# The Georgian Economy: Problems of Reform

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Since independence in 1991, the Georgian economy has been in a severe decline. A break down in traditional trade and payments relations with other FSU countries, civil conflict and the war in Abkhazia, and expansionary financial policies have combined to effect a collapse in output, massive inflation and currency substitution, and a large external debt. The population's living standards have declined sharply, and the country has had to rely on external aid to help meet its most basic needs.

In close cooperation with the International Monetary Fund and World Bank, we have developed a program for economic stabilization and structural reform. This framework paper provides information on steps already taken by the Government on the road of economic reform and stabilization. In addition, this paper outlines measures the Government of Georgia proposes to implement in the immediate future. It is within this process of further and continuing reform that the Government of Georgia invites the international donor community to be a partner in Georgian development.

## A. Background

Georgia is a country of 5.4 million covering 70.000 square kilometers and bordered by Russia, Azerbaijan, Armenia, Turkey and the Black Sea. The country has traditionally served as an important trade and transit corridor between Europe and Asia.

Georgia is resource rich country. There are approximately 300 known mineral ores in the Republic; a bit more than half of which are currently being utilized. The principle mineral resource is manganese. There are also substantial reserves of corbanates and clay for production of cement and other construction materials. Total coal reserves are 400 million tons and known oil reserves are 27.5 million tons. About 40 % of the land area is agricultural, and 40 % is forested.

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Georgia was among the first republics of the FSU to declare independence doing so April 9, 1991. Although official pre-independence statistics on per capita income ranked Georgia relatively low among the republics of the FSU, it was in fact relatively well-off due in part to a strong tradition of entrepreneureship and an agricultural sector with significant private sector activity. The republic had the highest proportion of college graduates among the republics of the FSU and one of the highest levels of saving deposits.

In 1989-1991, industry accounted for 37 % of NMP and agruculture for 33 % - somewhat more than in the other FSU republics. The main products included agriculture (citrus, tea, wines), agro-industries (processed foods, fertilizers), and natural resources, notably manganese. Georgia was also a relatively large producer of steel-pipes, electric motors, synthetic fibres, roofing materials, texties, and shoes. The tourist subsector was well developed due to Georgia's geographical location, attractive climate, and abundance of agricultural product. Exports included wine, tea, citrus, mineral water, manganese, and light industrial products. Georgia was heavily dependent on imports of both raw materials and energy from other republics.

**B. Recent Economic Developments**

In recent years, the Georgian economy has experienced a severe economic decline. While they may underestimate private market activity, official estimates show NMP declining 21 % in 1991, 43 % in 1992, and 40 % in 1993. Since in 1989, industrial production has declined approximately 75 %, agricultural production has declined about 55 % and construction activity has virtually ceased. Real exports and imports have fallen sharply. Unfortunately, these tendencies have been continued in 1994.

Contributing factors in the economic decline include a number of factors common to all small, energy-importing republics of the FSU: the disruption of trade with the other republics sharply higher energy prices and difficulties in obtaining key imports. The increase in energy prices was devastating as the price of imported oil and natural gas increase over 500 % in dollar terms between 1990 and 1993. In addition, problems unique to Georgia have worsened the economic situation. The war in Abkhazia forced some 270.000 refugees to flee their homes placing a severe burden on the economy. The war directly affected Georgia's citrus and tea export crops and decimated the tourism industry. Civil strife and a deterioration of law and order in 1992 and 1993 disrupted the economy and consumed the Government's attention.

Fortunately, the political and social situation in the country has improved considerably over the last year althought the economic situation has not. The war in Abkhazia has ceased. While progress to date has been disappointingly slow, Georgia has consistently sought a peaceful resolution of the Abkhazia conflict and the peaceful return of the refugees to their homes. Actions implemented in the spring of 1994 have resulted in a sharp reduction in the criminal activity. The improvement in the political and social situation has enabled the Government to turn its full attention to solving the economic crisis. With the assistance of the World Bank, IMF, other international agencies and bilateral donors we are determined to do so.

The impact of the economic decline on the Georgian population has been considerable. Even with a substantial rise in private sector employment, total employment has declined approximately 30 % since 1990. In addition hidden unemployment is widespread. Wages of most workers in the state sector, as well as pentanes and unemployment compensation, are less then a US $ 2-3 per mounth. While many are able to supplement this wages with private sector activity, many can not. Natural gas and electricity are rationed and central heating was discontinued in 1993. From January 12, 1995 the Govlernment halted gas supply to the population (households) because only 9 % of due payments were paid by them. Many rural families have been able to swich to wood heat but this is creating a problem with deforestation. Most rural residents are without electricity and urban residents are subject to extended blackouts. Recent increases in bread prices will increase the hardship for many.

While the situation has improved dramatically in recent months, the Georgan economy has also been beset with hyperinflation. Prices increased approximately 60 % a mounth from mid 1993 through mid 1994. The foreign exchange value of the Georgian coupon declined accordingly. Shortly after it was issued in April 1993 the Georgian coupon traded at 700 hundred coupons per US $ 1. In late October 1994 the rate was 2.030.000 coupons per US $ 1. As a result there has been widespread currency substitution. The Dollar and Ruble are now used in most private market transactions. The Government of Georgia recognizes that this inflation is primarily the result of the fiscal policies followed in recent years. It the past the Government had little alternative to large budget deficits due to the large economic and social problems faced by the Government and reduced ability to collect taxes due to the civil unrest and decline in the Government's authority. As outlined below, steps are now being taken to reduce our budget deficit. In recent months the inflation has lessened and the foreign exchange value of the coupon has stabilized.

Georgia joined the World Bank and IMF in 1992 and began reform program in cooperation with both institutions shortly thereafter. Unfortunately, both these relationships and our reform program were interrupted by the war and accompanying breakdown of law and order. With the return of social stability, our relationships with the Bretton Wood institutions were re-established early 1994 and we have been working closely with them to stabilize and reform the Georgian economy. In December 1994, Georgia received first tranche of **Systemic Transformation Facility** (STF) from the IMF. We expect negotiations with the World Bank on the Economic Rehabilitation Loan to be completed in the near future. We will now detail the reforms which we have undertaken to date and our plans for the future.

### C. Stabilization Polices

**Fiscal Policy.** Our most immediate economic challenge is to stop the inflation which has beset the Georgian economy. High inflation hampers investment and discourages economic activity. As noted above, the Georgian Government that this inflation is the result of the fiscal and monetary policies of the recent years. In 1993, taxes and other revenues covered about 28 % of the combined government budget; the rest was financed by money emission. With the assistance of the IMF, we have put together a program to reduce our budget defficts and strict limits on National Bank financing have been agreed to. Our Parliament has passed a budget which provides a "zero" deficit for the final quarter of 1994 and we have put in place expenditure controls to assure that this is realized. This "zero" deficit was covered not by money emission but by monetarization of humanitarian aid. The same principles were used for the 1995 budget, which was approved by the Parliament on January 11, 1995.

**Expenditures.** Despite the greate needs facing our Government, we are working to reduce expenditures. In the recent past, subsidies for natural gas, electricity, and bread accounted for sizable portion of Government expenditures. In May 1994, energy prices for the non-household sector were increased significantly and many large natural gas consumers began negotiating their own contracts with foreign suppliers. In September 1994, natural gas and electricity prices were increased to world levels for all consumers including households. In the future, these prices will be adjusted each month to maintain parity with world energy prices. In September 1994, bread prices were raised from 700 coupons per kg to 200.000 coupons a kg - an increase of 285 times the previous level. From December 1994 bread prices increased by 40 %. The Government intends to completely eliminate bread subsidy in the nearest future. In conjunction with energy and bread price increases, Government wages and pensions were increased somewhat but the overall effect was a substantial reduction in expenditures (and real wages). Obviously, these price increases are difficult for he Georgian people in the current economic conditions but the Government felt they were necessary in order to establish control of the budget and inflation.

Budget subsidies to state owned enterprises (SOEs) have been elimated. In addition, the Government reduced the number of workers on the state payroll approximately 30 %. Defence expenditures, which were never very high - even during the war in Abkhazia - are also being reduced. To improve budgetary control all accounts of the Republican Government have now been centralized in the National Bank and a system of strict expenditure control under the Minister of Finance has been instituted. Local Governments are prohibited from borrowing from the National Bank.

**Taxes.** The Government is also working to improve tax collections, which amounted to only 3 % of GDP in 1993 and reached 4 % of GDP in 1994. To this end, a special enforcement unit has been established within the office of the Tax Inspectorate with strong economic incentives for finding tax avoiders. In addition, penalties for late payment and for non-payment of taxes have been increased substantially. The decline in the inflation rate should also help improve tax collections by reducing the incentive to delay tax payment. The Tax Law adopted in December 1993, moved the tax structure away from taxes which are difficult to collect, such as the profits tax, and toward more collectible taxes, such as excise taxes. Finally, we look forward to further improvements in the tax area with technical assistance of the World Bank and IMF.

Until the Fall 1994, Georgia has a 14 % VAT, a profit tax with rates ranging from 10 % to 35 % with exemptions for new enterprise, an income tax with rates ranging from 12 % to 20 %, a 2 % duty on non-CIS imports, a property tax, several excise taxes, a tax on kiosks, and several minor taxes. Following the IMF recommendations, by the end of 1994 we raised the VAT to 20 %, imposed a 10 % VAT on bread, increased the import duty to 12 %, increased the tax on kiosks, raised the tax on gasoline to 15 %, and eliminated the tax on exports. In addition, road transport, precious metals, casinos, and some agricultural raw materials will no longer the exempt from the VAT.

**Monetary Policy.** Since the present National Bank administration was installed in mid 1993, monetary policy has been more strictly enforced. Almost no new credit has been extended to the banking system since that time. As some of the old bank debt was repaid to the National Bank, a portion (but a small portion) was re-auctioned off in order to establish the free market base rate. In dollar terms, credit to banks has been reduced over 90 % from the June 1993 level. All restrictions on cash withdrawals from Coupon accounts have been elimanated. In attempt to sterlize part of the money emission due to the Government deficits, reserve requirements on deposits in both domestic and foreign currencise were raised to 20 %. Many banks, particularly the private commercial banks, are having trouble in meeting these requirements but actual reserve holdings have been increasing steadily and the National Bank has frozen the accounts of those banks which are not making progress in increasing their reserves.

As proviously noted, due to the hyperinflation which has occurred, the population has lost confidence in the Georgian Coupon and currency substitution is widespread. Once the budget is under control and the foreign exchange value of currency can be stabilized, we intend to introduce a new national currency, the Lari.

**Exchange rate and trade policies.** Georgia has flexible exchange rate. Exchange rates are set twice weekly in auctions on the Tbilisi Interbank Currency Exchange (TICEX). At present, there is a 32 % surrender requirement at the market rate determined in the TICEX auctions; the Government intends to abolish this requirement by the end of 1995.

Since the fiscal reforms were introduced in September 1994, the Coupon has stabilized against the US dollar and strenghened against the Russian ruble. On September 20, the coupon traded at 2.4 million coupons per $ 1 and 1030 coupons per 1 ruble on TICEX. On October 28, the rates on the TICEX were 2.03 million coupons per $ 1 and 660 coupons per 1 ruble. End February 1995, the rates on the TICEX were 1.3 million coupons per $ 1 and 300 coupons per 1 ruble.

**External Debt.** Presently, Georgia's external debt totals approximately $ 1 billion including arrears. Our largest obligation consists of debt arising from our imports of natural gas from Turkmenistan. We also have sizable debts to Russia and EU. Georgia takes its debt obligations seriously and intends to do its best to meet them. However, our present lack of foreign exchange earnings makes this extremely difficult. We are instituting negotiations with our creditors in hopes of restructuring our debt on more concessional terms and within our ability to pay.

**D. Structural Policies.**

**Prices.** Almost all prices were liberalized in 1992. Currently under the Government's control are prices of bread, municipal services, natural gas, electricity, public transportation, communications, and some medicines. With the recent increase in energy price, most of these administered prices have now been raised to world levels. Bread prices have also been raised considerably. We intend to completely eliminate the bread subsidy in the nearest future, and in 1995 the Bread Corporation wil broken up and privatized. We also intend to increase transportation prices to world levels.

The recent energy price increases create several problems. In the case of natural gas, most gas for household sector is not metered but is priced on the basis of average consumption. It is not technologically possible to cut off many natural gas users for non-payment. The electricity situation is better but again some users are not metered. The problem of collecting gas and electricity bills is serious one and is receiving the Governments closest attention.

**Social Safety net and Wages.** Our budget resources do not allow us to establish an adequate social safety net. In september 1994, in conjunction with the price increases for bread, gas and electricty, the minimum wage level was increased to 1 million coupons (or about $ 0.50) a month. In addition, wages and pension of all receiving less than 2.5 million coupons (about $ 1.20) have been supplemented to bring them to that level - resulting in significant salary compression. Allowances are also received by single mothers and refugees. From January 1995 these amounts increased by 50 %. This shift from general subsidies to a benefit system will allow us to target the Governments limited resources to those most in need.

The new wage and benefit levels are clearly not adequate, but our budget constraints do not allow us to do more at this time. The current minimum wage and pension (which is about 10 kg. of bread) is not sufficient to feed a family much less provide clothing or housing. Indeed, our statisticians estimate the cost of the necessary market basket for one person at 73 million coupons per month. Of course many are able to supplement this income with private sector activities or by selling family assets but many can not. Most of the Georgian population was without heat last winter and will be again next winter. Electiricity will be severely rationed. The patience of the Georgian people in the face of this hardship is remarkable.

**Privatization.** Georgia was one of the first republics to privatize housing doing so in early 1992. At present about 40 % of cultivated agricultural land and 75 % of vineyards have been privatized. While more then 2100 enterprises had been privatized by mid February 1995, privatization of state enterprises has not proceeded as fast as the Government wishes. However, a new law passed in spring of 1994 giving employees the right of first refusal and allowing the Ministry of State Property Management to initiate the privatization process is speeding up the privatization process significantly. We intend to complete the small scale privatization process in 1995. We expect to commence a voucher based program of mass privatization of large enterprises in the first half of 1995. About 30 % of large enterprises have corporatized to date.

**Financial sector reform.** Some 225 private commercial banks have been formed in Georgia but many are not financially sound. The National Banks has made substantial progress in its efforts to regulate and strengthen the banking system. Minimum capital requirements have been increased over ten fold and reserve requirements have been increased to 20 %. Accounts of non-complying banks have been frozen and several banks have been closed. The payments system has been strengthened and speeded up and penalties for overdrafts have been increased substantially. The state commercial banks are being corporatized and will be privatized.

In co-operation with the IMF, the Government has drafted a new National Bank law which will strengthen money and credit regulations, enhance the National Bank's supervisory role, and increase the independence of the National Bank. The National Bank intends to start a system of on-site inspections code and debtor-creditor laws inhibit banks from making mortgage or collateralized loans. In addition, modern accounting and control system need to be introduced. We also need to develop financial markets, including a money market, and to increase the accountability and reliability of investment firms (several of which have disapperad with their depositors' money).

**Health and Education.** Georgia has a high quality health system but one that is beyond our current ability to finance. A detailed reform proposal has been approved by the Cabinet of Ministers and will be submitted to Parliament shortly. This reform will guarentee all citizens basic but limited health services. All other treatment will be on a free for services basis. Some hospitals and clinics will be privatized and all will become self managing. Our educational reform program guarantees nine years of free basic education. Education beyond this basic level would be self-financed with asistance for the needy.

**Government reform and private sector development.** To help balance the budget and to better accommotade the role of the state in a market economy, the Government is planning a restrueturing of the state administrative structure. We reduced the number of workers on the government payroll by approximately 30 %. Obsolete and redundant government structures will be elimanated. The current state order system phased out and replaced by procurement according to market principles. To encourage exports, legislation has been submitted to the Parliament to eliminate the current export duty. In addition current export licensing requirements (which are basically automatic at present) will be eliminated. Recognizing the importance of attracting foreign investment, the Government of Georgia intends to create an environment which will encourage foreign investors to participate in our economy including unrestricted remission of earnings and dividends.

**E. Financial Needs.**

The Government of Georgia is extermely indebted to our friends in the international community who have already extended aid to us. The level of humanitarian assistance to Georgia has been immense and is greatly appreciated by both the Government and people of Georgia. Without it many of our people would have faced starvation. We still face a large grain shortage and still have approximately 270.000 refugees who can not return to their homes in Abkhazia.

At this point, our main development need is for balance of payments assistance which will allow Georgian producers to import the imputes, equipment, and energy necessary to restart production. Before independence, Georgia was highly integrated with the rest of the Soviet Union and was dependent on imports for raw materials, intermediate goods and energy. The disruption of trade with the FSU has had a large negative impact on the Georgian economy. The decline in exports has been sharp with estimates ranging as high as 90 %. Due to the resulting lack of foreign exchange, imports of imputes and energy have also been severely curtailed.

Aside from some hydroelectric power, virtually all of Georgia's energy is imported. Since 1990 official imports of fuel oil, gasoline and diesel fuel have been reduced approximately 90 % - although official imports are supplemented somewhat by cross-border imports of gasoline. Imports of electricty, which totaled 5.5 billon KWH in 1990, have virtually ceased and the power line from Russia has been destroyed. Due to substantial arrears, Turkmenistan has reduced its natural gas deliveries to less than one third the 1990 level.

Balance of payments (BDP) support at this time will enable Georgian producers to obtain the necessary inputs to restart production so that they can employ our citizens to export once again. Imports of crucial agricultural chemicals will enable private Georgian formers to increase production (which has declined 55 % since 1991) and restore our position as an exporter of fruits, vegetable, and wine to the FSU.

Together with our fiscal reforms, balance of payments support will allow us to stop the hyperinflation which is hampering our development and our transformation to a market economy. While beneficial in the long-run, the expenditure cuts and tax increases which we have instituted to-date, and are planning to institute in the near future will have a negative impact on economic activity in the immediate future. BOP support will enable us to bridge the gap until our economy can adjust to this new fiscal structure. By providing some foreign exchange reserves, BOP support will allow us to stabilize and restore confidence in the Georgian coupon and allow us to introduce our new currency, the Lari. Finally, BOP support will ease the adjustment to our structural reforms.

While our main purpose at this time is to seek BOP support, the need and potential for public investment support in the future is also great. To mention a few, Georgia has great hydroelectric potential both for domestic consumption and export that is not being realized at present. Our power supply systems are also in disrepair. We have reserves of oil, gas, and coal and need assistance in evaluating and realizing their potential. Our roads and railways are in serious disrepair and are a hindrance to economic development.

Improvements in this sector would provide some of the needed infrastructure for development. Improvements in our ports in Poti and Batumi are needed both for our use and to enable us to serve other countries in the region.

The economic challenge facing the Georgian Government is formidable. The condition of our economy and our people is dire. However, the Georgian people are highly educated and resourceful and, as demonstrated by their perseverance the last few years, their tolerance for hardship and will to survive is great. With the assistance of the international community, we are confident that we can thorough our current problems and realize our high economic potential.