GEO-ECONOMICS

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ON THE FIRST-GENERATION POST-COMMUNIST REFORMS OF GEORGIA'S ECONOMY (*A RETROSPECTIVE ANALYSIS*)

Abstract

This article reviews the first-generation post-Communist reforms of Georgia's economy. It points out the mistakes made during the reform of post-Communist Georgia's economy and identifies the reasons for the failure of Shock Therapy in post-Communist Georgia based on an analysis of the successful economic reforms carried out in Poland.

It focuses special attention on how the mistakes were corrected, thus leading to the Minimum Shock with Maximum Therapy program that proved favorable for Georgia's economy.

Introduction

Twenty years after the disintegration of the Soviet Union and the restoration of Georgia's independence, an analysis of the processes characteristic of the initial stage of transition to a market economy warrants special attention.

The entire post-Communist space, as well as economic science, was unprepared for the fall of the command economy and the transition to a market economy. This caused the plethora of mistakes made at the beginning of the initial stage of the reforms.

The countries that were successful and those that failed in carrying out their economic reforms became apparent from the very beginning. Poland led the group of successful countries. So it stands to reason that many countries began following Poland's experience, although most of them were not as successful as Poland. This is mainly explained by the fact that neither the prerequisites required for beginning such reforms, nor the realities prevailing in these countries were taken into consideration before the reform process was launched.

The reform process in post-Communist Georgia was faulty from the very beginning, although later it was possible to overcome the problems. A study of Georgia's post-Communist economic reforms is interesting because Georgia became a country where Shock Therapy 'stretched over time,' which ultimately ended in a reform program known as Minimum Shock with Maximum Therapy.

This article aims to analyze the first-generation post-Communist reforms of Georgia's economy and the achievements and mistakes made at that stage. This is crucial for a better understanding of the difficulties related to the post-Communist transition economy.

How the Economic Reforms Began

The year 1989, when the idea of national independence first embraced the whole of society, should be considered the starting point of the post-Communist reforms in Georgia. It became a turning point for economists, resulting in the creation of a number of interesting new concepts linked to the idea of economic independence.[1] This stage of incipient reforms can provisionally be called *the stage of naive comprehension*.

The second stage of economic reforms started after the election of the Supreme Council in the fall of 1990. At that time, several very important laws on economic reform were passed, though they were unfortunately not implemented effectively. This stage of reform can therefore be considered *the stage of reform stagnation*.[2]

After the coup d'état of December 1991-January 1992, *the stage of populist economic reform* began.[3] At that time the government transferred land and housing to the people without compensation in order to enlist the easy support of the population. These redistributive policies caused substantial damage to the agricultural sector and housing construction. In particular, land privatization was carried out mechanically and it practically ruined the necessary infrastructure for agricultural production (the system responsible for supplying machinery, fertilizers, and other resources); and without a legal basis for private ownership of land, the efficiency of land tenure was very low. If housing rent had been differentiated according to location and amenities, the money thus received could have been accumulated for further housing development. This became impossible because of the overly hasty, free distribution of housing.[4]

During this populist stage of economic reform, the Shock Therapy method was launched in Georgia at almost the same time as it was applied in Russia and in accordance with the Russian scenario. Was Georgia ready to apply this well-known approach to economic reform?

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[1] See: V. Papava, "O kontseptsiakh ekonomicheskikh reform v SSSR," *Ekonomika i matamaticheskie metody*, Vol. 26, No. 6, 1990.

[2] See: V. Papava, "The Georgian Economy: Problems of Reform," *Eurasian Studies*, Vol. 2, No. 2, 1995.

[3] See: V. Papava, T. Beridze, "Problemy reformirovania gruzinskoi ekonomika," *Rossiiskii ekonomicheskii zhurnal*, No. 3, 1994.

[4] See: V. Papava, "O privatizatsii osnovnykh faktorov proizvodstva," *Pravila igry, Fair Play*, No. 3, 1992, pp. 97-101.

In order to answer this question, an important distinction of principle should be pointed out concerning the nature of the state. Whether or not a country enjoyed its own independent statehood at the beginning of its reform proved extremely important.[5] The countries of Eastern Europe, such as Poland, Hungary, Bulgaria, and so on, belonged to the first category, whereas the new countries formed following the disintegration of the U.S.S.R, Yugoslavia and Czechoslovakia, can be classified among the second. The only exceptions among the latter countries were the legal successors of the original larger states because they preserved almost all the attributes of statehood. So, after the disintegration of the U.S.S.R., Russia was recognized as its legal successor, retained Moscow as its capital, and preserved all the attributes of statehood, inheriting the institutions of the Former Soviet Union (FSU). Hence Russia can be classified among the group of post-Communist countries already possessing statehood. All the other countries had to build their own state institutions, often from almost nothing (to a certain extent, Ukraine and Belarus can be considered exceptions, since, although formally lacking independent statehood, they were already members of the United Nations). Georgia was one of the countries facing this situation. It therefore had to manage two major tasks simultaneously: the need to build new state institutions and undergo the transition from central planning to a market-type economy.[6]

As is well known, the Shock Therapy method of economic reform was first developed and used in West Germany after World War II. New life was breathed into it in post-Communist Poland with the introduction of the Balcerowicz Plan in 1990.[7] Implementation of this approach with respect to macroeconomic stabilization requires the active involvement of several different governmental institutions. Shock Therapy cannot be successfully applied in the absence of these crucial institutions, and any attempt to do so is doomed to failure. Georgia's experience also supports the validity of this view. It is not difficult to demonstrate this. It is enough to elaborate what Shock Therapy means according to the so-called Balcerowicz Plan (considered today to be the modern and already classical version of Shock Therapy) and then to study the mistakes made in implementing Shock Therapy in Georgia, where it blindly imitated the reflections in the Russian mirror.[8]

The Polish Experience and its Georgian Modification

Shock Therapy generally assumes implementing a tight fiscal policy. It entails the simultaneous adoption of measures involving price liberalization, a considerable reduction in the national budget deficit by canceling budgetary subsidies, and stringent control over the money supply and income of the population. The plan developed by former Polish finance minister Leszek Balcerowicz is considered an excellent modern example of the Shock Therapy method and is frequently referred to favora-

[5] See: L. Balcerowicz, *Socialism, Capitalism, Transformation,* CEU, Budapest, 1995, p. 146; B. Milanovic, *Income, Inequality and Poverty during the Transition from Planned to Market* Economy, The World Bank, Washington, D.C., 1998, p. 3; V. Papava, "O teorii postkommunisticheskoi transformatss ekonomiki," *Obschestvo i ekonomika,* No. 7, 2000; V. Papava, "On the Theory of Post-Communist Economic Transition to Market," *International Journal of Social Economics,* Vol. 32, No. 1/2, 2005.

[6] See: V. Papava, "The Georgian Economy: From 'Shock Therapy' to 'Social Promotion,'" *Communist Economies & Economic Transformation,* Vol. 8, No. 8, 1996, p. 252.

[7] See: L. Balcerowicz, "Poland, 1989-1992," in: *Political Economy of Economic Reform,* ed. by J. Williamson, Institute for International Economics, Washington, D.C., 1994; M. Schaffer, *The Economy of Poland,* Center for Economic Performance, Discussion Paper, No. 67, LSE, London, 1992.

[8] See: V. Papava, "The Georgian Economy: From 'Shock Therapy' to 'Social Promotion,'" V. Papava, "'Social Promotion' of Economic Reform in Georgia," *Economic Systems,* Vol. 20, No. 4, 1996; V. Papava, "The Georgian Economy: Main Directions and Initial Results of Reforms," in: *Systemic Change in Post-Communist Economies,* ed. by P.G. Hare, Macmillan Press, London, 1999.

bly by other transition economies. In accordance with this plan (which is the classical version of the modern Shock Therapy approach in post-Communist countries), the following measures were simultaneously implemented in Poland from the very start:

1. Multiple increases in all types of prices; a deliberate, although it was hoped temporary, increase in inflation aimed at ensuring and maintaining market equilibrium;
2. Tight restrictions on the (real) income of the population;
3. A substantial increase in (nominal) interest rates and restrictions of the money supply;
4. Increases in the interest rates on deposits aimed at encouraging the population to save;
5. Sharp cuts in national budget expenses by reducing government investments and by refusing to subsidize unprofitable enterprises any longer;
6. Issuing government bonds to help cover the national budget deficit;
7. Regulating the tax system and moving toward a more uniform, Western-type tax structure;
8. Introducing a common rate of exchange of the złoty to the dollar (involving substantial initial devaluation) and ensuring złoty convertibility in the domestic market;
9. Introducing a common customs tariff in order to restrict imports and stimulate exports;
10. Providing social assistance to the population within the limits of the government's capacity;
11. Eliminating monopoly positions and effecting a substantial withdrawal of administrative intervention in enterprise activities.

The use of Shock Therapy began in Russia on 2 January, 1992. A month later, it began in Georgia. To explain how the Shock Therapy method used in Georgia deviated from the Polish approach, it will be helpful to compare each step taken in Georgia with the corresponding item in the Balcerowicz Plan:

1. The reform of price formation started in Georgia as early as the spring of 1991 when free prices on some types of goods were introduced. Whereas in 1991 these changes were still of an exceptional nature, by February 1992 (that is, a month later than in Russia), radical changes had occurred in the price formation system in Georgia. For example, the price of one group of goods and services were liberalized, while the regulated price of another group increased considerably. All this was aimed at balancing the market. Whereas in 1991 the consumer price index stood at 1.8, in 1992 it rose to 25. At the same time, it is worth noting that regulated consumer prices increased 68-fold in 1992 compared to1991 (for bread, the main food product in Georgia, this hike was 100-fold). So we can say that the first item of the Balcerowicz Plan was on the whole fulfilled in Georgia;
2. In 1992, indexation of minimum wages and social security benefits was introduced in Georgia. In 1991, this indexation was carried out only once, but in 1992, during price formation liberalization, income indexation was performed six times. In 1991, the minimum wage and the average wage of employees increased compared to the previous year 1.85-fold and 1.26-fold, respectively, and in 1992, compared to 1991, 13.14-fold and 17.94-fold, respectively. True, no strict regulatory measures were carried out in Georgia to control increases in the wage fund (as was done in Poland, when in the event of a 2 percent overdraft from the wage fund the penalty imposed on an enterprise was equal to 200 percent of this sum; and if the overdraft was more than 2 percent the penalty was 300-500 percent of the corresponding sum); however, increases in wages and social security benefits lagged behind the price increases. Thus it can be considered that item two of the Balcerowicz Plan was also more or less fulfilled in Georgia;

3 and 4. In 1992, compared to 1991, the interest rate on deposits increased from 2 percent to 5 percent per annum, and for ten-year deposits it increased from 9 percent to 80 percent. This increase in the interest rate still far from reflected the actual inflation rate. It should also be noted that it was generally impossible to restrict the money supply in Georgia in those days by raising the interest rate, because the country had no monetary system of its own; only the ruble of the already disintegrated U.S.S.R. and the newly issued Russian ruble were in circulation in Georgia.

In the summer of 1992 it was decided to double cash deposits on a deferred withdrawal basis. In particular, on July 25 a decision was made to double cash deposits devalued by inflation on 1 August. The population immediately responded by depositing more money in cash deposits. On 1 August, a new decision was made to prolong the time for placing money in cash deposits for doubling until August 10. After doubling the additional money could not be withdrawn for another year, unless the money was to be used for privatization (which was, however, suspended at that time in Georgia). As it became rather difficult to receive the necessary quantity of bank notes from Russia in a timely manner in the second half of 1992, the money accumulated in this way was paid out as wages and pensions, which essentially prevented the government from restricting the money supply. As a result, it can be concluded that items three and four of the Balcerowicz Plan were not fulfilled in Georgia;

5. In 1992, the share of government investment in the total expenditure of the national budget was not reduced, and until that year it fluctuated within the range of 20-25 percent. The nominal amount of subsidies in 1992 compared to 1991 increased about 5.1-fold. However, in 1991 the share of subsidies in budget spending amounted to the remarkably high level of 47 percent, and in 1992 this was cut back to 30.1 percent. Even so, this does not make it possible to say that item five of the Balcerowicz Plan was realized in Georgia;
6. Government internal bonds were formally issued in 1992. But they were not offered for sale until the fall of 1993 and mainly in order to convert FSU bonds into new Georgian bonds. As for using government bonds to cover the national budget deficit, this did not prove feasible in subsequent years in Georgia.So it is clear that item six of the Balcerowicz Plan was not implemented either;
7. Comprehensive reform of the tax system in accordance with the requirements of the market economy started as early as the spring of 1991. For this reason, it can be considered that item seven of the Balcerowicz Plan was essentially fulfilled in Georgia at that time, although it should also be noted that further reform of the tax system is still going on, as it is in many other countries of the world;
8. In 1992, there was no national currency in Georgia, so it was essentially impossible to fulfill item eight of the Balcerowicz Plan;
9. In 1992, general customs tariffs were introduced at rates of 2 percent on imports and 8 percent on exports. Obviously, this policy did not favor either import restrictions or the export stimulation, so item nine of the Balcerowicz Plan was clearly not fulfilled in Georgia either;
10. It has already been mentioned that in 1992, as in 1991, there was income indexation, albeit imperfectly applied and subject to lags. At that time, any type of assistance to families with small incomes was disregarded. That is to say, the social protection system did not differentiate income levels in a way that supported those with low real incomes. As a result, the real minimum wage in 1992 amounted to only 86 percent of that of 1991. Since, despite the income indexation carried out in 1992, targeted assistance to the neediest families was inadequate, item ten of the Balcerowicz Plan was unfortunately not fulfilled;

11. In 1992, legal and government resolutions and decrees restricting monopolistic institutions and practices and promoting competition were issued for the first time in Georgia, although their effective implementation was significantly delayed. True, as early as 1991, the Soviet procedures ensuring centralized supply of resources to enterprises and final customers were disrupted and gradually abandoned, but many elements of state administrative interference in enterprise activity were still preserved. Hence, item eleven of the Balcerowicz Plan was not carried out at that time.

Thus, in 1992 in Georgia, eight out of the eleven items in the Balcerowicz Plan (that is, all apart from items one, two, and seven) were not fulfilled.

Such important measures as the cancelation or at least serious restriction of budgetary subsidies and tough restriction of the money supply were also neglected. Many of those items were indeed doomed to failure, particularly since there was no independent monetary system at that time in Georgia. In these conditions, implementing a defective version of Shock Therapy based only on price liberalization could hardly be expected to succeed. In other words, in the absence of corresponding governmental institutions, it was essentially impossible to make the transition to a market economy using Shock Therapy. In this situation it would have been much more effective to create the various institutions necessary both for pursuing the reforms and for building the Georgian state.

The populist stage of economic reform ended in the inevitable failure of the abortive Georgian modification of Shock Therapy, and this subsequently gave rise to serious delays in the economic reform process.

Manifestation of Mistakes

The stage of accumulation of mistakes includes 1993 and the first half of 1994.[9] One factor resulting in the delayed reforms was outside the economic sphere, while another factor explained the delays in terms of basic mistakes of economic policy. The economy of Georgia (and not only the economy) was neither prepared for the full-scale military operations that started in Abkhazia in the summer of 1992, nor for the civil war that intensified in the fall of 1993. These events seriously strained the national budget, and in 1993-1994 it proved impossible to get the budget approved in advance in the normal manner. The only possible way to cover the resulting deficits was money emissions.

Both due to the general amnesty announced in the winter of 1992, and later on through its participation in military operations (as a country without an army), the crime situation in Georgia worsened to the extent that it became too dangerous to conduct most economic activity. As a result, many businessmen left their native land, and this accelerated the outflow of capital. At the same time, undisguised robbery was replaced by racketeering, which was also detrimental to successful business development. As a rule, these criminal elements were unable to accumulate wealth. The reason for this was that the overwhelming majority of these people were drug addicts or had links with the drug industry, so there was substantial leakage of stolen property to the neighboring countries from where drugs illegally penetrated into Georgia.

In late 1992 and early 1993 the most important policy mistake was made. The government, for some reason, did not expect that it would receive additional banknotes from Moscow, so it put temporary banknotes of Georgia—the coupon of the National Bank of Georgia (NBG)—into circulation.[10] Unfortunately, representatives of the Georgian Government and the NBG were unable to take the new

[9] See: V. Papava, "The Georgian Economy: Problems of Reform."

[10] See: R. Gotsiridze, "National Currency of Georgia—The Lari," in: *Central Eurasia: National Currencies*, ed. by E.M. Ismailov, CA&CC Press, Stockholm, 2008, pp. 164-166.

currency seriously, sometimes showing a contemptuous attitude toward it. This had a decisive impact on the already serious devaluation process underway. Basically, the nature of the mistake was the illusion that it was economically expedient for Georgia to remain temporarily or even permanently in the proposed "ruble zone." As a result of this unfortunate illusion, the coupon did not become the sole legal tender of payment until July-August 1993 when Russia carried out partial currency reform of its own and withdrew the FSU ruble from circulation. This act made it clear that Georgia would have to introduce its own currency.

Uncontrolled credit emissions caused the inflationary process in Georgia. Attempts to solve agricultural problems (e.g., the procurement of agricultural products in the fall of 1993 and carrying out the essential agricultural work in the spring of 1994) from a budget that had been practically nonexistent since the fall of 1993 resulted in initially unreported budgetary emissions that ultimately ruined the country's financial system. Georgia developed a hyperinflationary spiral, with inflation galloping at a rate of about 60-70 percent per month from 1993 until the fall of 1994. In the long run, this money was not, unfortunately, used for agricultural purposes. In conditions of such high inflation, the coupon could not perform the normal function of sustaining commercial turnover because the real value of the coupon supply was constantly falling. All other things being equal, this promoted wider use of the ruble instead of the coupon as a means of payment.[11]

In 1991-1992, the foundations of the system of informal relations characteristic of low-income countries[12] were laid in Georgia.

The incorrect policy of the NBG toward restricting cash circulation (which gave rise, contrary to common sense, to restrictions on the withdrawal of coupons from the banking system) resulted in substantial discrepancies between cash and noncash monetary values. This further restricted the circulation of the coupon. Also, state-owned commercial banks tolerated excessive overdrafts, which promoted hidden credit emission. Subsidized prices on bread, gas, electricity, and transport put an additional load on the budget and also prompted budgetary emissions.

A serious error was perpetrated in Georgia's foreign trade policy, which allowed the "unique Georgian" clearing system to be consolidated. Barter was considered the only way to receive gas from Turkmenistan. The price of both Turkmen gas and of many poor-quality goods produced in Georgia was artificially high. According to the "innovators" of this approach, it would result in the creation of an environment for Georgian enterprises that stimulated their activity. It should be mentioned that such an environment for producing poor-quality goods has indeed been created. At the same time, this production had to be purchased by government. In the absence of a proper budget, however, this operation could be only partially carried out, and even then only by means of money emission (which also increased inflation). The government purchased most of this production from enterprises using a form of the state order system, with guarantees to pay the corresponding price in the future. Use of the state orders system required a complicated system of quotas and licensing. When receiving loans from different foreign countries and international organizations, in some cases the interest rates and prices on goods bought with the help of loans were artificially increased, and the loans received were partly used in less important directions. Needless to say, this put these enterprises in a difficult financial situation and resulted in the formation of a nonpayment network within the country, which was difficult to stop. It became impossible for the government to gather the full volume of goods within the country to fulfill the barter commodity exchange agreed upon with Turkmenistan. In recent years, the existing difficulties with the Azerbaijan transport route, i.e. the blocking of the railway line passing through Chechnia, have complicated the normal transportation of goods procured by the government to Turkmenistan, subsequently making it impossible. As a result of these difficulties and mis-

[11] See: L. Gurgenidze, M. Lobzhanidze, D. Onoprishvili, "Georgia: From Planning to Hyperinflation," *Communist Economies & Economic Transformation*, Vol. 6, No. 2, 1994.

[12] See: *Informal Finance in Low-Income Countries*, ed. by D.W. Adams, D.A. Fitchett, Westview Press, Boulder, 1992.

takes, Georgia's debt to Turkmenistan amounted to about half a billion U.S. dollars over two years. The country's total external debt rose to $1 billion.

Ignoring the interests of enterprise workers and employees effectively impeded the privatization process in 1992-1993 and held up the restructuring of enterprises into joint-stock companies.

Much of this lay behind the energy crisis associated with using loans for purposes other than those intended. This, along with nonpayment of the real cost of power resources (in other words, absurdly low domestic prices), chronic irresponsibility with respect to technical specifications that made it impossible to carry out not only capital renewal, but even routine repairs and maintenance, and constant theft of power equipment containing copper (including wire) to sell in Turkey, gave rise to an unprecedented collapse of production.

Moreover, given the general state of disarray in both national and enterprise-level accounting, it became impossible to obtain full information on companies and their activities. This, in turn, artificially exaggerated the already apparent decline in the major macroeconomic indicators and, at the enterprise level, facilitated companies' efforts to hide their tax liabilities.

This stage of economic reform was characterized by extremely imperfect recording of foreign economic activities, inefficient customs procedures, extensive waste of commodity stocks, a decline in the economic role of normal wages, unrecorded expansion of the shadow economy, and the use of humanitarian aid for purposes other than those intended. Overall, the picture of the Georgian economy was exceedingly bleak.

Minimum Shock with Maximum Therapy

At the beginning of 1994, Head of the Georgian State Eduard Shevardnadze initiated preparations for implementing an anti-crisis program of macroeconomic stabilization and systemic change. The program began in the spring of 1994, and this gave a good start to *the stage of correction of mistakes* committed during the earlier stages of the economic reforms.

This new stage of economic reform was also characterized by problems of a noneconomic nature. By the spring of 1994 the hostilities in Abkhazia had come to an end. This fact had a positive influence on the economy as a whole, but it also gave rise to a new problem: social protection of internally displaced persons (IDP), which placed a heavy burden on the national budget.

Law-enforcement institutions intensified the fight against criminals in order to improve the situation. Definite positive results were achieved, but the country still had a long way to go to solve the problem. Many enterprises, for instance, were afraid to undertake high levels of production for fear of being robbed by organized (including semi-official) and other criminal elements.

In the spring of 1994 the government gradually changed its attitude toward the coupon. According to the standard policy of the International Monetary Fund (IMF), it was ready to assist any country that had its own currency and whose government was doing its best to strengthen it. If Georgia stayed within the ruble zone, the IMF would undoubtedly prefer to work with Russia—the country issuing the ruble. This fact undermined the position of those in the Parliament and the Government (like Speaker of the Parliament and the Minister of Finance) supporting the ruble zone, since they would have had to openly advocate regarding the Russian ruble as the sole legal tender. Conversely, it assisted those in power who, from the very beginning, realized that the Georgian economy had no prospects without its own national currency. Interestingly, in 1994 a noble but perhaps hopeless experiment was already going on in Kutaisi, where the city authorities were supporting the coupon—the one region of Georgia to do so. All of this, together with the relative stabilization of the Georgian coupon and the worsening depreciation of the ruble, encouraged the population to take the coupon more seriously.

Uncontrolled monetary emissions became impossible owing to the increasing resolve of the authorities of the NBG. In the fall of 1994 the Bank cancelled the prevailing restrictions on the withdrawal of cash from banks under obvious pressure from the IMF. As a result, cash and noncash money values drew considerably closer to each other.

In late 1994, on the advice of the IMF, the NBG started regulating the banking system by means of the classical methods widely used elsewhere in the world. In addition to solving other problems, this also prevented the state-owned commercial banks from continuing to work in overdraft conditions. Moreover, corporatization of state-owned commercial banks began in the second half of 1994.

According to the program developed with the IMF in September 1994, the price of gas and electricity was raised to world levels, the price of bread increased 285-fold(!), subway fares increased greatly, and so did tariffs on other municipal services. Budget-supported employees enjoyed a wage increase, and pensions and social welfare payments were also raised, but these increases lagged considerably behind inflation. This enabled a great reduction in the budgetary subsidies needed to cover the discrepancies between consumer and production prices or between production prices and actual costs. This was followed by substantial strengthening of the rate of the Georgian coupon. Whereas before the price rise on bread, one dollar was worth 5.3 million coupons, after the price rise, one dollar was already valued at 2.4 million coupons. This process continued; at the end of 1994 the price of bread increased again by 40 percent and resulted in the establishment of a stable coupon exchange rate (at one dollar = 1.3 million coupons).[13]

Unfortunately, Georgia could not manage full money recovery on either gas or electricity. However, whereas enterprises and the population did not pay for their gas and electricity supplies, or paid only negligible sums, the cost of bread had to essentially be covered in full by the population. Delays in enforcing these payments encouraged economic entities to be more skeptical about the coupon: trade organizations, enterprises, and banks delayed corresponding money transfers and conducted speculative operations in the currency market, sustaining significant losses in the process. Starting in 1995, when the coupon rate became stable, timely withdrawal of these sums was prevented not only by the sluggishness of the banks, but also by some local authorities using these sums temporarily in order to manage their local budget problems.

What is more, the pseudo-protection of enterprises by some representatives of government, and the often groundless fears of the population about interruptions in supply, meant that enforcement of payments by cessation of deliveries—the normal method in market-type economies—was not achieved. Gas supply to the population of Tbilisi did not stop until January 1995. Carrying out a tighter policy to cover the cost of bread was achieved step-by-step in the first and second quarters of 1995.

The impossibility of collecting the full cost of gas and electricity also meant that the government could not revise the corresponding prices because of its general commitment to the reforms. The dollar prices of gas and electricity increased every month as a result of the strengthening of the coupon. This led to an artificial increase in the product cost, which primarily had an adverse effect on industrial enterprises. Following a review of its commitments to the IMF, the Georgian government reduced coupon prices. In particular, since April 1995 the cost of gas has been reduced by 35 percent and the cost of electricity by 25 percent. At the same time, the government of Georgia refused to purchase gas after June 1995. Instead, purchases had to be undertaken by immediate consumers, namely Sakenergo (the Georgian State Energy Company), big industrial enterprises, and municipalities. To enable consumers to directly purchase gas, the aforementioned Georgian clearing system was, in effect, annulled.

All this made it necessary to terminate quotas and simplify licensing. This process soon started. The system of quotas was completely annulled after 1 June, 1995, and licensing was preserved for

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[13] See: J.-Y. Wang, "From Coupon to Lari: Hyperinflation and Stabilization in Georgia," *Caucasica. The Journal of Caucasian Studies*, Vol. 1, 1998; S. Wellisz, "Georgia: A Brief Survey of Macroeconomic Problems and Policies," *Studies & Analyses*, Working Papers, No. 87, CASE, Warsaw, 1996.

only a limited list of goods.[14] Order was also reestablished in borrowing and the use of loans based on the practices established in connection with Georgia's first loans from the IMF and the World Bank. In December 1994, Georgia received the first tranche of a Systemic Transformation Facility (STF) (approximately $39 million) from the IMF.

Approval of the national budget by the Parliament at the beginning of 1995, after a two-year interval, can be considered a very important step toward establishing order in Georgia's financial system. The real significance of this budget was that credit and monetary emissions themselves were not used to balance budgetary revenue and expenditure. In 1995, only 47 percent of the expenditures of the national budget were covered by taxes and the remaining 53 percent had to be covered through the monetization of wheat and flour received as humanitarian aid (mobilizing the proceeds from sales in the national budget). In that way, the unbalanced budget could be balanced without money emission. This was achieved with the help of donor countries and institutions promoting the reforms in Georgia. Unfortunately, the planned macroeconomic indicators for the first two quarters were not achieved, although the actual results improved considerably with each passing month.

With the support and efforts of the IMF, most of the countries to which Georgia owed approximately $1 billion agreed to debt rescheduling. This allowed the IMF to issue the second credit tranche of the STF at the end of June 1995 (approximately $44 million) and a stand-by loan of approximately $113 million. All of this was expected to create conditions for Georgia to preserve financial stability, carry out currency reform, and put the Lari (the national currency) into circulation, avoiding the errors previously committed by the government in connection with the coupon.[15]

The exchange rate of the national currency was expected to remain unaltered until the end of 1995. After July 1995, the price of bread increased by 7 percent on average, while the wages of budget sector employees increased by an average of 50 percent. In the fall of 1995, there were plans to liberalize bread prices. The planned elimination of government monopoly in this sphere was expected to make this possible.

Beginning on 1 July, 1995, the minimum monthly wage of those employed in the budget sector was just $2.69 and the maximum $12.69. These figures are, of course, very low, although it should be recalled that at the beginning of September 1994 the minimum wage was less than ten cents, and the maximum a little more than one dollar (all evaluated based on the exchange rate at that time without adjustment for purchasing power parity).

As for sectoral development, the reforms in Georgia are being implemented most vigorously in healthcare where the reform project was elaborated in close cooperation with experts from the World Bank. A gradual transition to paid medical services and establishing a system of medical insurance began in the public health system.

In May 1994, the head of state issued a decree according to which enterprise personnel were given precedence in corporatization. This speeded up the process. At the same time, privatization by means of direct purchases was also encouraged. In 1995, the use of privatization vouchers began in Georgia, as in many other former Communist countries: part of public property was distributed to people free of charge.[16] This approach was justified by the necessity to give everyone a fair chance to acquire assets during privatization.[17]

The success of Shock Therapy in 1994-1995 rests on the paradox "The Worse, the Better." This situation can be classified as Minimum Shock with Maximum Therapy. Whereas there is a big question mark over the country's future and its ability to survive, there can be no doubt about

[14] See: V. Papava, T. Beridze, "Industrial Policy and Trade Regime in Georgia," *Eurasian Studies*, 1996/1997, Vol. 3, No. 4, 1996/1997.

[15] See: M. Kakulia, "Before and After the Introduction of the Lari: Georgian National Currency in Retrospect," in: *Central Eurasia: National Currencies*.

[16] See: A. Silagadze, T. Beridze, "Note on Privatization in Georgia," in: *Economic Transition in Russia and the New States of Eurasia*, ed. by B. Kamiński, M.E. Sharpe, New York, 1996.

[17] See: V. Papava, "Privatizatsia osnovnykh faktorov proizvodstva," pp. 92-97.

whether Shock Therapy was really needed, since under the circumstances the country had no other choice and positive results were almost guaranteed. Another way to describe this situation is a Soft Big Bang.[18]

Conclusion

Transition to a market economy was on Georgia's agenda immediately after regaining its independence. Unfortunately, the first steps toward a market economy were inconsistent. The later attempt to blindly copy the Polish model of Shock Therapy was not successful either, which is not surprising since Georgia did not even have its own monetary system.

Failure of Shock Therapy in Georgia gave the green light to populism in Georgia's economic policy. As a result, in 1993-1994 Georgia did not have a state budget approved by the Parliament. The country was caught in a hyperinflationary spiral and its temporary currency—the Georgian Coupon—was unacceptable to the market and population alike.

Steps were taken to achieve macroeconomic stability in a country facing economic failure. These steps included tight monetary policy, liberalization of bread prices, and enhancement of budget discipline. As a result, the Shock Therapy initially started was successfully completed and macroeconomic stability was achieved in Georgia in 1995. This made it possible to carry out successful currency reform, which completes the first-generation post-Communist reforms implemented in Georgia's economy.

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[18] See: V. Papava, *Necroeconomics: The Political Economy of Post-Communist Capitalism (Lessons from Georgia)*. New York, iUniverse, 2005, pp. 23-24; V. Papava, "On the Theory of Post-Communist Economic Transition to Market," *International Journal of Social Economics*, Vol. 32, No. 1/2, 2005, pp. 85-86.

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FACTORS DETERMINING THE DIFFERENCES IN FDI INFLOWS INTO AZERBAIJAN'S AND RUSSIA'S OIL SECTORS AFTER INDEPENDENCE

Abstract

This article examines the FDI inflows into Azerbaijan's and Russia's oil sectors between 1991 and 2006. It identifies the main reasons for Azerbaijan's advantage over Russia. The author first gives a brief explanation of FDI in general, then