Vladimer Papava

The “Rosy” Mistakes of the IMF and World Bank in Georgia

Abstract: The author criticizes the Georgian president for corrupt, populist, and incompetent economic policies and the IMF and World Bank for conniving at these policies for unprofessional reasons.

There is constant discussion in the academic literature of the role and significance of the institutions of the Bretton-Woods system and especially of the International Monetary Fund (IMF) in the world economy and in individual countries. The question of reforming the IMF becomes especially topical after the start of each more or less large-scale financial crisis. So it was after the crisis at the end of the 1990s; and this problem continues to be discussed today. The need to reform international financial institutions and the IMF in particular is not only acknowledged by the latter: it has become one of the priorities in the work of the IMF under conditions of financial crisis.

In order to work out a strategy for transforming these institutions, it is necessary to know about the mistakes that they have made in various countries of the world. In the context of postcommunist transformation, analysis of their activity in the countries of the former Soviet Union is of special interest. Unfortunately, emphasis is usually placed on the activity of the IMF and not on that of the World Bank.


Vladimer Papava is a Doctor of Economic Sciences, professor, corresponding member of the National Academy of Sciences of Georgia, and a chief research associate of the P. Gugushvili Institute of Economics.

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Of the post-Soviet countries, it is Georgia that has suffered the deepest economic decline. Far from all of the economic transformations conducted there have been justified and effective. IMF programs occupy a special place in the reform of the Georgian economy. Despite numerous miscalculations, important economic successes have been achieved on the basis of these programs.

In the present article, which is a continuation of a seven-year-old investigation, I analyze the period since the “Rose Revolution.” Besides the activity of the IMF, I examine the work that the World Bank has done throughout this period.

First, it is necessary to emphasize that the functions of these financial institutions are strictly divided. The main focus of the IMF’s activity is macroeconomic stability, while the programs of the World Bank are aimed at economic reforms in general, at institutional transformation, and at development of infrastructure and of sectors of the economy. Despite this division into spheres of activity, certain issues belong simultaneously to the fields of macroeconomic policy and institutional transformation; these, naturally, require joint consideration.

While before the “Rose Revolution” members of the IMF mission simply offered the government of Georgia erroneous recommendations, since 2004 both the IMF and the World Bank have looked at the transformations carried out by the Georgian government (including its mistakes) only through “rose-colored spectacles” and seen them in a rosy light. On this basis, the mistakes of the IMF and World Bank may be called “rosy.”

After 1999, due to the inert character of the Georgian government, the international financial institutions (and not they alone) lost hope in the ability of Georgia to return to the path of economic reform. The efforts of the Georgian government in the area of planning and implementing the state budget looked quite hopeless. Endless sequestrations made it completely obvious that the government lacked sufficient political will to fight corruption and that it was therefore unable qualitatively to change the situation with regard to tax collection. As a result, the IMF halted cooperation with Georgia in summer 2003; this also led automatically to curtailment of the program of the World Bank.

It must be regarded as a special achievement of the postrevolutionary government that it acquired the necessary political potential and imposed financial order. Even in 2004 tax revenues doubled, and the growth promised to be stable. This success, which was accompanied by declarations of adhesion to democratic values, made a very strong impression on countries and international organizations that were friendly to Georgia. The result was that the IMF renewed its program in Georgia, and this was followed by an analogous decision of the World Bank.
The success in fiscal policy (before the revolution it had been the government’s “Achilles’ heel”)—the upward leap in budgetary revenues—weakened the influence of the international financial institutions over the Georgian government. The staff of the IMF mission considered that the government was coping successfully with the mobilization of budgetary revenues and that recommendations on this matter from the IMF might even be superfluous. Furthermore, while before 2004 the IMF had literally prevented the Georgian government from changing the tax code, in 2004 it no longer blocked a reduction in the tax burden, which came into effect in 2005.11

Of special significance in this context was a conflict between the Georgian government and the heads of the IMF mission that became extremely acute in spring 2005 and was connected mainly with the existence of extrabudgetary accounts. This conflict culminated in the complete victory of the prime minister of Georgia, who in May 2005 visited Washington and demanded that the IMF leadership replace the acting head of the mission. The professionalism of the head of the mission could hardly be doubted: his demands had been justified. Nevertheless, he was recalled. This was a serious warning to all members of the mission and to its new head: any conflict with the Georgian government might put a sorry end to the career of any one of them. The permanent representative of the IMF in Tbilisi eventually managed to establish cooperation with the Georgian government in a form acceptable to both sides, and his stay in Georgia was extended twice—something that happens extremely rarely in IMF practice. Naturally, after this episode members of the IMF staff did not find it in their interest to enter into serious conflict with the Georgian government.

At the beginning of autumn 2007 the IMF program came to an end, and the government had no plans to start a new program. Only after the Russian–Georgian conflict in August 2008 did the IMF renew cooperation with the Georgian government.

**Extrabudgetary accounts**

Almost immediately after the “Rose Revolution,” extrabudgetary accounts were created in the name of the force structures; former state officials who were accused of corruption paid so-called freedom charges into these accounts after their arrest. It was considered that in this way people exposed as corrupt returned stolen money and property to the state, while the state gained an additional source of revenue. To be fair, it should be noted that only part of the “freedom charges” ended up in these accounts; the rest accumulated on the revenue side of the state budget.

It is of special importance that the spending of extrabudgetary funds was
a prerogative of the government and was not subject to public oversight: information about extrabudgetary accounts was not available to parliament, to the Audit Chamber of Georgia, or to the mass media. Only the magnitude of corresponding accruals to the state budget was therefore known, while the volume of funds in extrabudgetary accounts was not even susceptible to expert assessment.

It is clear that such a practice cannot ensure a stable source of revenue. Initially collections were more or less successful, but then the amounts collected from officials declined significantly. So the government switched its attention to business, compelling businessmen to pay so-called voluntary contributions into the extrabudgetary accounts.12

It is necessary to acknowledge that the system of extrabudgetary accounts was first used in Georgia as early as 1992. One of the chief measures initiated by the IMF in the second half of 1994 was to ensure that by 1995 all such accounts should either be made part of the budget or be eliminated. Against this background, it was unexpected that the IMF should close its eyes to the reopening of such accounts after the “Rose Revolution.” Unofficially the situation was explained in the IMF as follows: “If extrabudgetary accounts will help to reduce the level of corruption in the country, then so be it!” They seemed a lesser evil by comparison with bribery. But the IMF was mistaken in supporting the existence of a potentially corrupt and opaque institution.

Only after businessmen began to be pressed for “voluntary contributions” did the IMF demand that the Georgian government abolish extrabudgetary accounts. The greatest and most prolonged resistance to this came from the Ministry of Defense, whose extrabudgetary account was closed last—in the spring of 2006. As for the World Bank, despite its work against corruption it did not react in any way to the existence of extrabudgetary accounts.

Systematic violation of property rights

The greatest mistake made by the postrevolutionary government has been its encroachment on the right to private property.13 People have been compelled by pressure from the force structures “voluntarily” to cede their property to the state. This process has been carried out under the cover of so-called privatization, which is allegedly designed to correct the mistakes made in the course of privatization up to 2004—that is, under the Shevardnadze administration. In fact, there has been a redistribution of property in favor of businessmen who have close connections with the authorities. In this case too, however, the World Bank has not reacted in any way.

True, the permanent representative of the IMF in Tbilisi has pointed out the impermissibility of violations of property rights.14 He did so, however,
in an extraordinarily mild form and his statement had no consequences of any kind.

The selling off of state property

The large-scale privatization that was begun in 2004 has involved the violation of legislation. It is precisely by such means that Russian, Kazakh, and Arab capital has entered Georgia. Often a contract concluded between the state and a new private owner has indicated a sum that is only a small fraction of that originally announced. In the privatization of power engineering plants, for example, the Czech company Energo-pro declared that it would pay $312 million for ownership rights, but later the sum indicated in the contract was just $123 million.\(^{15}\) Not infrequently, firms with dubious founders and dubious capital were created for the purpose of privatizing certain objects, and it was precisely these firms that won the corresponding tenders.

In some cases, another state became the owner of Georgian state property (for instance, after the sale of Tbilisi Gas [Tbilgaz] its owner became a state company of Kazakhstan); this cannot be considered privatization. Unfortunately, however, no one has heard the World Bank’s opinion on this matter, although privatization is one of the most important issues for it.

Restriction of competition

After the “Rose Revolution” state institutions started to be dismantled, thereby weakening the Georgian state. In particular, at the end of 2004, in the framework of the reforms being conducted, the state antimonopoly service was abolished, and this contributed to growing monopolization of the market.

In October 2007, at a session of the government, the president of Georgia entrusted the function of antimonopoly regulation of the markets in salt, sugar, and other commodities to the Ministry of Internal Affairs.\(^ {16}\) This is complete nonsense, because this function has no connection with the work of the police or of the state security service. (Another curious incident of this sort occurred in spring 2006, when the president instructed the minister of defense to look for markets for the sale of Georgian wine.) This too, unfortunately, failed to attract the attention of the World Bank.

Manipulation of statistical data

Up to 2004 the State Department of Statistics (SDS) was directly subordinated to the country’s president. In 2004 the department was incorporated into the Ministry of Economic Development; this is absurd, for it means that the gov-
ernment not only works out and implements one or another economic policy but also publishes statistical information about the degree of success of this policy.* As a result, the statistical service now performs the same political function in Georgia as it did in the Soviet Union.

In August 2006, the SDS reported that the annual inflation rate as of July was 14.5 percent. The country’s central bank—the National Bank of Georgia (NBG)—and the government were rightly criticized by the permanent representative of the IMF in Tbilisi. But as a result the government dismissed the chairman of the SDS and the official who succeeded him was instructed by the prime minister gradually to “lower” the inflation indicators. The government declared that as of December 2006 the inflation rate in Georgia had fallen to 8.8 percent; formally this satisfied the IMF requirement that the rate should not reach double figures. Apart from the government, no one in Georgia believed the official inflation estimate, but the IMF not only made no protest at this “solution” to the inflation problem but even gave a positive appraisal of the work of the NBG and of the Georgian government as a whole.

**Populism of the government**

Unfortunately, after the revolution the Georgian government started to carry out populist economic programs, leading in practice to rising inflation. A special place among these programs is occupied by measures that have the noble aim of increasing employment: employers are required to place unemployed people in their firms for a period of three months with the state paying their wages, which rose from 150 lari per month in 2006 to 200 lari in 2007–8. As a result, tens of millions of lari have been spent from the state budget, but only a few individuals have obtained long-term employment. In the majority of cases, the employer and the unemployed person reach an understanding: the former is willing to sign any document stating that a specific person really is going to work and doing something in his firm, while the unemployed person is glad to receive 450 lari (later 600 lari) over three months for doing nothing. Some employers agree to sign the corresponding documents only if they are given half of the sum received from the state. As a result, the work placement program amounts to an unemployment benefits program. The additional money released onto the consumer market has, of course, fueled inflation. Moreover, before the elections the government initiated a program for students to clean up the city; this also added to inflation. Over the winter of 2007–8 the population was given vouchers, paid for from the state budget, for the purchase of

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*In Georgia, as in other post-Soviet states, the government under the prime minister is distinct from the president.—Trans.
various commodities, and the level of inflation rose even higher. And although controlling inflation is one of the most important functions of the IMF, it has not responded with any warnings to the government.

A taxation oddity

In 2006, on the initiative of the president, the 20 percent social tax and the 12 percent income tax became a single income tax set at 25 percent. The corresponding change in the taxation code entered into force in 2007. As the income tax and the social tax are calculated on different bases (the income tax is deducted from wages, while the social tax is based on the wage fund), it is impossible in principle to combine them, and it is hard to imagine the specialists at the IMF not knowing about this. In essence, the social tax on employers was abolished while the income tax on employees was increased from 12 percent to 25 percent.

Program to overcome poverty

As early as 2003, a program of economic development and poverty reduction was prepared and affirmed by the president; it then had strong approval from the IMF, World Bank, and other international institutions, which had participated actively in its preparation. But the government at that time was quite incapable of functioning and did not even begin to implement this program. The new authorities, rejecting everything done before them, assigned it to oblivion for four years. Nevertheless, both the IMF and the World Bank publicly declared that they were assisting in the implementation of a poverty reduction program in Georgia. Moreover, in September 2007 the IMF even announced that the program had been successfully completed. This was probably far from being the case, considering that in 2008 the authorities declared anew the start of the fight against poverty. However, it is a mere formality to call the preelectoral program under the slogan “A United Georgia Without Poverty!” a “program” at all, inasmuch as the document contained only adjurations, spread over several pages.

A free economic zone—an economic trap

The idea of a free economic zone (or an economic space in which privileges of various sorts are granted that do not apply in the rest of the country) is associated with the name of Aslan Abashidze, the former leader of Ajaria. Under conditions of economic liberalization the creation of a free economic zone is
superfluous, but neither Abashidze nor the postrevolutionary government took this into account.

The situation is complicated by the fact that the Georgian economy is currently suffering from an investment “famine.” To create a free economic zone under these conditions (the authorities have decided to put this idea into effect in the port city of Poti) will exacerbate the shortage of investment, thereby impeding economic development as a whole. Both foreign and domestic investors will put money only into the free economic zone around Poti. And this means that the economic development of Poti and the adjacent areas will take place at the expense of the rest of Georgia.

The IMF specialists held a seminar for those government ministers and members of parliament who are responsible for making economic policy, devoted to the negative consequences of creating free economic zones in countries suffering from an investment “famine.” They recommended in a mild manner that the Georgian government should not create a free economic zone, but no heed was taken of them.

Why has the IMF, in dealing with this problem, acted behind the scenes rather than publicly? After all, it had a joint program with the Georgian government that allowed it to convey its demands more firmly. As later became clear, one of the experts of the World Bank, even before the seminar was held, had given the authorities in the name of the bank a positive recommendation: the IMF wished to avoid an institutional confrontation with the World Bank. In this way, the economic interests of Georgia received short shrift.

Rejection of an independent central bank

As early as spring 2006, the Georgian government intended to curtail the powers of the National Bank of Georgia (NBG) and to this end prepared draft amendments to the law on the NBG, designed to transfer the function of banking oversight to an agency specially created for this purpose. These plans could not be carried out due to resistance from the directors of the NBG and from the parliamentary committee for finance and budget. In spring 2008, when the president of the NBG had retired and his duties were being performed by the vice president, the government seized the moment and (despite the opposition of the parliamentary committee) deprived the NBG of the power to exercise banking oversight, leaving it the sole function of regulating inflation. The IMF voiced in a memorandum the modest request not to violate the independence of the NBG. But no one was obliged to take any notice because by spring 2008 the IMF no longer had a program in Georgia.
Emission of Eurobonds and increase in the country’s foreign debt

After the “Rose Revolution” there was stable growth in revenues to the state budget. Nevertheless, in spring 2008 the government made an emission of Eurobonds, thereby increasing the country’s foreign debt by $500 million.\textsuperscript{23} The Georgian government has never stated the purpose of this borrowing, and so the taxpayers, who will have to repay 7.5 percent of the total credit each year up to 2013, remain ignorant of the plans for spending the borrowed money. Alas, neither the Georgian government nor the IMF has given any sort of explanation of this senseless emission.

“Green Friday”

After the “Rose Revolution” the Georgian economy began to fall sick with one of the varieties of “Dutch disease.”\textsuperscript{24} A substantial inflow of foreign currency resulted, above all, from the growth of foreign direct investment (FDI) and from monetary transfers by Georgian citizens living abroad.\textsuperscript{25} In autumn 2008, with the start of the global financial crisis, these sources dried up. The Georgian–Russian military conflict in August 2008 also had a negative effect on FDI.\textsuperscript{26} It became obvious that objective conditions necessitated devaluation of the national currency. But instead of carrying out a gradual devaluation of the lari, the NBG held the exchange rate practically unchanged for forty days, expending a fifth of its foreign currency reserves in the process.

On Friday, November 7, 2008, the exchange rate of the dollar flew up: in the morning a dollar cost 1.44 lari; by the evening the cash machines were empty and the exchange rate at the currency exchange points stood at 1.65, although no one was selling dollars. After completion of the first deal, trading at the Interbank Currency Exchange (ICE) was halted, supposedly for technical reasons; this caused a panic.\textsuperscript{27}

With four times as many imported as domestically produced goods on Georgia’s consumer market, “Green Friday” brought about a rise in prices, because importers did not understand what further steps the NBG would take.

In October 2008, a conference took place in Brussels under the aegis of the World Bank at which it was decided to allocate Georgia $4.55 billion in financial aid ($2 billion as grants, the rest as loans). This money is intended to cover the economic and social losses borne by Georgia as a result of the August war.\textsuperscript{28} For its part, the IMF also allocated $750 million for the purpose of macroeconomic stabilization.\textsuperscript{29} Such a substantial inflow of foreign currency
in principle excludes the possibility of a currency crisis in Georgia, but, unfortunately, the country is not insured against a repetition of “Green Friday.”\(^{30}\)

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Whether the postrevolutionary transformations in Georgia were real reforms or simply the destruction of previous institutions (as, for instance, in the case of the antimonopoly service), with the assistance of the international financial organizations all of them were eventually called reforms, and one of the agencies that issues international business ratings moved Georgia up from one-hundred twelfth to thirty-seventh, then to eighteenth, and finally to fifteenth place.\(^{31}\) But the prudent entrepreneur will hardly prefer to do business in Georgia, where elementary property rights are not protected, rather than in Sweden or Germany, which the same rating agency assigns to seventeenth and twenty-fifth place, respectively. Ratings are, as a rule, determined on the basis of information obtained from expert surveys, and these take no account of the problems that I have examined in this article.

For Georgia, as for any other country, it is important that the international financial institutions should not only patch up holes in the state budget but also provide competent advice. And, obviously, harm is done to a country when they acquiesce in mistakes made by its government. Although I do not doubt for a second that there are qualified specialists at the IMF and World Bank, the experience of postrevolutionary Georgia bears witness to the need to reform these institutions: their work should be guided primarily by professional values and not by considerations of any other kind.

Notes


5. See V. Papava and T. Beridze, Ocherki politicheskoi ekonomii postkommunisticheskogo kapitalizma (opit Gruzii) (Moscow: Delo i Servis, 2005).


9. It is only fair to note that such mistakes have been made not only by the Bretton-Woods institutions, but by many other partners and allies of Georgia (see V. Papava, “Georgia’s Hollow Revolution: Does Georgia’s Pro-Western and Anti-Russian Policy Amount to Democracy?” Harvard International Review, February 6, 2008; available at www.harvardir.org/articles/1682/1/).

10. V. Papava, “Ob osnovnykh makroekonomicheskikh indikatorakh ‘revoliutsii roz’ v Gruzii,” Ohschestvo i ekonomika, 2004, nos. 7–8; V. Papava, “The Political Economy of Georgia’s Rose Revolution,” Orbis: A Journal of World Affairs, 2006, vol. 50, no. 4. If the IMF reaches negative conclusions regarding macroeconomic stability, then funding of the World Bank’s program becomes senseless because under conditions of macroeconomic instability such funds cannot be used effectively or—the main thing—for their intended purpose.


20. V. Papava, “O tseleseobraznosti formirovaniia svobodnykh ekonomicheskikh zon
i opyt Gruzii,” in Problemy razvitiia vnesheekonomicheskikh sviazей i privlecheniya inostrannykh investitsii: regional’nyi aspekt, part 1 (Donetsk, 2002).

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