomes said, they do not have recommendations concerning improvement of activity of SOFAZ.

"We valued positively its activity in 2009 on management of own assets. SOFAZ demonstrated good risk management, its investment policy and procedures showed vitality and efficiency," N. Oomes said.

In 2009, SOFAZ received profit due to placing of its assets practically single out of the world Sovereign Wealth Funds.

The IMF does not make a tragedy out of integration of the SOCAR due transfer to it of functions of national operator for gas supplies and manufacture of chemical industry.

N. Oomes said, both advantages and lacks are available in dominating of SOCAR that often occurs in oil-producing countries.

"In 2009, SOCAR faced unexpected for it fall in the world oil prices and experienced problems with liquidity that caused necessity of lending by the Central Bank of Azerbaijan. It tells about poor quality of risk-management and finance management in the company, although, did not create problems for the country's tax policy. It is necessary for SOCAR to strengthen risk management system to exclude risk of tax losses for the state. Just in this connection, IMF recommends the government to strengthen financial monitoring system of all companies with the state participation," N. Oomes said.

Earlier, IMF recommended Azerbaijan to restructure the large state company monopolists, and now agrees to turn SOCAR into the first national company of Azerbaijan.