Political and economic risk assessment: Georgia

Commissioned by the
Ministry of Energy Georgia

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1 General description

Located in the troubled South Caucasian region between the Caspian and the Black Sea, two factors have combined to put Georgia on the geopolitical map over the last few years: First of all, the 2003 Rose Revolution that swept Mikhail Saakashvili to power made Georgia a symbol of Western values in a region troubled by an authoritarian past as well as present, and it put the question of NATO expansion firmly on the alliance's agenda. Second, Georgia has become a transit country for Caspian and possibly Central Asian oil and gas through the pipelines running through the country. While making the country more important for the Euro-Atlantic structures, these two factors have at the same time antagonised Russia, which holds the key to resolving the two frozen conflicts in Georgia – in Abkhazia and in South Ossetia.

1.1 Current investment climate in brief

The formal framework for foreign direct investment in Georgia has long been favourable, established by the Law on Investment Activity Promotion and Guarantees from 1996, and includes the right of an investor to convert profit and other monetary assets into foreign currency and freely repatriate them, as well as export property. However, for a long time, these favourable laws mattered less to investors than insecure property rights, rampant corruption and political mismanagement.

However, since the 2003, the Saakashvili administration has made substantial progress in these areas, and made further efforts to improve the general business climate. Georgia was named the world's top anticorruption reformer by the World Bank's "Anticorruption in Transition-3" report in 2006. There are still some problems with corruption, and according to a 2005 EBRD/World Bank Business Environment and Enterprise Performance Survey (BEEPS), 38% of Georgian companies state that corruption is a constraint when doing business. However, compared to the 2002 survey, where 60% reported corruption as a major obstacle, this result implies significant progress.

The climate for new businesses is good, and improving in Georgia. Starting up a business is relatively simple. According to the World Bank/IFC Doing Business Survey 2006, it requires only seven procedures and takes 16 days. Georgia has also done a lot to cut back on red tape. The Law on Licenses and Permits has introduced new measures to curb corruption and to streamline the process of setting up a business, cutting the number of licenses from more than 900 to approximately 150. A similar simplification has been applied to customs, where there are now only three different tariffs, and where all raw materials and equipment imported to Georgia are exempt from custom fees, with the exception of construction materials. The number of permits related to export and import has been reduced to eight.

As seen in Table 1.1, Georgia has improved dramatically only in the year from 2005 to 2007 on almost all aspects of doing business in a World Bank Survey. The country has moved up from 137 place in the world in 2005 to 18 place in 2005. These improvements have earned Georgia a 2^{th} place of 29 countries in Eastern Europe and Central Asia with Estonia only one place ahead and countries like Germany and the Netherlands now behind Georgia in the rankings.

Table 1.1 *The ease of doing business in Georgia ranking worldwide*

Ease of...	Doing Business 2008 rank	Doing Business 2007 rank	Change in rank
Doing Business	**18**	**35**	**17**
Starting a Business	10	39	29
Dealing with Licenses	11	27	16
Employing Workers	4	4	0
Registering Property	11	18	7
Getting Credit	48	62	14
Protecting Investors	33	120	87
Paying Taxes	102	103	1
Trading Across Borders	64	59	-5
Enforcing Contracts	42	42	0
Closing a Business	105	87	-18

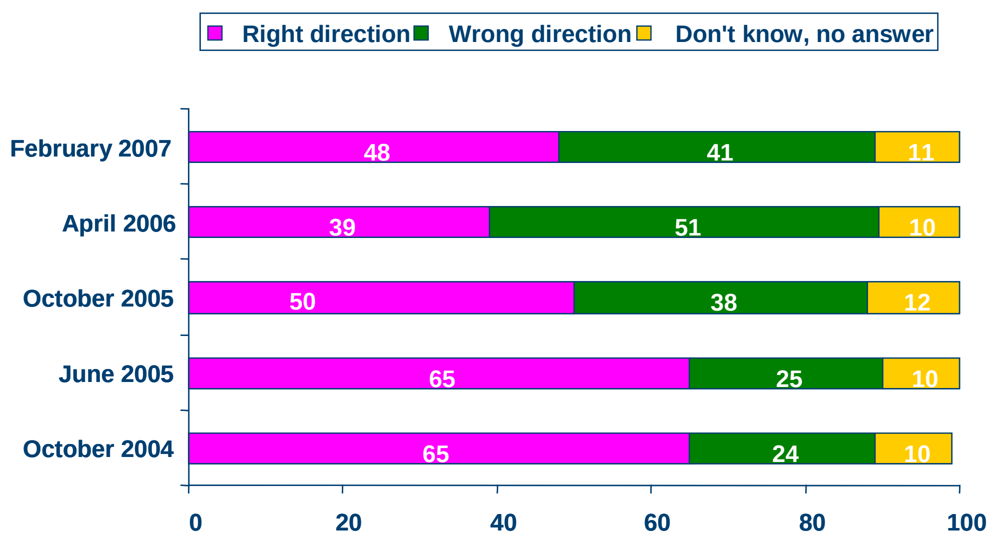
Source: www.doingbusiness.org (The World Bank)

1.2 Regime stability and reform sustainability

1.2.1 General mood of the population

President Saakshvili came to power on a reform agenda that enjoyed public support against a backdrop of rampant corruption and ineffective government. Winning 96 percent of the votes in elections in January 2004, Saakashvili had a powerful mandate to instigate reforms. However, many of the reforms the new regime initiated have been and are painful for different groups within society, both for business groups that previously enjoyed privileged positions, and for the part of population that has seen prices on important goods rise faster than income.

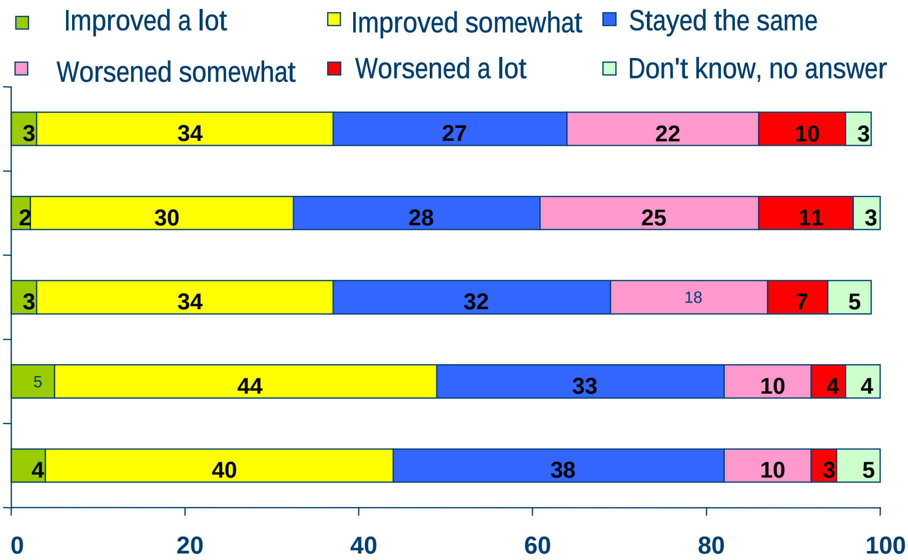
Figure 1.1 *General political sentiment*



Source: Georgian National Voter Study, 2007

If we look at the general mood of the population, the Saakashvili government's policies enjoyed relatively high approval ratings throughout 2004 and early 2005. However, the proportion who believed the country to be heading in the right direction declined markedly through 2005 and 2006, as the first euphoria of revolution passed, and as reforms started to bite, reaching a low of 39 percent. However, the downward trend seems to have been reversed. Increasing welfare in the wake of sustained growth is a likely candidate to explain the positive turn.

Figure 1.2 Economic sentiment. Has the economic condition in Georgia…



Source: Georgian National Voter Study, 2007

If we look in more detail at people's perception of the economic situation in the country, it shows a roughly similar trend, with a decline until 2006, and then a growing optimism. In February 2007, 37 percent believed things had got better over the last three months, and only 32 percent believed the opposite. It was widely expected that the combination of unrealistic expectations and painful reform would lead to a drop in confidence in the government – the question was how deep and how lasting that effect would be, and whether the positive effects of better governance would be evident fast enough to stop the decline.

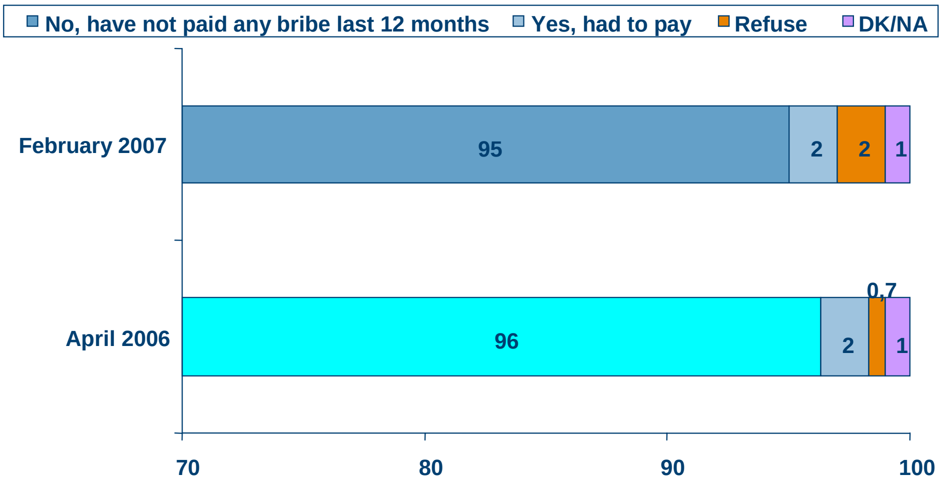
Several other parameters show a similar development over time, and points to a turning of the tide in late 2006, even as the country endured political and economic conflicts with Russia, as will be discussed more below. That the tide seems to have turned might reflect both an adaptation of initial expectations, and a real improvement of conditions. Whether or not the positive attitudes will continue, will largely depend on the economic performance in the years come. Important parameters are not only GDP growth, but also inflation, wages and unemployment. These factors will be discussed in more detail below.

1.2.2 Reforms

A major area for reform in the Saakashvili administration has been anti-corruption campaigns. By reorganizing – and firing much of – the previously endemically corrupt traffic police, much petty corruption has disappeared. The administration also dismissed corrupt officials in the judiciary. In the Customs Department of Georgia, a significant source of corruption in the Shervernadze era, the new administration has reduced and cut tariffs, simplified rules, and enhanced transparency. Another sector where major achievements have been accomplished is within higher education, a system previously dominated by nepotism, petty corruption and unequal access. Stricter controls concerning exams and admissions have improved the situation significantly.

Corruption is by its illicit nature not an easy thing to measure. As mentioned above, Georgia was named the world's top anticorruption reformer by the World Bank in 2006. And indeed, by some measurements of how people experience corruption in their every day life, it seems that results have been significant. In February 2007, 95% reported that they had not paid any bribes in the last 12 months. Unfortunately, comparable data do not exist for the pre-Saakashvili era.

Figure 1.3 People's experience with everyday corruption last 12 months



Source: Georgian National Voter Study, 2007

However, some comparisons can be done regarding the overall monetary size of the problem. According to companies surveyed in 2005 in BEEPS, bribes amounted to 0.4 % of annual sales, compared to 2.7% of sales reported by companies in 2002.

Still, these efforts do not imply that all is well still. Some have complained that the reforms to some extent have replaced an old corrupt elite with a new elite, which, although less corrupt, is not immune to the underlying logic of the system. Allegations of cronyism within the Saakashvili government do not alleviate fears that favouritism in investigation of corruption might occur. That corruption still occurs in prominent cases was exemplified by the arrest of Davit Gogichaishvili, head of the Economic Development Ministry's department for registration and privatizations of state property in the Samtskhe-Javakheti province, on charges for extorting USD 105 000 from entrepreneurs, related to their prospects of success at auctions. The ministry says the crime warrants a sentence of 15 years' imprisonment. Hopefully, the arrest also signals that corruption is taken seriously at the highest level, and that incidents will be prosecuted.

Transparency International is perhaps the most authoritative source on corruption world wide. Their evaluation of Georgia is not as bright as that of the World Bank. However, they, too, have noted significant and accelerating progress – from a very low level.

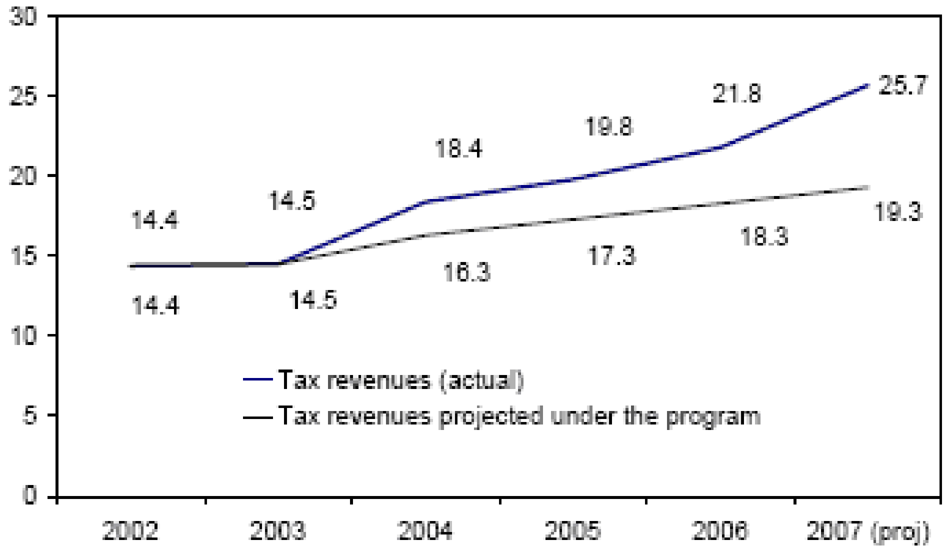
Table 1.2 Transparency International Corruption Perception Index

TI Corruption Perception Index	2003	Rank	2004	Rank	2005	Rank	2006	Rank	2007	Rank
Georgia	1.8	124/133	2.0	133/146	2.3	130/159	2.8	99/163		

Source: Transparency International

Another early reform priority of the Saakashvili administration was a newly, simplified tax code, introduced in 2005, with a flat 12 percent income tax. Simpler and more favourable rules have induced increased collection rates, and tax revenue has increased significantly each year, as shown on the figure.

Figure 1.4 Tax revenues, percentage of GDP

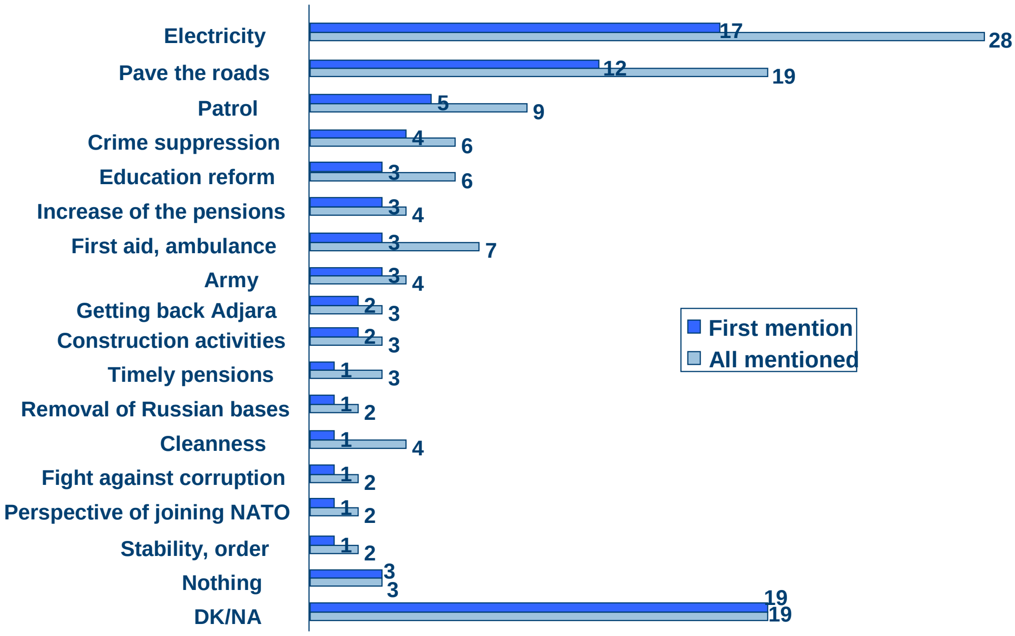


Source: IMF

The government continues its drive for lower and simpler taxes. This summer, it was decided further to reduce corporate profit taxes from 20% to 15%, and furthermore to combine the personal income tax (currently 12%) and the social payroll tax (currently (20%) at a new level of 25%. Given the positive development of government revenues, strong economic growth, and acceptable levels of public debt, these tax cuts seem sustainable in the medium term.

Another main area for reform has been the power sector itself, as is detailed in a separate report. Suffice it here to say that increased collection rate, planning, investment and management have contributed to increase the reliability and robustness of the power sector dramatically. This improvement has had a direct and significant impact in the lives of ordinary people, and the Saakashvili administration's work in this field is in polls hailed as its greatest achievement.

Figure 1.5 Achievements of the Saakashvili administration



Source: Georgian National Voter Study, 2007

Thus, although there from time to time is discontent with high prices, both in the era of electricity and in other areas, it seems that the public in general prefers a system that works to a system that doesn't, even if they have to pay for it.

1.2.3 Opposition

The opposition to the Saakashvili regime and to the economic reforms associated with it, is relatively weak, and relatively fragmented. National Movement – Democrats, which is the faction representing Saakashvili's party and that of his partner Nino Burjanadze, holds 125 of 235 representatives in Parliament, and all other factions hold less than 20, and frequently quarrel between them. Most agree on the fundamental principles of market reform, although some politicians seek to benefit from some popular resentment, particularly towards higher prices. For instance, when the government presented a new programme for economic reform this autumn, the criticism from opposition was that the programme was not *specific*, rather than that the goals or even the means were misguided. However, the opposition does sometimes unite in protesting what it sees as tendencies towards authoritarianism, favouritism or corruption within the ruling party.

The National Movement reiterated its electoral success in local elections in autumn 2006, and seems set to a new victory in elections in October 2008, when parliamentary and presidential elections will be held together, in a change that opposition parties have deemed authoritarian.

Interestingly, as in several former Soviet republics, the most potent threat to the sitting leader comes not from any real political opposition, but rather from within. Today, the second most popular politician in Georgia is former defence minister Irakli Okruashvili, who has gained popularity with a hawkish, nationalist stance in relation to Russia and to the two break-away regions, South Ossetia and Abkhazia. Okruashvili made a name for himself by such infamous statements as the one saying that Georgian troops would celebrate New Year's Eve in Tskinkhvali, the capital of South Ossetia.

Outlook: All in all, the domestic political situation in the years to come seems relatively stable, as long as relatively stable macroeconomic conditions can be maintained, as will be discussed in more detail below. The general mood of the population, even after the euphoria of the first post-revolution period, is relatively good, and improving as reforms start having effect on people's everyday life.

Many important reforms have been carried through in the areas of corruption, taxation, electricity and other areas. Although results are not perfect, reforms seem generally to have positive effects, and by now they are also perceived favourably. Favourable legislation already exists for foreign direct investment, and the trend is to improve conditions, for instance through the creation of special economic zones. There is little opposition to the principles of economic reform, so even in the unlikely event of a landslide election for opposition parties, the main policies would remain in place.

However, nationalist, hawkish politicians could gain credence if relations with Russia and the break-away regions spin out of control. Thus, these conflicts also represent a danger for Georgia's internal development and policy choices.

1.3 The frozen conflicts and relations with Russia

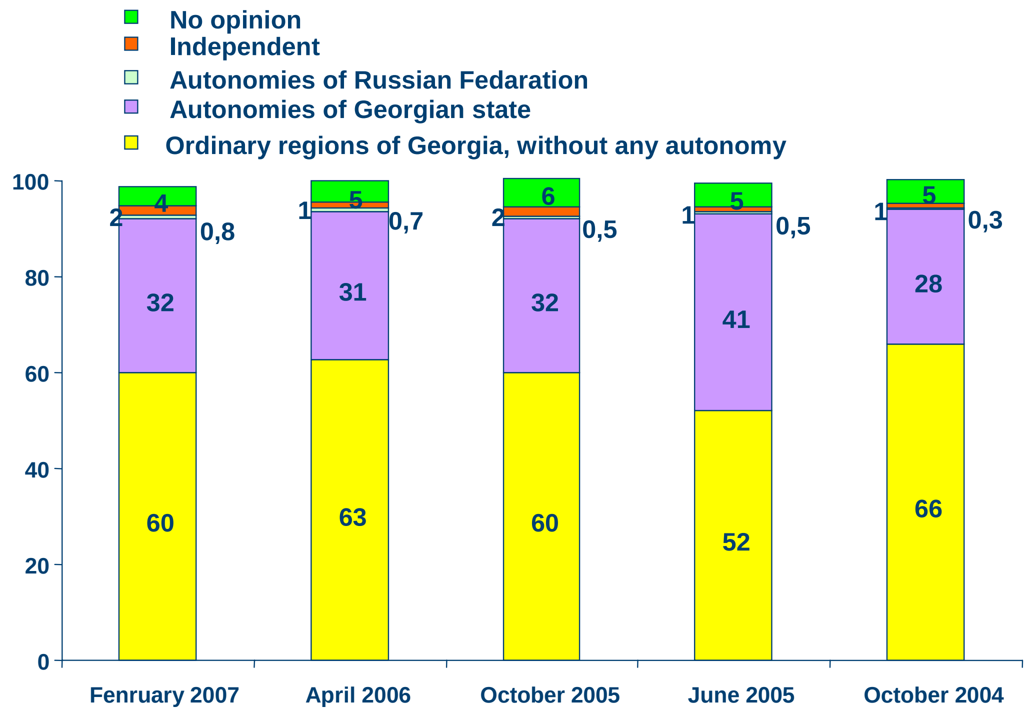
The conflicts with Abkhazia and South Ossetia remain Georgia's main political challenge, and are inextricably linked to the country's relations with Russia. Both conflicts date to the post-independence civil wars, which left some 20,000 dead and forced several hundred thousands to flee their homes. Continuing ethnic tensions, unhealed wounds from the wars, power politics and corruption have combined with a strong Russian interest in the break-away regions to hamper attempts at reaching settlements to these conflicts.

1.3.1 Georgian strategy

Since coming to power, the Saakashvili has made it a priority to re-establish Georgian authority in the three break-away regions he inherited, Abkhazia, Adjara and South Ossetia. The goal has been to convince the break-away regions to accept a high degree of autonomy within a sovereign Georgian state. The means have been a mixture of threats, negotiation initiatives, a military build-up and a wish to attract the population of the break-away regions through economic opportunities in a Georgian economy in growth. Furthermore, the Georgian government's aim to join NATO and the EU, should also be seen in light of these conflicts. The Saakashvili government has from time to time appeared to act in an overly confrontational manner with regard to these conflicts. However, it should be pointed out that under Saakashvili's watch, a solution was found with the third break-away region, Adjara. In the other two break-away regions, however, the Georgian strategy has yielded mixed results.

The Georgian population is overwhelmingly and relatively stably against granting any for of independence or even autonomy to the break-away regions. Memories of war, the experience of war veterans and the large number of internally displaced people combine to make concessions politically extremely difficult, and also opens up the possibility of populist politicians playing the nationalist card.

Figure 1.6 Attitude towards future status of break-away regions



Source: Georgian National Voter Study, 2007

1.3.2 South Ossetia

In South-Ossetia, the harsher stance of the Saakashvili Government led to renewed tensions in 2004. Since then, the Georgian side has put on the table numerous initiatives aimed at resolving the situation, receiving support from both OSCE and PACE. South Ossetian secessionist authorities, led by Eduard Kokoity, have responded by holding a referendum on the status of the territory, which resulted in an overwhelming majority for continuing *de facto* independence, without the participation of the territory's ethnic Georgians. In parallel, however, an Ossetian opposition to Kokoity, led by Dmitri Sanakoev, organised presidential elections where both ethnic Georgians and ethnic Ossetians participated. In April 2007, Georgia recognised Sanakoev's "government" as the "Provisional Administration of South Ossetia".

Saakashvili's government has put a lot of effort into resolving the South Ossetian conflict. However, these efforts have provoked both Russia – who will not risk losing its influence in the region – and many Ossetians, who have little trust in Georgian intentions. Trust has not been helped by the often bellicose and anti-Russian form of Georgian initiatives, especially during the tenure of Minister of Defence Irakli Okruashvili. As Okruashvili has been replaced by the more moderate Davit Kezerashvili, and as Russo-Georgian relations are slowly starting to "normalise" somewhat, it might be hoped that future Georgian initiatives could have a higher chance of being heard.

1.3.3 Abkhazia

In Abkhazia, the conflict seems even more difficult to resolve. The Georgian offer of a high degree of autonomy in 2005 was turned down by the Moscow-backed Sukhumi-based government, and the Russian involvement in Abkhazia is so heavy that no solution seems possible without a marked shift in Russia's policies. In 2000, Russia started issuing passports to citizens of Abkhazia, who would not otherwise be able to travel. Subsequently, about 80 percent of the population have received Russian citizenship, although they are exempt of Russian taxes and military obligations, and although they have no voting rights.

The situation in Abkhazia intensified in October 2006, when Georgian troops conducted operations in the Georgian controlled Kodori valley, coinciding with a general deterioration in Russo-Georgian relations.

Outlook: In the short term, the Georgian initiatives might have made the situation less predictable and more unstable, first and foremost by bringing front and centre the continued Georgian insistence on sovereignty over the region, a claim which was not pursued actively in the preceding years. Although there is no reason to doubt the sincere wish of the Georgian side for a peaceful solution to the issues, Russia has so far proved unwilling seriously to discuss any initiatives, and Russia might very well wish to use South Ossetia and especially Abkhazia as a stumbling stone for Georgian accession to NATO.

In South Ossetia, there is some contact between the parties, and there is the confusing and unclear effect of the provisional authority, supporting dialogue with Tbilisi. However, even here, tensions can easily be reignited, as demonstrated by the dispute about the water situation in Tsinkhvali in June 2007, caused by a pipeline problem.

In Abkhazia, the situation seems more deadlocked, and the both the territory, the economy and the population is more closely linked to Russia. With Sochi hosting the Olympics in 2014, Moscow might be inclined to avoid serious confrontations next door; but if present policies persist, Russia is also unlikely to yield Abkhazia.

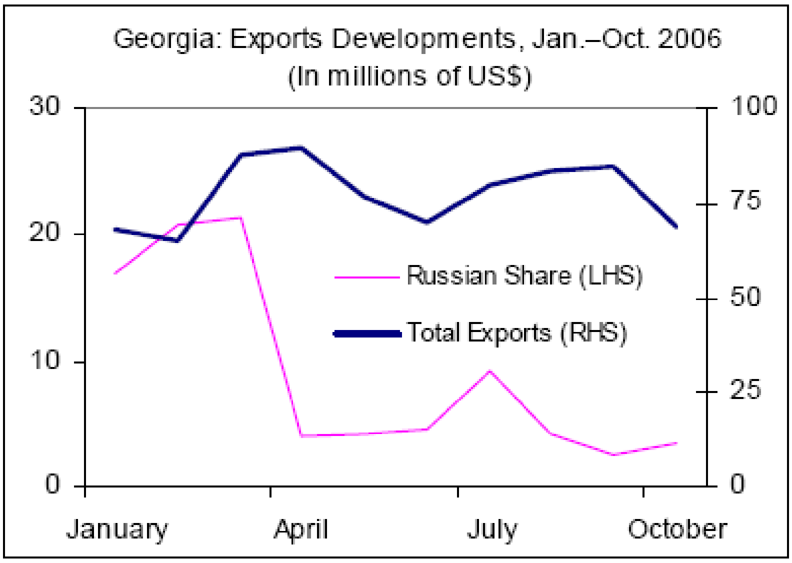
1.4 Russian interests in the frozen conflicts and in Georgia

At present, Russia does not seem inclined to do much to find a solution – any solution – to these conflicts. The main reason is that Russia has a strategic interest in retaining influence in the South Caucasus. One vehicle for such influence has been the frozen conflicts in the region, including in Abkhazia, South Ossetia in Georgia and also in Nagorny Karabach in Azerbaijan.

In the Georgian case, the usefulness of such influence has, in the Russian mind, increased as Georgia is aspiring towards integration into Euro-Atlantic structures. Russia presently considers the prevention of such inclusion by countries in its "near abroad" a strategic priority, not least in the South Caucasus. The pipelines through Georgia linking Caspian oil and gas to European markets in competition with Russian pipelines, further strengthen the Russian perception that an ability to influence the development and the stability in the region both for better and for worse remains essential.

To accomplish these objectives, Russia has often not shied away from covert and open interference to create instability in Georgia. Russia seized on the espionage controversy in September 2006, and moved to halt trade and direct flights between the two countries, as well as clamping down on Georgians living in Russia. Apart from playing to an ever more xenophobic and nationalist Russian public, these moves apparently intended to hurt the Georgian economy, thus creating instability in the country. However, the Georgian economy adapted surprisingly quickly to the Russian trade sanctions, shifting to other markets, or reaching Russia through third countries. In this respect, the Russian move was a one-off, and has deprived Russia of economic leverage in Georiga. However, although these specific moves must be considered unsuccessful, there is no reason to assume that the Russian intent has changed.

Figure 1.7 Georgian exports to Russia



Source: IMF

Russia still has many tools at its disposal in conflicts with Georgia. In addition to the ability to block any solutions in Abkhazia and South Ossetia, Russia controls important assets in Georgia, and in particular in the energy sector. RAO UES, the Russian electricity monopolist, holds the following positions:

- a 75 per cent stake in AO "Telasi" distribution company which owns the 0.4-110 kV networks and substations
- a 100 per cent stake in OOO "Mtkvari Energetika" (the company owns power units 9 and 10 at the Tbilisskaya TPP, each having an installed capacity of 300 MW
- the right to manage 100 percent shares in AO "Khrami HPP I" and AO "Khrami HPP II", two hydropower plants each having installed capacity of 110 MW.

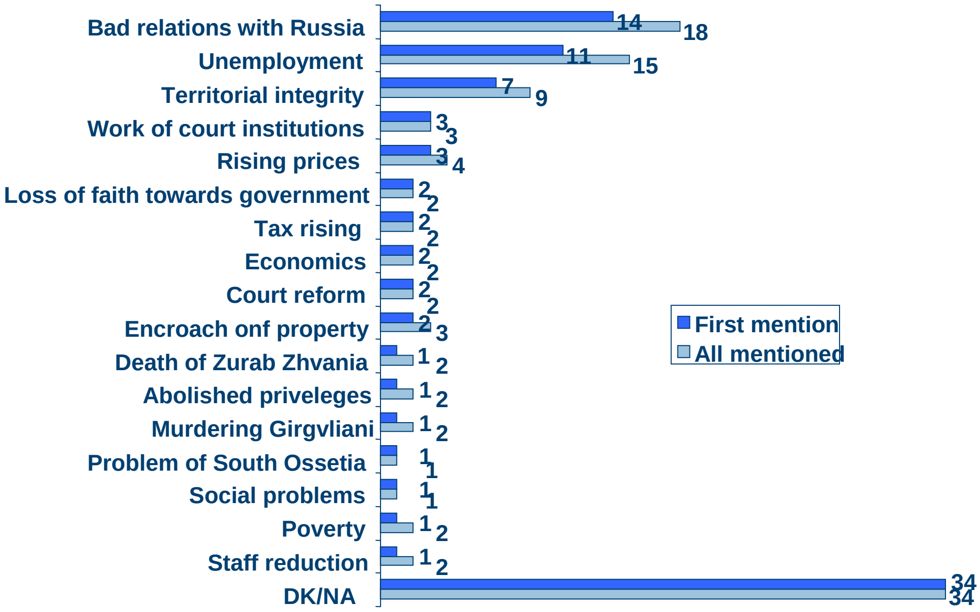
Although these investments do make sense from a business perspective, and although RAO UES has so far been used markedly less to further political goals than its gas counterpart Gazprom, nothing should be excluded if relations continue to deteriorate.

Russia's actions towards Georgia are not an isolated aberration in Russian foreign policy; rather, the last three-four years have increasingly seen Russian authorities applying crude economic sanctions toward former Soviet states in (mostly unsuccessful) attempts to influence developments there. A direct precedent for the trade sanctions against Georgia might have been the gas price increases in the Ukraine, a move that might have influenced election results in that country.

A small sign of rapprochement was given when president Saakashvili and president Putin met in St. Petersburg in June, and hints were given that the trade sanctions might be lifted gradually. However, on 6 August, a new round of confrontations started, as a missile hit a field in Georgia. Georgian authorities maintain the missile was fired from Russian military aircrafts, a charge denied by Russia.

Although there is a political stand-off between the two countries, it should be noted that anti-Russian feelings have not been a feature in the Georgian public in the same way as has been the case in for instance the Baltic states. On the contrary, bad relations with Russia is mentioned in polls as one of the Saakashvili administration's major failures:

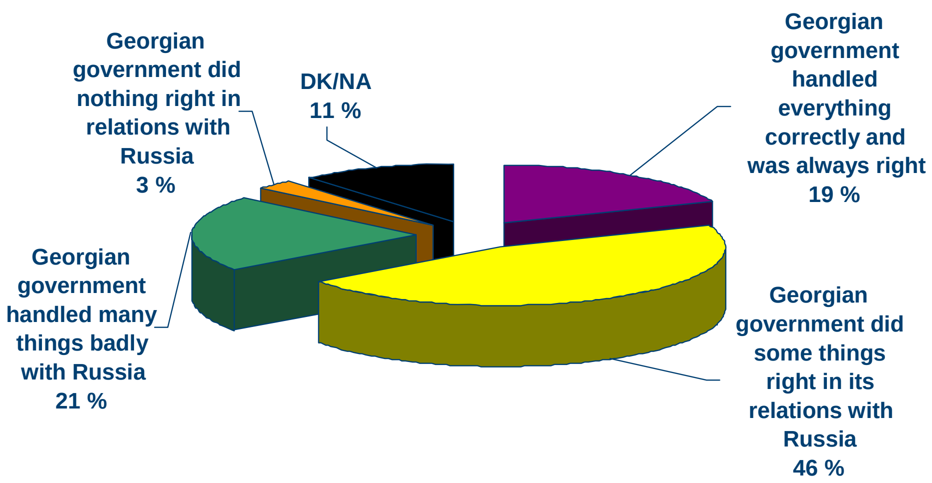
Figure 1.8 Public perception of major failings of the Saakashvili administration



Source: Georgian National Voter Study, 2007

However, a majority of the population has supported the Georgian government's handling of Russian relations, suggesting that, at least on the psychological-political level, relations with Russia do not seem to pose much of a threat for the stability of the sitting regime.

Figure 1.9 Support for the Government's handling of Russian relations



Source: Georgian National Voter Study, 2007

Outlook: Relations between Russia and Georgia will largely depend on wider Russian political developments, and on Russia's relations with the West. The increasing authoritarianism in Russia, and the more frequent displays of crude, though not always effective, power have been seen against the backdrop of parliamentary elections in December of 2007, and, more importantly, the presidential elections in March 2008.

There are some signs that things might get better after that. Most importantly, Russia is facing a gas supply squeeze – although its reserves unrivalled in the world, too little has been invested over the last years. Unless actions are taken to stimulate competent investment in the sector, Russia faces a serious challenge fulfilling both its contractual export obligations and satisfying growing domestic demand. This challenge might well convince a new Russian leadership to instigate more benevolent policies towards both foreign and domestic private capital – which again implies a need both for more cordial relations with the West, and for more predictable policies overall.

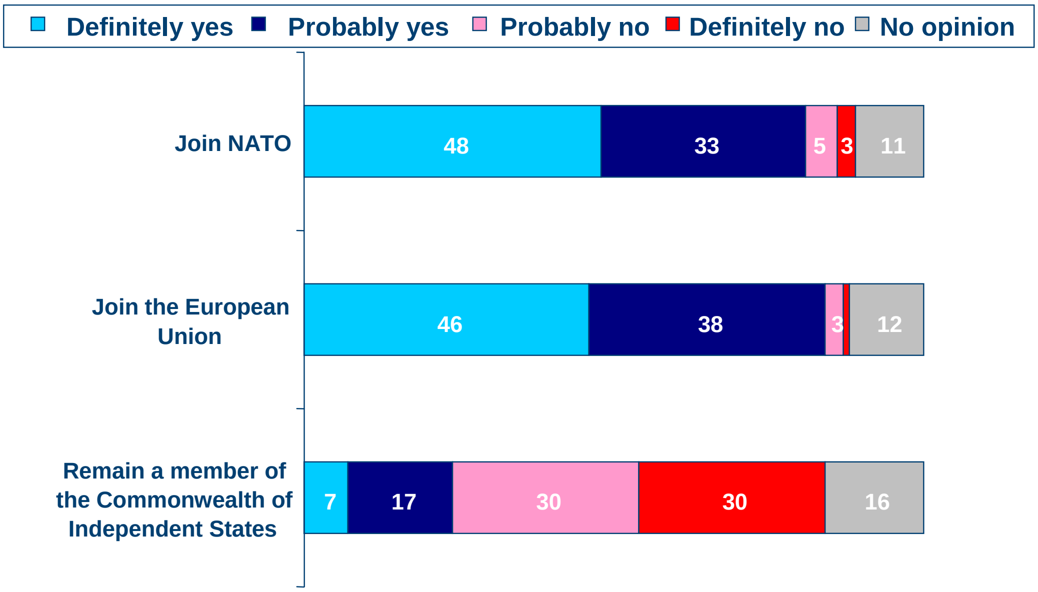
There are also some Russo-Georgian specifics that might influence the relationship. Most important among them is probably the issue of Georgian NATO membership, discussed below. Preventing Georgian accession will in all likelihood remain a Russian priority in the years to come, and might serve as a reason for attempting to create instability, both in the break-away regions, and in Georgia's political landscape. However, an interesting question is Russian reactions in a case where Georgia actually *does* become a member state. Policies aiming at destabilising Georgia then lose much of their rationale, and the downside of serious conflict with a NATO member are much larger.

1.4.1 EU and NATO

A significant opportunity for Georgia is its relationship to Euro-Atlantic structures. Closer integration with NATO and EU provides basis for political stability, Western involvement, better security and increased investment. Even in the absence of outright membership, the integration processes provide impetus for adaptation of the legal framework; for administrative reform; for reform of the police, security services and armed forces; and for improvement of human rights standards.

In Georgia, a consensus has developed on this Euro-Atlantic strategy. More than 80 percent of respondents support both NATO membership, and a bid for EU membership.

Figure 1.10 *Views of the Georgian public on the country's international relations: Should Georgia…*



Source: Georgian National Voter Study, 2007

Of course, Georgian integration in Euro-Atlantic institutions depends not only on Georgia's priorities, but also – and mainly – on the views of those institutions and their members.

In the most important country in this regard, the US, President George W. Bush has been a clear advocate of Georgian NATO-membership. An uncertainty in this regard is US presidential elections nest autumn, as the views of the candidates are not well known on this point.

In Europe, the prospects of Georgian membership have improved with political changes in France and Germany in 2005 and 2007. Both Merkel and Sarkozy have some personal experience with the meaning of Russian authoritarian influence in Eastern Europe (Sarkozy is the son of a Hungarian immigrant who flew Soviet rule after WWII). Whereas both Schröder and Chirac placed much weight on the importance of not antagonizing Russia, their successors stress to a larger extent the need for being fair, but firm. In the election campaign, Sarkozy affirmed his support for Georgia and Ukraina. His Russian policy would "avoid complacency without falling into confrontation, would be more constructive than friendly" as a diplomat put it. In a meeting on June 13 between Sarkozy and Saakashvili, the French President expressed that France would not oppose membership. In this meeting, cooperation on civil nuclear power, military cooperation (French officers training Georgian mountain troops) was also mentioned. France will also place an adviser in the reorganization process of the interior ministry in Georgia.

Other important countries for Georgia include Turkey. Turkey's ambassador to Georgia, Firat Sunel has expressed that Turkey supports Georgia's wish to become a full NATO member, and will continue to provide assistance in preparing the country for this. German foreign minister Frank-Walter Steinmeier has also expressed support for Georgian aspirations, albeit somewhat more modestly.

Finally, the Russian position remains of importance, since NATO members cannot completely disregard it, and since Russia leverage within Georgia. Russia is actively opposing Georgian membership, a view which is explained above.

An EU bid, on the other hand, seems completely unrealistic at the moment, not least given the EU's own "expansion fatigue", and should not be considered a factor in the near to medium term. Most Georgian politicians realize that membership is not imminent, regardless of Georgian policies. Thus, the positive effects of the EU process that many have argued were important in the Eastern and Central European transitions, might not be quite as strong in Georgia.

Outlook: There is a decent chance of Georgian NATO accession within the next few years. A window of opportunity opens up in the years following the Russian presidential elections in March 2008. As Putin has vowed to step down, a new president might feel that he has less personal prestige to loose by Georgian membership. In particular, the remainder of 2008 might be an era of both Georgian and US activity in the area. In the US, George W. Bush, who is leaving office in January 2009, might seek to secure some positive foreign policy achievements on his watch; in Georgia, elections in October 2008 might inspire Mikhail Saakashvili to achieve concrete results in this field. In any case, relatively favourable governments will remain in power in the major European NATO countries at least through 2009, which gives some time to make progress on the issue.

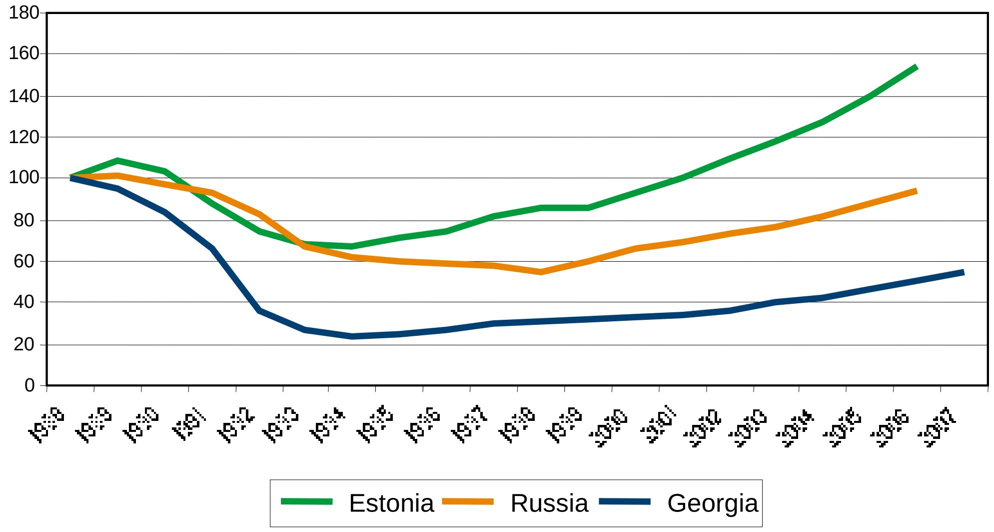
On EU membership, there is little hope of intensified activity in the immediate future. However, EU presence in Georgia will remain and perhaps increase, which has numerous possibly positive spill-over effects on the Georgian polity. In the longer run, much depends on the development of the EU itself, and predicting that, as always, is hazardous. Surely, it will involve painstaking negotiations, reorientations, bureaucratic indecision and popular protest – leading to often inconsistent and sometimes surprisingly bold decisions.

2 Macroeconomic risks

2.1 Economic growth

The Georgian economy has been growing rapidly for several years, a trend which is likely to continue. Georgia is still the post-Soviet economy lagging farthest behind its Soviet time peak. Institutional collapse, civil war, disruption of all existing economic ties, and gross led the economy to contract some 75 percent from 1988 to 1995. Since then, the economy has grown each year, but still stands only at 55 percent of its 1988 peak.

Figure 2.1 Post-Soviet economic development in selected countries, 1988=100



Source: EBRD

Under the Saakashvili administration, growth has accelerated, averaging 9 percent from 2003 to 2006. Measures have been implemented both with regard to domestic and foreign investors. The most important include a strong anti-corruption drive that made the World Bank rank Georgia as the best anticorruption government in July 2006; a new Tax Code, reducing and simplifying taxes; further developing policies towards foreign investment; better budget control and exchange rate stability.

Of course, problems still remain. Although the legal regime is generally favourable, implementation is uneven. Intellectual and industrial property rights are sometimes difficult to enforce, although the situation is improving. Foreign investors have encountered problems protecting contracts and property rights in local courts. And although significantly reduced, corruption continues to be a problem.

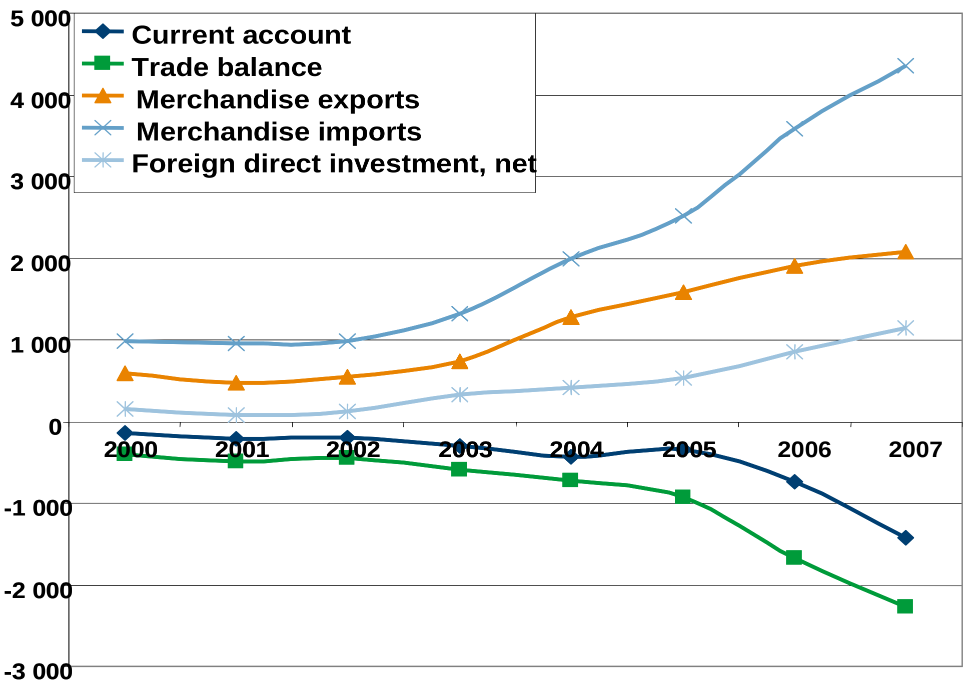
Outlook: IMF projections for 2007 originally anticipated 7.5 percent growth; however, it is already probably that actual growth will be double digits, between 10 percent and possibly as high as 12-13 percent. Growth projections for 2008 and 2009 are slightly below 7 percent per annum; however, it is worth noting that projecting GDP growth in a country such as Georgia is a relatively arbitrary exercise, as data are of too poor quality, too short time span with too many structural breaks, and with no reason to expect *ceteris paribus* to apply even over shorter time spans.

We argue here that projections are likely to underestimate the growth potential in Georgia. There are three main reasons for this. First, the level of output in Georgia is still extremely low. Economic activity that was disrupted by war, extreme instability and extreme corruption gradually resumes, even if the Government succeeds in little else than avoiding a return to the chaos of the past. Second, when a population that has experienced "financial traumas" goes through longer time periods with relative financial stability, the financial sector might expand more rapidly and more profoundly than expected. Of course, for this condition to obtain, it is mandatory to avoid new bank scandals during this rapid expansion. Third, looking at other post-Soviet countries such as the Baltic states, a reforming government delivering growth can maintain popular support for reforms over time. If reforms are maintained and continued, and macroeconomic stability prioritised, economic growth could be significantly higher than current estimates.

2.1.1 Current account and exchange rate risks

Strong economic growth brings several challenges for macroeconomic policy. Not least among them are changes in the current account. Over the last four years, imports and exports have started to rise significantly; however, imports have risen much faster. So far, a large part of the negative trade balance has been financed through foreign direct investment (FDI).

Figure 2.2 Current account and FDI



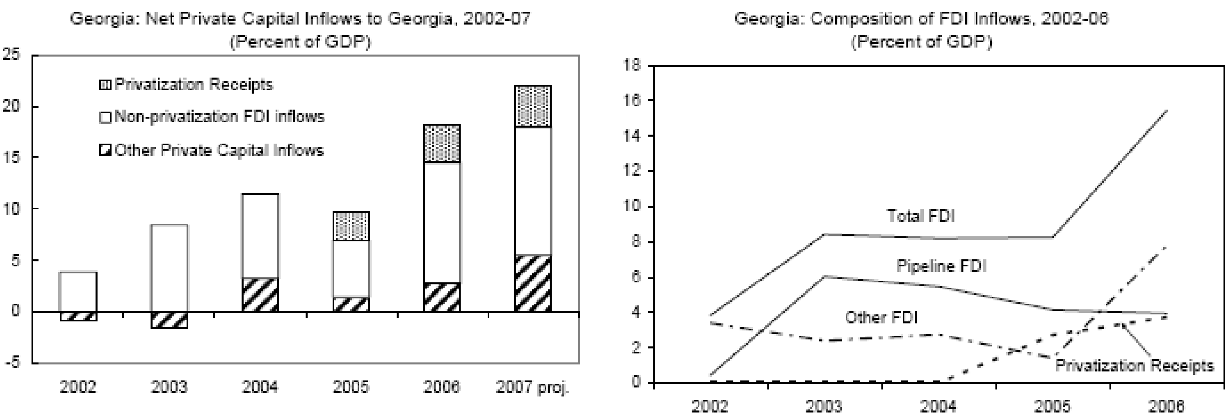
Source: ?

The widening current account deficit is explained by increased imports, due to economic growth, strong need of capital equipment, and a strengthening of the lari compared to the dollar. Part of the import comes as more people can afford to produce new goods that are not produces locally. The import of capital goods is also natural in the current phase of Georgia's development, with underinvestment over more than a decade. Over time, it is believed that import of capital goods will boost export capacity, thus improving the trade balance. Finally, as a country where the State at the onset of the Rose Revolution still held disproportionally many industrial and other assets, privatizations of such assets have presented attractive investment opportunities for foreign investors.

However, the current situation does pose some risks. In particular, the dependence on FDI implies that the current account will be severely hit by any deterioration in the political situation, for instance related to the break-away regions, relations with Russia, or even conditions in neighbouring countries such as Azerbaijan, as much of the FDI is still connected with work on the now completed BTC pipeline. Changes in the global price of capital and the willingness of investors to place long money also affect the situation in Georgia. A dry out of FDI would normally lead to exchange rate adjustments and possibly to increased inflation.

A major question is therefore the development and composition of FDI, and the policy responses chosen by the Georgian government.

Figure 2.3 Composition of FDI inflows



Source: National Bank of Georgia, IMF

As shown by Figure 11, FDI has grown rapidly as a percent of GDP, from roughly 4 percent in 2002 to well above 20 percent projected for 2007. Benignly, non-privatization inflows is the largest share, and also growing most rapidly since 2005, when the privatizations started. Furthermore, the last two years, non-pipeline related FDI have grown rapidly, whereas pipeline related FDI, while still at a high level, have decreased steadily.

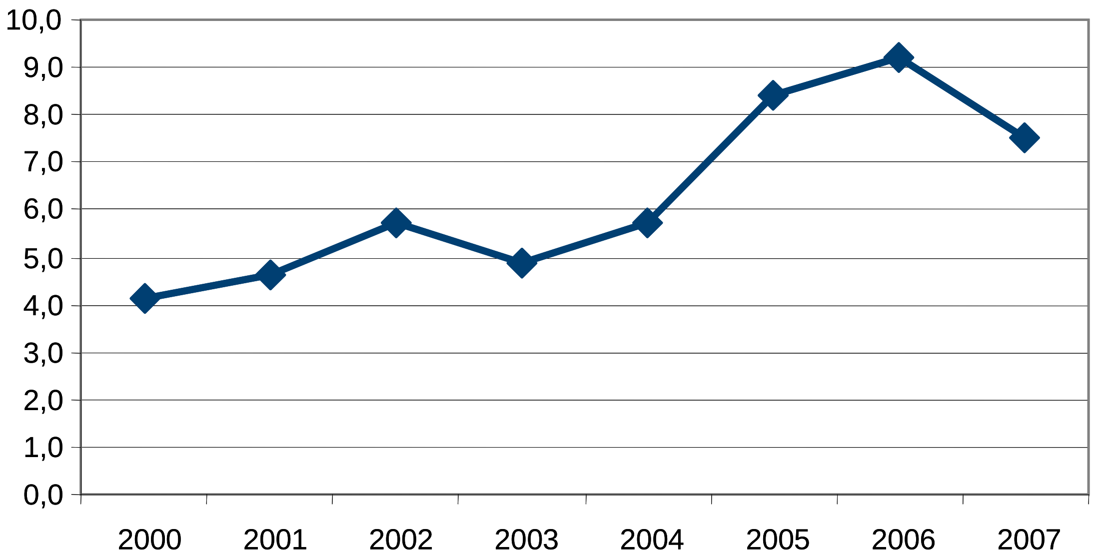
2.1.2 Responses to the current account challenge: Appreciation or inflation?

In order to reduce the negative effects of a current account deficit, the Georgian authorities have two options. The first one is to have a fixed or managed nominal exchange rate which provides relative short term stability to foreign investors. In the case of Georgia, it would reduce the nominal currency appreciation due to the increasing FDI. However, inflation pressures would increase because imports would become relatively more expensive. This could lead to a decrease in exports competitiveness due to a rising real exchange rate and the risk of devaluation by the Georgian authorities at a later stage.

The second option is to have a floating exchange rate in which current account imbalances are reflected in the nominal exchange rate directly. The large FDI inflows that Georgia witnesses would thus cause a nominal appreciation. This set up prevents inflation from increasing as imports would become relatively cheaper. Currently, the Georgian authorities are pursuing a managed floating exchange rate policy with a target inflation of 9% in 2007. In a substantial review in August 2007, the IMF and the Georgian authorities agreed on the importance of managing the fiscal budget to reign in any inflationary pressures on the economy.

Inflation has presented a major dilemma for macroeconomic policy in Georgia, as the Government strives to balance a wish no to strengthen the lari unnecessarily with a wish not to tighten monetary policies too much. Measures were enacted in 2006 in consultation with the IMF, and inflation is down in 2007, having reached double digits following gas price increases in 2006. However, there is also some hidden inflation, and rapid price increases in the housing market, driven as much by expectations as by monetary policy. This might increasingly become a problem, not least from a social perspective.

Figure 2.4 Consumer prices (annual average)



Source: Statistics Georgia

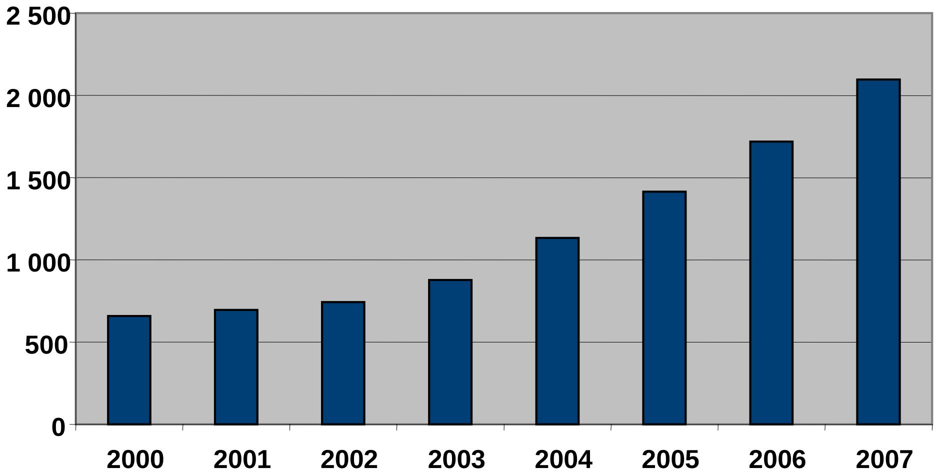
In general, Georgia has had a spectacular fiscal performance over the last years, raising tax revenues, increasing investment, and at the same time reducing public debt from close to 50 percent of GDP in 2003 to 22 percent in 2006. But the stability of the managed exchange rate policy could still be undermined, as the forecasted deficit in the government budget of 3% of GDP this year despite an important increase in the tax revenues. It can be presumed, for example, that increased defence spending resulting from the increasing tension with Russia could further complicate macroeconomic management. Similarly, the introduction of free economic zones, as the government has planned on doing, might also undermine this policy because it narrows the tax base and reduces the tax revenues.

Outlook: Ultimately, the Georgian Government is preoccupied with sustaining the confidence of foreign investors, and should therefore tighten its fiscal policy. Thus, as long as inflationary pressures are controlled efficiently by a tight fiscal policy, the current foreign exchange policy will remain stable. Foreign direct investment inflows seem to be forthcoming in the next few years. It is to be hoped that hydropower can prove a significant source of FDI in the short to medium term. In conclusion, it can be stated that consistency in macroeconomic policies more than the precise policy chosen is an essential base to prevent speculative attacks on the Lari and reduce the risk of currency crises.

2.2 Social aspects

Rapid growth has given rising wages for most Georgians. GDP per capita has more than doubled in real terms since 2003, although PPP growth is somewhat more modest.

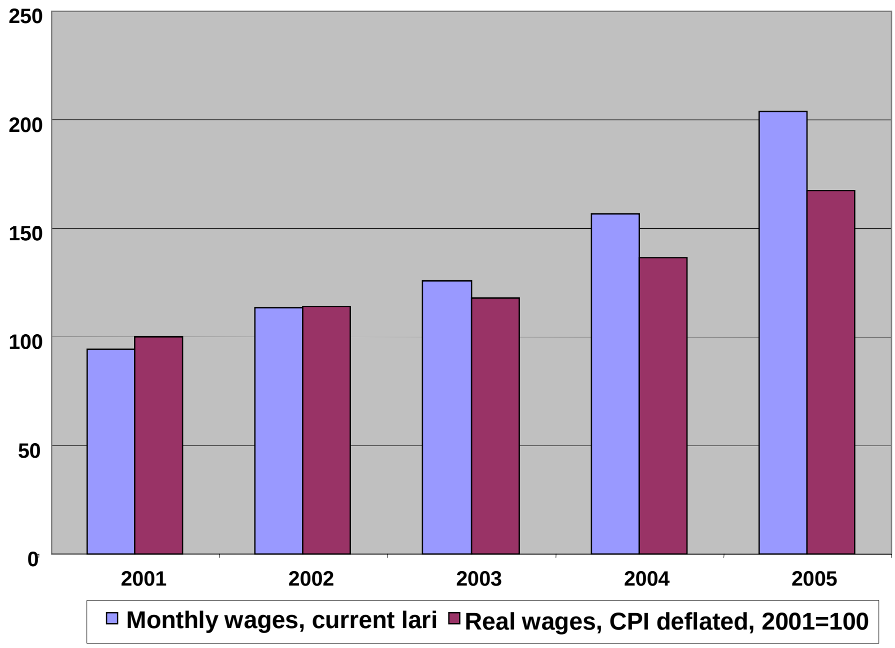
Figure 2.5 GDP per capita (US dollars)



Source: ?

Real wages improved significantly in the period from 2001 through 2005 – there is a lack of reliable data for 2006. In total, real wages increased by 68 percent over the period, which is impressive by any standard.

Figure 2.6 Wages, 2001-2005

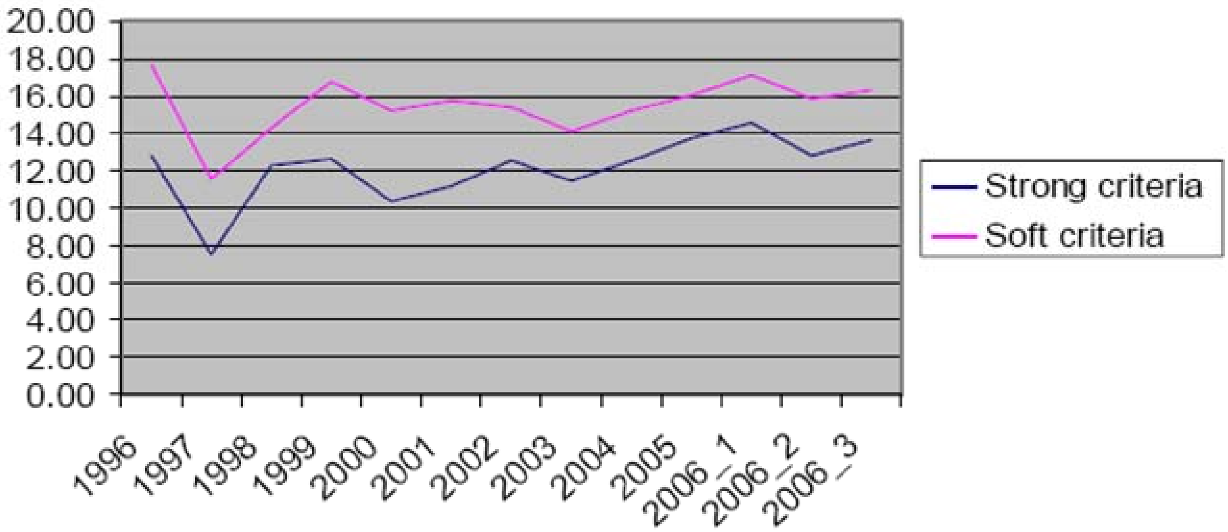


Source: Statistics Georgia

However, it should be noted that the quality of data is not very good, and that there are numerous problems by the CPI baskets used. First, and as noted above, certain costs are not included in CPI, such as the cost of housing. Secondly, poorer families spend disproportionately much on items that have become significantly more expensive, such as electricity.

An additional aspect that stresses the need for a clear strategy to fight poverty is the high and rising level of unemployment, which has been a serious problem under the Saakashvili government has been increasing unemployment, partly as a result of down-sizing of the public sector.

Figure 2.7 Unemployment, percent



Source: ILO

Official statistics from Statistics Georgia are roughly equal to the strong criteria presented in the ILO data. There is reason to believe that unemployment have gone down in 2007, and strong economic growth and generational shifts will in the longer run translate into more jobs.

About 30 percent of the population remain below the poverty line, according to World Bank estimates, in particular in underdeveloped rural areas. In deliberations with IMF, it appears as a somewhat of a conundrum why the strong growth has not done more to reduce poverty. A problem in fighting poverty at present is that although government revenues have increased, macroeconomic conditions impose a need for contractive financial policies, to reduce inflationary pressures and real appreciation of the lari. At the same time, the government has increased military spending significantly, in part due to the conflicts with the break-away regions and Russia, and in part also because of genuine needs of modernization.

Outlook: Until now, growth in Georgia has not been evenly distributed, and although wages have risen significantly, unemployment has remained high, as has poverty levels. However, given the strong and sustained growth performance, and given that important painful reforms, such as downsizing of public sector, have already been achieved, it seems that social indicators have every reason to improve in the short and medium term. This, in turn, will widen the consumer market in Georgia considerably.