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## Georgia on Its Way to the Market-Oriented Economy

### Introduction

#### *Political and Economic Background*

##### *A Painful Transition: Civil Conflicts and Economic Collapse*

Georgia, a country of 5.4 million people, is bounded by the Black Sea, Russia, Azerbaijan, Armenia, and Turkey. At independence in April 1991, it appeared to be among the best positioned of the former Soviet states to make a successful transition. It had a highly educated labor force, a long tradition of entrepreneurship, a significant underground economy, a prosperous agricultural sector, and substantial natural resources. Furthermore, its location made it a primary transit corridor in the Caucasus.

Despite these favorable conditions, Georgia's political and economic situation went into a tailspin. In the early years following the breakup of the former Soviet Union (FSU) Georgia suffered from intense civil conflicts, first in South Ossetia, then in Abkhazia, and with the followers of former President Gamsakhurdia. President Shevardnadze, who was invited to return to Georgia in early 1992 and was elected Chairman of the State Council in October 1992, played a major role in mediation and reconciliation. Toward the end of 1993 the intensity of armed conflicts abated. A cease-fire

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was enacted in Abkhazia and an agreement including Russia and the United Nations was signed to work out a peaceful resolution of the conflict.

Georgia emerged with a collapsed economy after these two years of civil conflicts and erosion of the government's authority. Output had experienced one of the sharpest declines observed among FSU countries (70 percent between 1990 and 1994); tax revenues had collapsed to 2–3 percent of GDP and the resulting huge deficits had led to hyperinflation and to a sharp depreciation of the domestic currency. In addition, the external debt contracted since independence, mostly on commercial terms and with short maturities, had grown to unsustainable levels (over 200 percent of exports).

#### *A Remarkable Turnaround*

In early 1994, having made progress toward greater political stability, the government turned its attention toward rebuilding the Georgian economy, and by the end of the summer had embarked on a stabilization and structural reform program with support of both the International Monetary Fund (IMF) and the World Bank. Since then, implementation has been sustained and achievements have been impressive. The monthly inflation rate has been brought down from hyperinflation levels to about 1 percent. The exchange rate has remained stable since the end of 1994 and a new currency [the lari] was successfully introduced in September 1995. Gross official reserves have been rebuilt after having been virtually exhausted in 1994. The current account deficit has narrowed to 4.6 percent of GDP. Most of the bilateral debt has been rescheduled. And after four years of continuous decline, growth resumed with real GDP rising by 2.4 percent in 1996—a turnaround unique among transition economies.

#### *An Ambitious Reform Program*

The stabilization and structural reform program that brought about this turnaround in economic developments was ambitious. The stabilization program relied on a drastic fiscal adjustment and tight monetary policies. The fiscal deficit was reduced from 26.2 percent of GDP in 1993 to 7.4 percent in 1994 with most of the adjustment resting on a compression of expenditures. This was effected through the elimination of costly subsidies for bread, gas, and electricity and a substantial downsizing of the budgetary sector that brought down budgetary expenditures from 24.3 percent to 12.3 percent of GDP. In 1995 and 1996 the deficit was further reduced to 4.5 percent of GDP and efforts were directed toward improving revenue performance.

In terms of structural reforms, the core of the program has been the

establishment of an appropriate incentive framework for the development of private sector activities. Subsidies have been virtually eliminated, prices and trade have been liberalized, and an adequate legal framework has begun to be introduced. Privatization has proceeded quickly. Small-scale privatization is virtually complete with about half of the medium- and large-scale enterprises having been privatized to date. In the agricultural sector, over 50 percent of cultivated land has been distributed to private farmers and the legal basis for the functioning of a land market is in place. In the banking sector, prudential regulations and the regulatory framework have been upgraded and a restructuring strategy is being implemented. In addition, the collapse of public finance compelled the government to impose hard-budget constraints upon state-owned enterprises, and to increase the participation of the private sector in activities that used to be largely publicly financed, such as health, education, and transport. In a number of cases—perhaps simply as a result of the very difficult circumstances—the government took fairly radical measures, such as increasing the retirement age by five years, granting financial and management autonomy to all hospitals, and removing 120,000 employees of the health sector from the government payroll.

#### *Political Consensus Toward Reforms*

This extensive set of policy measures reflected the government's strong commitment to reforms and its capacity to implement them. This capacity has been strengthened by recent political events. In July 1995, Parliament approved a new constitution that established a strong executive presidency. In August an assassination attempt on President Shevardnadze gave the latter the opportunity to eradicate a paramilitary group occupying dominant positions in governmental and economic structures, and to launch a vigorous campaign against corruption. Finally, presidential and parliamentary elections held on November 5, 1995, affirmed the government's proreform platform. Eduard Shevardnadze was elected president with 75 percent of the vote and his became the majority party in Parliament. Since the new government has been in place, policy issues have been debated widely, and discussions increasingly involve members of Parliament (including those from the opposition) at an early stage of the decision-making process.

#### *Social Developments*

The sharp economic contraction experienced until the end of 1994 and the collapse of public expenditures have caused a substantial increase in poverty: real wages fell significantly between 1990 and 1994; public expenditures in

health and education declined from 12 percent of GDP in 1991 to less than 2 percent in 1994 leading to a worsening in health indicators and a drop in enrollment ratios; spending on pensions and other benefits fell to 1 percent of GDP in 1993, although pensioners represent one-fifth of the population; and unemployment is estimated to have risen to about 20 percent in urban areas. In addition, the civil conflicts have resulted in an influx of about 270,000 refugees—mostly from Abkhazia—who receive assistance financed to a large extent with humanitarian aid provided by foreign donors. Most Georgian families have to rely extensively on occasional income from informal sector activities, sales of personal effects and assets, and aid from relatives or remittances from abroad to cover their basic expenditures. Furthermore, the rationing of electricity and a lack of heating during winters impose considerable hardship on the population.

Since the very start of the reform program in September 1994, the government has paid substantial attention to social issues and has undertaken corrective measures: improving the targeting of social benefits while allowing a real increase in their levels; increasing wages in the budgetary sector to improve efficiency and restore motivation; and introducing reforms in the health and education sectors to target the scarce public resources to the most effective uses.

### *External Environment*

Georgia's opportunities for growth largely depend on the country's capacity to integrate into international markets and attract foreign investment. In this regard, the recovery of trade in 1996, following a sharp decline of imports and exports in 1995, is encouraging. Exports grew by 20 percent, contributing to a significant reduction of the current account deficit to below 8 percent of GDP (down from 37 percent in 1994). The recovery can be attributed to the increased economic activity in Georgia and in the region. In addition, progress toward political stability and an environment favorable to private sector activities helped Georgia to regain its traditional role as a transit country between Asia and Europe. Trade data, although deficient, show significant penetration into new markets: about 50 percent of exports are to non-FSU countries and among those, Turkey has become the most important trade partner.

### *Caspian Oil*

Recent political and economic events have given Georgia an opportunity to be considered as a possible outlet for the huge oil reserves of the Caspian region. In October 1995, Georgia was chosen as one of two transit countries

(along with Russia) for "Early Oil"—the first phase of the Azerbaijan International Operation Company (AIOC [a consortium composed of eleven major foreign oil companies]). AIOC is financing a project that involves creating a continuous pipeline from Baku, Azerbaijan to Supsa on the Georgian Black Sea coast. The capacity of this pipeline is estimated at about 5 million metric tons per year and Early Oil is expected to begin flowing by the end of 1998. The rehabilitation of the pipeline will bring a significant amount of foreign direct investment during the coming two years, in addition to the tariff income expected to be received when the oil starts flowing. Furthermore, there are prospects for substantial additional foreign direct investment after 1998, as Georgia is also one of the transit options being considered for major export pipelines beyond the Early Oil phase.

#### *External Debt*

Over the past two years Georgia's capacity to repay debt has improved considerably following the rescheduling on concessional terms of 94 percent of its bilateral debt. After independence, Georgia accumulated substantial external obligations amounting to US\$ 1 billion by the end of 1994, most of it on commercial terms and due by 1997. The bulk of the obligations to FSU countries had arisen from nonpayment for natural gas imports from Turkmenistan. In 1995 and 1996, unable to meet its debt service obligations, Georgia obtained a standstill on obligations falling due, and, while building up a reserve for debt service payments in a special account in the Netherlands Bank, requested of its creditors a rescheduling on concessional terms. To date agreements have been signed with seven creditors, including the largest (Turkmenistan and the Russian Federation), and negotiations are ongoing with the remaining creditors.

#### **Recent Economic Developments**

The first quarter of 1997 saw a seasonal decline in economic activity but the annualized growth rate remains impressive. Inflation is firmly under control and the lari remains stable. The small-scale private sector seems to be responding to stability with greatly increased activity. However, the largest enterprises are still overwhelmingly state owned and are making little progress in restructuring. The capacity of the government and the legal system to enforce the reforms that have been passed is low. The physical infrastructure is still poor, and its renovation is still largely dependent on foreign assistance, as the state remains unable to significantly improve revenue collection. Yet there are recent signs that, after pressure from donors, the

government recognizes the need to press ahead with deeper structural reforms, particularly in privatization. If continued progress can be made in resolving separatist conflicts, then the chances for increased investment and sustained rapid growth look promising.

GDP growth in the current year to the end of March 1997 was estimated at 8.9 percent by the State Department for Statistics (SDS), but figures remain very approximate as at least 40 percent of activity is unrecorded. The government has revised its target range for 1997 upward to between 10.2 percent and 14.1 percent. The IMF predicts 10 percent growth, which would maintain Georgia's position as the fastest growing economy in the Commonwealth of Independent States (CIS). Trade remains the fastest growing sector, though the rate of increase is declining and now accounts for 25 percent of value added. Industry continues the recovery begun in 1996 but now accounts for only 15 percent of GDP. Foreign investment data is also highly unreliable, but does seem to be rising, although total amounts remain low.

Passed on February 21, the 1997 budget sets revenue and deficit targets of 12.2 and 2.8 percent of GDP, respectively. Tax collection will have to more than double from that achieved in 1996. In the first quarter revenue was 14.6 percent below target. The passing of the new tax code should help to improve performance in the second half of the year. For now, government revenue collection is easily the weakest in the CIS and among the worst in the world. Some progress is being made in expenditure management, but rather than being reduced, expenditure arrears continue to accumulate. In 1996, health and education spending amounted to just US\$ 5 and US\$ 10, respectively, per capita. The government's inability to mobilize significant revenue is a threat to the sustainability and enforceability of reforms. Significant concessions have been given to Achara in terms of reduced transfers to the central budget.

The money supply and, therefore, inflation remain under control, albeit with donor assistance. However, the high degree of dollarization in the economy coupled with the continued lack of confidence in the banking sector remain problems in terms of monetary policy. Nevertheless, confidence in the lari and the continuing reform of the banking sector provide a basis for future stability and an opportunity for more sophisticated financial instruments to be introduced, such as short-term government bonds. One instrument that seems to require reform is the credit auction, as it appears to be essentially an implicit subsidy and its effectiveness in terms of lowering commercial banks' lending rates and broadening the interbank market is unclear.

The dollar-lari exchange rate continues to show remarkable stability, particularly in view of the fact that Georgia is still emerging from economic crisis. National Bank of Georgia (NBG) interventions have been successful

in maintaining a rate of below \$1.30 to the lari. The Tbilisi Interbank Currency Exchange has also been successful in maintaining a healthy US\$ 5 million volume of interbank trade per month.

Prices rose seasonally in the first quarter, mostly accounted for by fruit and vegetables. The government's 10–12 percent inflation target for 1997 remains realistic and could even be lower given the tight control exercised over the money supply. There is, however, still concern regarding the out of date measures used for the Consumer Price Index and the lack of a Producer Price Index.

According to SDS estimates, the current account deficit narrowed from 12.7 percent of GDP in 1995 to 6.9 percent of GDP in 1996 as a result of revisions to figures, which are still particularly unreliable. The State Customs Department collected only 2.2 percent of the value of recorded imports in customs duties in 1996. Progress continues on the application for membership in the World Trade Organization, which will involve substantial improvements in customs procedures. Imports seem to be falling in terms of GDP, as humanitarian aid and cheap financing dries up, but exports have yet to show significant increases. Capital account recording in the balance of payments is even weaker than the current account, but great progress has been made in recording and rescheduling foreign debt obligations, which now stand at 32 percent of 1996 GDP. The European Union, Turkey, and China are the only debtors with whom agreements still have to be reached.

There was almost no progress in privatization in the first quarter but it seems that the government will press ahead with cash auctions at lower prices in the second half of the year. Currently 88 percent of shares issued in medium and large enterprises (MLEs) are still held by the state. Only in trade, services, and agriculture has more than half of state property approved for privatization actually been sold. The ten largest enterprises account for 71 percent of the total valuation of MLEs, and very little has been done about selling or restructuring most of these. Electricity distribution companies are to be offered for sale at cash auctions, but demand will depend on progress made with regulation proposals. Twenty-five percent of agricultural land has now been privatized, but much of this is still apparently not used, and there is no active market in land due to the lack of proper land registration systems. Financial markets are similarly hampered by a continuing lack of regulations, for example, on share registry.

The government is attempting to improve the social safety net. A recent law has established the need to determine a minimum subsistence level and progressively raise the minimum wage toward this level. As yet no mechanism is in place for this exercise. Data on the household sector remain poor, but incomes do appear to be rising fast. Households still rely overwhelmingly on irregular income rather than salaries. The SDS estimates that the

average monthly wage at the end of the first quarter was GEL 52. Incomes from self-employment are significantly higher. National unemployment is estimated by the SDS at 13.7 percent, but the Conjunction Research Center found a figure of 28 percent of the workforce in Tbilisi in 1996, if discouraged workers are included. Underemployment remains significant but uninvestigated. The social safety net continues to provide particularly low benefits to too many people.

### **Production and Investments**

Growth seems to be continuing at an impressive rate, albeit from a low base. Preliminary estimates by the State Department for Statistics for the first quarter of 1997 show that GDP for the three months was GEL 856 million (US\$ 664 million), or approximately GEL 171 (US\$ 133) per capita. This is approximately 40 percent lower than in the fourth quarter of 1996, but economic activity remains so seasonal that it is more appropriate to compare with the first quarter of 1996. The SDS estimates that over this period GDP has increased by 8.9 percent in real terms. The government's target for growth in 1997 has been revised up to between 10.2 percent and 14.1 percent. IMF forecasts, using slightly different estimates, agree that in 1997 Georgia will retain its 1996 position as the fastest growing economy in the CIS. Figures remain highly subjective, however, with the SDS now estimating that 40 percent of GDP may be produced in the unrecorded economy. While investment appears to be starting to recover, it is still far below the levels that will be necessary if such growth rates are to be sustained.

### **GDP and Growth**

The figures in Table 1, calculated by the SDS on the basis of reports from enterprises, clearly show how much activity still fluctuates. Reported value added in the first quarter of 1996 was in nominal terms less than half that in the last quarter of the year. In part, this may be a statistical phenomenon: GDP figures are reported cumulatively and the last quarter's figures may include some production for the whole year. Declines in agricultural production and the construction sector at the beginning of the year are also to be expected. (However, the substantial declines in most other sectors may be due to energy supply constraints, though the substantial drop in transport and communications, a key issue, could be a combination of poor access, disrupted electricity supply, and a decline in demand for its services from other sectors. During the first quarter of the year, when the network relies on expensive thermal electricity generation, supply is at its most unreliable. A large part of

Table 1

## GDP at Current Prices, 1995-97 (GEL millions)

	GDP in current prices						
	1995	1996	1996 first quarter	1996 second quarter	1996 third quarter	1996 fourth quarter	1997 first quarter
Industry	454.2	616.6	130.0	143.0	167.6	176.0	150.0
Agriculture	1,192.7	1,432.7	217.3	324.5	474.9	416.0	239.0
Construction	135.4	225.8	12.7	43.1	81.0	89.0	14.0
Transport and communications	126.3	260.2	17.0	76.2	80.0	87.0	37.0
Trade	671.9	1,077.9	170.8	238.5	309.6	359.0	209.0
Other branches	52.4	78.1	10.6	12.5	25.0	30.0	13.0
Total material production	2,632.9	3,691.3	558.4	837.8	1,138.1	1,157.0	662.0
Total nonmarketing production	384.1	699.1	118.2	160.1	190.8	230.0	148.0
GDP at factor cost	3,017.0	4,390.4	676.6	997.9	1,328.9	1,387.0	810.0
Net taxes	120.0	154.0	22.0	38.0	47.0	47.0	46.0
GDP at market prices	3,137.0	4,544.4	698.6	1,035.9	1,375.9	1,434.0	856.0
GDP per capita (US\$)	490.0	716.0	111.0	162.0	217.0	226.0	133.0

Source: State Department for Statistics.

productive capacity is thus left standing idle. If energy and infrastructure problems can be solved, the potential for further high growth is great.)

Changes of growth in real terms are at present calculated using the CPI as a deflator. This is not standard international practice. When a Producer Price Index is calculated for Georgia, then this will more accurately reflect real growth rates when substituted for the consumer price index as a deflator. The SDS thus considers the estimates of changes below [see Table 2] only preliminary.

### Structure of the Economy

It is clear, however, that growth is still very strong. This seems to come overwhelmingly from the small-scale private sector. Most medium- and large-scale industry has not yet been privatized but the State Tax Service reports that 80 percent of its revenues come from the private sector, despite the fact that the old state sector is much better registered. It seems that much of the state sector is inactive, and there is an urgent need to press ahead with privatization, restructuring, and liquidation for the parts that cannot be restructured, to free up assets for the more active sectors. The breakdown of

Table 2

## Real Annual GDP Growth, 1995-97 (percent)

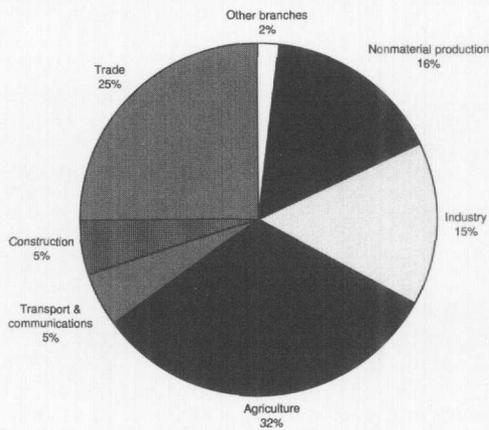
	GDP in current prices						
	1995	1996	1996 first quarter	1996 second quarter	1996 third quarter	1996 fourth quarter	1997 first quarter
Industry	-9.6	7.0	4.9	3.2	7.0	11.4	6.8
Agriculture	17.9	5.1	8.2	15.7	12.9	-13.7	4.7
Construction	14.6	25.1	-16.0	6.7	36.0	43.5	0.8
Transport and communications	15.8	0.4	10.3	-0.3	0.0	-0.6	3.0
Trade	155.1	30.0	51.7	-0.8	20.1	73.6	10.2
Other branches	4.8	6.9	2.7	17.6	4.9	6.5	12.5
Total material production	21.2	13.0	16.0	8.7	14.4	19.8	6.8
Total nonmarketing production	5.6	10.9	1.7	17.6	8.5	14.2	4.1
GDP at factor cost	19.0	12.0	13.8	9.7	13.6	16.7	6.3
Net taxes	-83.6	—	183.0	85.7	40.7	—	86.4
GDP at market prices	2.4	11.4	18.2	10.7	15.0	10.6	8.9

Source: State Department for Statistics.

activity by economic sectors [see Figure 1] over the year is practically unchanged since the previous quarter. However, the growth rate of the trade sector is slowing down. Having more than tripled in official statistics in two years, the growth rate in trade was only 10 percent in the first quarter of 1997. With continuing stability and low inflation it should now be possible for activities requiring a longer time horizon to expand.

Yet new businesses continue to face considerable problems. It is still almost impossible to obtain credit from banks for over six months, unless the loans are subsidized by international donors. There are continuing problems with the application of tax rules, in some cases amounting effectively to extortion. Small enterprises still complain about excessive intrusion from police and local authorities, sometimes apparently with the aim of reducing competition for more well-connected businesses. The removal of kiosks from the streets of Tbilisi and Kutaisi is a case in point. Local authorities, who are still not democratically elected, also continue to have influence over the availability of premises. There is no free market in urban land. The small-scale private sector has adapted extremely effectively to operating in what, in some sectors more accurately than others, has been described as a "clan economy." Sustainable growth will be easier to achieve when politicians and officials are forced to reduce their involvement.

Figure 1. GDP by Sector, Year to January 1997



Source: Data of the State Department for Statistics.

The GDP figures in Tables 1 and 2 have been compiled on the basis of the SDS's business register, which, as of the end of April, contained details of 35,100 enterprises. The 1994 law on entrepreneurship required all businesses to reregister by the end of 1995. This deadline was extended to September (then December) 1996 but the process continues. The register provides some further information on the structure of the economy, the details of which are given in Tables 3 and 4. Of enterprises that have registered, over half are in trade, though these are mostly very small. One-third are in Tbilisi. While 87 percent are recorded as privately owned, this may not take into account extensive state minority holdings. The largest enterprises are still overwhelmingly state owned.

### *The Shadow Economy*

Clearly, much work still needs to be done to improve the coverage of the business register, and thus of GDP figures. The SDS reports that more cooperation is needed from local authorities and banks, who often continue to deal with unregistered companies. A revised law on statistics has been presented to Parliament and was to be considered in the middle of May, although it may be further delayed. Some aspects of the current draft may need to be altered to clarify assurances of confidentiality and to guarantee to providers of information that no individual data will be publicized or passed on to organizations such as the tax service. Similarly, the penalties for not providing information or for providing wrong or partial

Table 3

**Enterprises on the Business Register, by Ownership, as of April 1, 1997**

	Number	Percent
State	3,202	9.5
Municipal, public, and unions	980	2.9
Private property without foreign participation	28,851	86.0
Private property with foreign participation	420	1.3
Foreign property	78	0.2
Georgia, total	33,531	100.0

Source: State Department for Statistics.

Table 4

**Enterprises on the Business Register, by Sector, as of April 1, 1997**

Sector	Number	Percent
Agriculture, forestry, and fishing	1,576	4.6
Mining	108	0.3
Manufacturing	5,150	15.1
Electricity, gas, and water supply	190	0.6
Construction	1,275	3.7
Trade and repair services	17,516	51.4
Hotels and restaurants	954	2.8
Transport, storage, and communications	2,127	6.2
Financial services	444	1.3
Real estate	1,348	4.0
Government and defence	736	2.2
Education	520	1.5
Health and social services	850	2.5
Other municipal and social services	1,271	3.7
Georgia, total	33,531	100.0

Source: State Department for Statistics.

data need to be established and enforced. Unfortunately, corruption and incompetence in official organizations still mean that registration can be time-consuming and expensive even for those who see it as worthwhile. There must be incentives to operate in the formal sector, and while banks provide little credit and the police seem to offer protection only for supplementary payments, these incentives are not obvious. The economy remains largely cash-based due to the population's experience of losing

savings in pyramid schemes and domestic currency bank accounts in 1993 and 1994, and suspicion of tax inspectors and other controlling bodies is still very strong. The reduction of regulation and corruption is likely to be the most effective method of bringing informal activity into the legal sphere, but winning confidence will be a slow process.

As mentioned above, the SDS estimates that about 40 percent of GDP may now be produced in the shadow economy. The production figures for 1996 include an adjustment to allow for unrecorded activity which amounts to 33 percent of the reported figures. The 40 percent figure arises from calculating GDP by expenditure for 1996. The introduction of a new household survey has allowed more reliable expenditure calculations to be made. Although many respondents still underestimate what they spend, coverage is likely to be better than that compiled from production reports. The result, as shown below [see Table 5], is a GDP of GEL 5,123 million (US\$ 4,100 million). This is 13 percent larger than the production estimates, of which a third is already ascribed to the shadow economy, and thus is 69 percent greater than GDP as recorded by production reports. This represents an unrecorded economy of 40 percent of the total. The true size of both the legal and illegal economies could be even higher. The expenditure calculation is unlikely to be complete, and a per capita GDP of GEL 1,000 still seems on the low side.

### *GNP and Other GDP Estimates*

The final stage in national account calculation is the consideration of the net factor income from abroad. For the first time in recent years the SDS has published estimates of these figures [see Table 6]. Foreigners are estimated to transfer abroad GEL 89 million more than Georgians abroad repatriate, therefore, GNP comes to GEL 5,034 million. Depreciation estimates the cost of replacing worn-out fixed capital, thus, net national product measures the amount of money available for spending on goods and services after setting aside enough to maintain the capital stock. National income is increased by a net inflow of GEL 106 million from abroad in the form of grants, wage remittances, and other current transfers. All these measures should be considered extremely approximate. Depreciation is always hard to estimate, and with nonexistent accounting standards, almost impossible. Given the current state of the banking system, large financial flows still happen in cash and can only be guessed at.

All the GDP estimates above will be superseded when the SDS completes its work on compiling full national accounts for the period since independence. However, final results are not expected until toward the end

Table 5

**GDP by Expenditure, 1996**

	GEL millions	Percent
Final consumption	4,841	94
Individual consumption	4,655	91
Household and business consumption	4,105	80
Nonprofit institutions serving households	505	10
Government	45	1
Collective consumption	186	4
Gross fixed capital formation	445	9
Changes in stocks	227	4
Net exports	-390	-8
Exports	593	12
Imports	-983	-19
GDP by expenditure	5,123	100
GDP by production	4,547	89
Statistical discrepancy	-576	-11

Source: State Department for Statistics.

Table 6

**GDP, GNP, and National Income, 1996**

	GEL millions
Gross domestic product	5,123
Plus revenues from property abroad	7
Minus revenues transferred abroad	-96
Gross national product	5,034
Minus depreciation	-616
Net national product	4,418
Plus current transfers received from abroad	106
Minus current transfers sent abroad	0
Net national income	4,524

Source: State Department for Statistics.

of 1997. Until then all figures available are only preliminary estimates. The IMF and the Ministry of Finance still use alternative IMF figures that put GDP approximately 20 percent higher than the SDS's production estimates. The Ministry of Economy in its Indicative Plan uses the SDS production figure for 1995 and the SDS expenditure figure for 1996. The SDS estimates are the only ones based on the collection of actual data rather than extrapolation from a base year, although, as explained above,

Table 7

## CIS Growth Rates 1995–97, Projected by IMF (percent)

	1995	1996	1997 (forecast)
Armenia	6.9	6.6	5.5
Azerbaijan	-11.0	1.3	5.2
Belarus	-10.2	2.0	0.0
Georgia	2.4	10.5	10.0
Kazakhstan	-8.9	1.0	2.0
Kyrgyzstan	1.3	5.6	6.9
Moldova	-3.0	-8.0	3.0
Russia	-4.0	-2.8	3.0
Tajikistan	-12.5	-7.0	-5.3
Turkmenistan	-8.2	-3.0	1.7
Ukraine	-12.0	-10.0	2.7
Uzbekistan	-0.9	1.6	2.0

Source: IMF Economic Outlook.

the subjective element of the total is still very large. Given the importance of GDP figures in assessing the progress of reform—not only for measuring growth but also for indicators such as the government tax take and velocity of money circulation—work on making the government's various estimates consistent should be a priority.

The IMF's estimate for GDP growth in 1996 was 10.5 percent, slightly lower than the 11.4 percent of the SDS. Still Georgia remains comfortably the fastest growing country in the CIS and among the fastest growing in the world. The IMF has published its own growth estimates and projections for all the countries of the CIS, shown below [see Table 7]. As emphasized previously in *Georgian Economic Trends (GET)*, the collapse of the Georgian economy was greater than any other post-communist depressions (so far) and fast growth from such a low base is hard to achieve. Yet, as the government of Belarus is demonstrating, the wrong policies and discouragement of investment can still stamp out recovery. Compared to many others in the region Georgian policy looks enlightened.

### Investment

The state of balance of payments and national accounts statistics make it impossible to be precise about the level of investment in the Georgian economy. GDP figures given above suggest that domestic investment is still negative: depreciation exceeds gross fixed capital formation by 40 percent.

The two are extremely hard to measure, however, and these figures should be treated with skepticism. Domestic savings may be rising, but certainly are low, as incomes are low and likely to rise. Unfortunately, only a small part of them is channeled by the banking sector, thus making it difficult to know where they are going. Capital expenditure by the government is planned to be only 1.1 percent of GDP in 1997, and this is likely to be cut further.

Foreign investment is going to play a crucial role in financing the necessary reconstruction and in helping to provide the foreign currency to pay off the large foreign debt. [Tables 8 and 9 show the amount of foreign direct investment by country of origin and sector, respectively.] Currently Georgia still relies on large grants and concessional loans from international financial organizations, Europe, and the United States. Again the balance of payments figures do not identify these flows reliably, and the government's plan to compile details of aid flows since independence has made little progress. Private foreign investment will certainly have to increase dramatically as the governmental flows dry up. Growth as it is seen now can be achieved with quite low levels of investment, as marginal returns are now extremely high and much can be achieved by simple reorganization and better use of existing human and physical capital. If fast growth is to be sustained Georgia will have to achieve investments well above the world average of about 25 percent of GDP. This seems unlikely in the short to medium term.

Data on private foreign investment give a rather worrisome picture. There have been only five investment projects, worth US\$ 2.5 million, registered at the Foreign Investment Agency of the Ministry of Trade since the end of 1996. There is serious concern about this within the government. A presidential decree of March 30 established a foreign investment council within the chancellery, chaired by the president, to develop policy for the attraction of investment. Three separate divisions will work on improving Georgia's international reputation as a safe place to invest, continuing the stabilization of the banking sector, and promoting tax and customs legislation reforms. Many in government have also been calling for the reestablishment of tax holidays for foreign investors that were abolished with the introduction of the Law on Investment in November 1996.

The latter change may not be necessary. First, there are clearly large investments coming in that are not being registered. The law requires investments of over US\$ 100,000 to be registered within sixty days of contracts being signed, but there are no sanctions established for instances

Table 8

**Registered Foreign Investments of over US\$ 100,000 by Country of Origin, as of May 7, 1997 (cumulative)**

Country	Licenses issued	Value (US\$)	Percent of total
Israel	7	16,269,165	16.2
Ireland	5	14,984,530	14.9
United States	19	10,220,426	10.2
Korea	2	9,120,500	9.1
Germany	24	7,983,221	7.9
Britain	16	6,693,570	6.7
Netherlands	9	6,516,770	6.5
Russia	22	6,820,938	6.8
Bermuda	2	4,120,190	4.1
Turkey	12	3,916,734	3.9
Australia	1	2,700,000	2.7
Italy	6	2,243,136	2.2
Switzerland	10	2,191,891	2.2
Cyprus	3	1,643,429	1.6
Greece	3	848,257	0.8
Austria	3	535,164	0.5
Bulgaria	2	487,650	0.5
Lichtenstein	1	462,159	0.5
Bahamas	1	400,000	0.4
Hong Kong	1	350,000	0.3
Venezuela	1	302,378	0.3
Monaco	1	270,000	0.3
Panama	2	160,000	0.2
Canada	1	150,000	0.1
Hungary	1	131,012	0.1
Malta	1	120,000	0.1
Lebanon	1	117,300	0.1
Seychelles	1	114,724	0.1
Lithuania	1	113,084	0.1
Latvia	1	108,500	0.1
France	1	104,612	0.1
Luxembourg	1	103,359	0.1
Belgium	1	102,000	0.1
Poland	1	100,000	0.1
Singapore	1	100,000	0.1
Total	165	100,604,699	100.0

Source: Ministry of Trade and Foreign Economic Relations.

where this is not done. Many large and well-publicized recent investments have not been reported to the Ministry of Trade, and many prominent Western companies have been operating in Georgia for years without registration. In addition, many investments that were previously recorded as foreign were apparently of domestic origin. Domestic firms set up

Table 9

**Registered Foreign Investments of over US\$ 100,000, by Sector, as of May 7, 1997 (cumulative)**

Sector	Licenses issued	Value (US\$)	Percent of total
Manufacturing	32	39,145,619	38.9
Communications	10	22,446,887	22.3
Food industry	43	13,392,853	13.3
Banking	13	7,704,756	7.7
Agriculture	4	5,894,730	5.9
Trade	30	5,233,575	5.2
Construction	8	2,691,594	2.7
Transport	4	2,479,080	2.5
Service	11	1,559,604	1.5
Health	1	107,000	0.1
Total	156	100,655,698	100.0

*Source:* Ministry of Trade and Foreign Economic Relations.

*Note:* This table includes all investments, since independence, on which the Ministry has information. However, it is seriously incomplete.

tenuous foreign investment accounts to take advantage of tax breaks, such as tax holidays. The new law has removed this distortion. The repatriation of Georgian money is likely to continue, and at increasing rates, but is no longer recorded as foreign investment. For larger investors and genuine foreigners most research indicates that tax holidays are not a significant attraction compared to stability and predictability of treatment. There is now considerable global competition for foreign investment, but there is some scope for Georgia to distinguish itself in the region if it can effectively address some problems of corruption and legal enforcement, and establish itself as an open economy that genuinely welcomes foreign involvement and supports private business.

Transport, communications, and energy remain perhaps the greatest priorities for investment, as they are bottlenecks for other sorts of investment. Given Georgia's small size, economic growth will depend on export performance, and most foreign investment is likely to be oriented toward the world market. In transport considerable concrete progress has been made. The Caspian will be a vital source of oil and gas for Europe, as well as an important trade route to Asia; Georgia has opportunities to benefit from this without suffering some of the economic problems associated with over-reliance on natural resource exports. The project to reconstruct the Baku-Supsa oil pipeline remains the largest source of foreign invest-

ment, which encourages other investors to follow, despite the fact that no decision has been made on the route for transporting the main flow of Azeri oil. Subcontracts have been awarded to Australian, French, German, and British companies, usually in partnership with Georgian firms. The World Bank has also provided a US\$ 1.4 million credit toward preliminary work to determine suitable routes for the main flow. There are also prospects for other pipeline deals. At the first session of the Georgian–Russian joint commission on economic cooperation, an agreement was signed envisaging transport of natural gas from Russia to Turkey through Georgia.

Other aspects of transport also show promise. The 1996 agreement on cotton transport signed by the presidents of Georgia and Uzbekistan represented one of the first significant commodity exports from the region to bypass Russia. At that time, agreements were also signed on setting independent rail tariffs, bypassing the CIS framework that had favored Russia. While the difficulties of building an export pipeline out of Kazakhstan continue, 1.2 million tons of oil is expected to be sent by train from the Tengiz field to Batumi. Much of the equipment required for oil exploitation in the Caspian is also to be sent by rail from Poti. The European Union's Traceca program is designed to provide technical assistance for the development of the corridor from Europe to Asia via the Caspian and Black seas. The World Bank has provided a US\$ 15 million loan for road rehabilitation, and the European Bank for Reconstruction and Development plans a US\$ 15 million investment in Poti port. Despite this progress there is a very long way to go.

Ferry services have resumed between Poti and two ports in Bulgaria and one in Ukraine, and additional services are expected this year with Russia, Romania, and Ukraine, but recorded volumes are extraordinarily low. The rail track and rolling stock that remain are still in very poor condition, after war, neglect, and corruption. With the Abkhazian route to Russia still blocked, the only international rail route currently operating is with Baku. A project to join Akhalkalaki in Georgia with Kars in Turkey and to connect to the European network is now out to tender. Until then, the idea of a transport hub or corridor is far from reality. The Ministry of Transport's forecast of 5 million tons to be carried by rail in 1997, should be considered in the context of 120 million tons carried in 1986.

In other sectors there is even more yet to be done. Energy investment awaits the completion of privatization plans. There has been foreign investment in communications, particularly in the mobile sphere, but large parts of the sector continue to be run as profitable private businesses by

the Ministry of Communications, and many potential investors have been put off. There may still be some resistance to the idea of foreign investment in Georgia, exemplified by the fact that foreigners are not allowed to own land, even commercial land. Yet overall, and certainly by regional standards, the climate for investment is welcoming, and inflows can be expected to rise rapidly.

### **Money and Banking**

The lari money supply remains under control in Georgia, underpinning the government's economic reform program. As a result, inflation is being steadily harnessed and the exchange rate with the dollar has been maintained since the lari's introduction, albeit with donor support. The past six months has seen a dramatic decline in the rate of increase of the lari money supply, suggesting a decrease in relative demand for the lari.

The size of the informal economy remains hard to estimate, although the imputed value of the informal economy in GDP statistics—40 percent—gives some indication of its size. This is still of concern, especially with regard to the control of the exchange rate.

Net foreign assets were depleted by 100 million lari in the first quarter of 1997 as the NBG successfully defended the lari against the dollar.

Commercial bank deposits continue to show an annualized increase, the majority of which represents an increase in lari holdings, indicating a cautious growth of confidence in Georgia's currency and banking sector. With regard to the latter, foreign banking influence seems to have stimulated competition for deposits as higher interest rates have been offered. Banks that do not meet prudential standards continue to face liquidation or merger.

The regulatory environment continues to approach international standards. However, the assessment of credit risk on loans still shows room for improvement, and laws, most importantly bankruptcy laws, have not been fully tested through the courts.

Credit auctions continue to provide a source of subsidized credit to the commercial banks, which use the facility enthusiastically. Whether the auction has reduced interest rates to commercial bank customers is open to question. However, the exercise has been valuable in introducing Georgian banks to products in new financial markets. One such market, short-term government bonds (treasury bills), is due to start in the near future with the 1997 budget allocating GEL 10 million for the purpose of testing the market's potential. The participation of foreign-

ers in this market has not been decided. If foreign participation is allowed, it is expected that the increased competition generated would reduce bond yields significantly.

### *Commercial Bank Credit*

Table 10 shows the commercial bank lending to enterprises from December 1995 to March 1997. Although still at a low level and concentrated on short-term lending to traders, there are signs of improvement. Total commercial bank lending to enterprises increased in the first quarter of 1997 by 13 percent. Despite amendments to loan-loss regulations, overdue short-term loans and overdue interest on loans increased in February and March 1997, indicating that commercial banks continue to have problems in adequately assessing credit risk and/or do not have adequate mechanisms of loan recovery (legal procedures have not, as yet, been tested). It is likely that more bad loans will be identified during 1997 as both the commercial banks and the supervision department of the NBG make more detailed assessments of the quality of loan portfolios.

### *Credit Auctions and Interest Rates*

During the first quarter, the NBG continued maintaining low interest rates on interbank credit auctions. The interbank credit auctions were introduced as a way to begin the process of developing financial markets. Before July 1996 it was strictly an interbank market and the NBG did not participate to any great extent. Thereafter the NBG began to take a more active role, starting to reduce interest rates on the basis of an assessment that interest rates were unnecessarily high in real terms. In a more sophisticated and liquid banking system, this kind of intervention would normally lead to a reduction in the general level of deposit and lending rates in the economy, however, as shown in Table 11, this has simply not happened. The NBG is not able to influence interest rates because it cannot (and should not) provide sufficient funds to exert such an influence because the interest rate levels in the economy are determined by structural factors.

Commercial banks still charge and are able to get very high interest rates on their short-term lending. Rates remain high for a number of reasons. Most loans are made to finance short-term trade activities that are high in risk and typically have a high return for traders. Although the interest rate spread has decreased, it remains substantially high; lending

Table 10  
Commercial Bank Lending to Enterprises, December 1995–March 1997 (GEL thousands)

	1995			1996			1997		
	December	March	June	September	December	January	February	March	
Commercial bank lending to enterprises, in GEL	81,362.0	104,222.0	81,178.0	60,425.0	67,065.0	68,787.0	69,668.0	76,181.0	
Current loans	21,008.0	26,392.0	25,671.0	40,732.0	53,493.0	55,259.0	54,566.0	57,038.0	
Overdue short-term loans	45,285.0	57,436.0	24,500.0	12,037.0	8,354.0	8,100.0	9,623.0	12,684.0	
Overdue interest on loans	15,068.0	20,395.0	31,007.0	7,656.0	5,218.0	5,428.0	5,479.0	6,459.0	
Overdue loans/loans to enterprises (%)	68.3	68.5	48.8	22.8	13.5	12.8	15.0	18.2	
Overdue interest and loans/total loans to enterprise (%)	74.2	74.7	68.4	32.6	20.2	19.7	21.7	25.1	

Source: *Georgian Economic Trends* calculations from data provided by the National Bank of Georgia.

Table 11

**Credit Auctions and Interbank Credit Market Annual Interest Rates, March 1996–March 1997**

	Credit auction rate (annualized)		Commercial bank rate (annualized)	
	1-month	3-month	1-month	3-month
March 1996	48	70	72	67
June 1996	41	46	62	59
September 1996	36	42	59	57
December 1996	25	28	65	58
January 1997	22	23	64	58
February 1997	20	20	64	60
March 1997	19	19	66	59

*Source:* Georgian Economic Trends calculations from data provided by the NBG.

*Note:* The credit auctions rate is calculated as a weighted average. The commercial banks' lending rate reported in the table can be treated only as indicative because it is an unweighted average of the rates reported on a haphazard basis to the NBG. For this reason, the average credit auction rate can appear higher than the commercial banks' lending rate. In practice, this does not occur at exactly the same moment in time.

rates still include very high risk premiums, regardless of their denomination (lari or dollar). Lending rates are decreasing, probably driven by increased competition and also by new inflows of foreign capital, mainly through development banks and international organizations.

According to some preliminary estimates, the average weighted lending rate (in lari-denominated loans) was 43.6 percent in March 1997 and 36.2 percent in April 1997. This suggests that the unweighted averages reported in Table 10 are substantially overestimated.

Such high rates also suggest a shortage of bank credit and therefore a lack of effective competition between banks. The shortage of credit is directly linked to the banks' inability to raise deposits, and particularly term deposits, despite the high deposit rates of interest. The deposit problem arises from the poor reputation of banks in the past. Once lost, banking credibility is hard to reestablish. Despite the dramatic improvement in the banking system achieved by the banking reforms introduced over the past two years, the public has yet to respond and the banking system as a whole has much to do in terms of educating the public to assess bank quality. Until the reputation problem is solved, the current NBG policy of reducing interest rates to banks does little more than increase the return to banks on their current lending activity.

### ***Banking Sector Reform***

On January 31, 1997, the NBG issued a resolution on the Minimum Size of Statutory Funds for Commercial Banks, amounting to GEL 5 million and applicable by January 1, 2001. There are nine certified banks and three commercial banks with statutory funds of more than GEL 1 million. The new standards for commercial banks will encourage banks with smaller capital bases to merge. Foreign banks with greater resources are also expected to enter the market.

The banking system reform has been analyzed in the last edition of *GET*. Much of the resulting shakedown occurred in 1995 and 1996. Table 12 displays the results of this process and also shows the healthy entrance of newly registered banks to the system continuing in the first quarter of 1997.

The three former state banks still in existence occupy a special place in this reform as a result of their size and geographical coverage. Two have displayed great progress in transforming themselves into commercial entities. The third, Agrobank, continues to have problems with past bad loans and asset management, but it requires sensitive restructuring if its valuable branch structure is to be maintained.

Finally, it should be noted that NBG itself has modernized in that it has undergone an external audit, prepared to write off some loans, has made loan loss provisions (including guarantees for wheat importers), and is to undergo a reform of its accounting system in the near future.

### ***Short-Term Government Bonds***

The 1997 budget includes GEL 10 million for the development of a short-term government bond (STGB) market. In terms of the projections for domestic financing of the budget deficit, this is little more than a token amount, but it remains an important step for the development of domestic debt markets. The first issue is planned for July 1997. The Ministry of Finance will be the issuer on behalf of the Government of Georgia. The NBG will be the official agent of the Ministry of Finance in accordance with the Law on the NBG.

Not all the operational details of the issuing and management of STGBs have been settled yet. It is intended that the first issues will be very short-term—twenty-eight-day—bonds, which will be used solely to test the issuance mechanism and educate participants in the primary market. It is anticipated that the primary dealers will be certified commercial banks. It is unlikely that any foreign companies or banks will be allowed to operate as primary dealers. But it is very important that foreigners be allowed to partici-

Table 12

**Bank Liquidation, December 1994–March 1997**

	Dec. 1994	June 1995	Dec. 1995	June 1996	Dec. 1996	Jan. 1997	March 1997
Liquidated banks	2	39	130	149	172	172	177
Self-liquidated banks	1	2	15	17	22	22	23
Liquidated by the NBG	0	36	106	116	127	127	131
Taken over	1	1	5	12	18	18	19
Merged	0	0	5	5	7	7	8
Newly registered banks	0	0	0	0	2	3	3
Total banks existing	228	191	101	82	61	62	58

Source: National Bank of Georgia.

pate in the STGB market if for no other reason than that it should work to lower the yields on these bonds. Reference to the experience in Russia is instructive in this regard. Normally, domestic buyers of national debt tend to put a lower risk premium on national debt than foreigners—if only because as a rule they do not perceive a foreign exchange risk. In Georgia, because of the widespread use of dollars as a savings mechanism and because of past experience with the government's default on domestic bonds, Georgians are likely to put a higher risk premium on government debt than are foreigners who are likely to be taking only a forward looking assessment of credit risk and will thus take greater comfort from the Enhanced Structural Adjustment Facility (ESAF) program. As a symbolic confidence-building gesture, the Ministry of Finance is to pay GEL 200,000 to 1992 bond holders.

STGBs are more likely to provide a basis for the NBG to develop alternative monetary policy instruments. Once a liquid STGB market is in place, the NBG should be able to trade in the buying and selling of STGBs in the secondary market to move interest rates, provided that STGBs develop as a reference rate for interest rates in the economy. While the credit auctions have failed to achieve that objective, STGBs can be used as an alternative to bank deposits, thus making banks likely to keep their deposit rates linked to STGB rates.

### Privatization

While performance in macroeconomic stabilization has been highly impressive, structural reform has been moving more slowly. There have been

some significant achievements. Budgetary subsidies to large state enterprises have been mostly stopped, small enterprise privatization is largely complete, and much of the legal framework for private business has been established. Plans have been issued for the privatization of much of the electricity generation sector. Yet there has been very little real progress since the middle of 1996. Eighty-eight percent of shares issued in medium and large enterprises remain under state control, and not a single new medium or large enterprise was privatized in the first quarter. Cash auctions of remaining government shares continue to attract almost no interest because reserve prices are set too high. The law on bankruptcy has yet to be tested. Growth is coming almost entirely from the new, small private sector, while ministries struggle for control of a largely inactive state sector.

The nature of inherited Soviet industry does not make it easy to privatize what is left, but there is also a question with regard to the political will to do so in parts of the government. After considerable pressure from donors, a new initiative has now been promised to push forward with what is described as the second stage of reform. This is long overdue. If current economic growth is to be sustained, new measures will have to be introduced to dispose of the huge state shareholdings at prices that investors will pay, and to extend privatization to urban and commercial land. To allow the private sector to develop, more attention will have to be paid to the development of capital and land markets, the improvement of the physical and legal infrastructure, and regulation.

### *Small Enterprise Privatization*

Small enterprise privatization has been highly successful in that the overwhelming majority of small enterprises have been transferred out of state hands. As of April 20, 1997, 9,667 small enterprises had been privatized [see Table 13], 93 of them in the first quarter of this year. The process is nearly complete everywhere except Achara, but even the autonomous republic has made some progress in the first quarter, both in corporatizing enterprises and in privatizing them. Most small enterprises are in trade or services, and were disposed of by auction, tender, or direct sale in approximately equal proportions. The sale process was by no means always transparent and it seems that in many cases the government could have received much higher prices through more open sales. However, it is more important that the enterprises are now in private hands and there is a flourishing resale market, which is starting to ensure that assets end up in the hands of those who can do the most with them.

Table 13

**Small Privatization by Sector, as of April 20, 1997**

Sector	Approved	Privatized	Percent of total privatized
Trade	3,741	3,845	39.8
Communal services	3,695	3,868	40.0
Manufacturing	319	214	2.2
Agriculture and food industry	548	289	3.0
Construction	165	222	2.3
Transport	73	79	0.8
Social services	85	372	3.8
Sakenergo	31	26	0.3
Oil products corporation	163	163	1.7
Health	747	505	5.2
Bread products corporation	139	84	0.9
Total	9,706	9,667	100.0

*Source:* Ministry of State Property Management.

*Note:* Numbers of enterprises actually privatized can exceed those approved for privatization since some are split up during corporatization.

**Medium and Large Enterprise Privatization**

Medium and large enterprise privatization is still largely stalled. The only consolation is that the period of inactivity has allowed the Ministry of State Property Management (MSPM) to improve significantly the quality of information available on progress so far.

Medium and large enterprises must first be approved for privatization and then valued and established as joint-stock companies. The results of this process to date are shown in Table 14. By April 1997, 1,049 medium or large joint-stock companies had been established on the base of state enterprises, and a further 211 had been approved for privatization but not corporatized. Only five more enterprises have been approved and two corporatized since the end of 1996. The valuation of many of the remaining enterprises, in particular, electricity generation companies, has triggered intense political debate, thereby slowing down the process.

As of the end of April, 524 medium and large enterprises had actually been privatized in the sense that more than 50 percent of their shares had been transferred to private ownership. This is exactly the same as at the end of 1996, and only eight more than in August 1996. For the first time, sectoral breakdowns of what has been privatized are available, calculated

Table 14

**Corporatization of Medium and Large Enterprises, by Sector, as of April 20, 1997**

Sector	Approved	Established
Manufacturing	197	170
Agriculture and food	404	314
Architecture and construction	219	208
Trade	81	62
Transport	116	96
Social services	49	45
Mining and chemicals	31	26
Oil products	46	27
Bread Corporation	61	40
Gas	54	26
Poti and Batumi airports	2	1
Energy sector	—	34
Total	1,260	1,049

Source: Ministry of State Property Management.

by *GET* on the basis of MSPM data [see Table 15]. The most progress has been made in trade and social services, and the least in the energy and mining sectors.

Not only has there been almost no progress since August 1996, but when the proportion of shares in government ownership is considered, it becomes clear that only the smaller enterprises have been privatized and that the remaining state shareholdings, even in nominally private enterprises, are very high. Eighty-eight percent of shares remain in state hands. The only sectors where more than half of the shares are privately held are trade, services, social services, and agriculture. In transport and energy, over 98 percent of shares are still state owned. These figures do not even include the large electricity generators, which have been held back for good reasons while a regulatory framework is being established. If these figures were added, it would greatly increase the proportion of assets still in state hands.

Seven percent of shares issued have been disposed of through voucher auctions, 3 percent have been sold directly, and 1 percent have been given free or at a discount to workers and managers. Voucher privatization was completed in July 1996. It was successful in that 90 percent of the vouchers issued were used. Yet only slightly over half of the shares offered at voucher auctions were bought, despite the fact that those offered were usually the more attractive enterprises. Direct sales of enterprises, often

Table 15

**Privatization of Medium and Large Enterprises (MLEs), by Sector, as of April 20, 1997**

Sector	No. of established MLEs	No. of privatized MLEs	Percent privatized
Agriculture and food	275	155	56.4
Construction	140	61	43.6
Energy	93	7	7.5
Manufacturing	265	133	50.2
Mining	20	2	10.0
Service	32	20	62.5
Social services	53	42	79.2
Trade	45	35	77.8
Transport	115	69	60.0
Total	1,038	524	50.5

*Source: Georgian Economic Trends* calculations from data of the Ministry of State Property Management.

through lease/purchase options and usually to existing management, were the next most important means of disposal, particularly in the smaller trade and service businesses. At the beginning of privatization, managers and employees of most companies were given the option to buy 51 percent of the shares of their enterprises. Thirty percent of the payment was to be made in privatization vouchers by November 15, 1995, with the remainder to be paid in cash at a discounted price by July 1, 1996. This was not a great success. While 600 enterprises applied for the option, only 140 made the first payment in full, despite postponements of the deadline. While 400 enterprises made partial payments, they subsequently lost the right to buy the rest of the shares at a discount. Often employees failed to collect enough money together, but it was also the case that discounts available at voucher auctions very often turned out to be greater than those offered to insiders, and many bought their shares at voucher auctions instead.

It is known that 20 percent of shares bought at voucher auctions were bought by foreign investors, although by only six companies, and three-quarters of them by New Century Holdings. There have also been cases of sales of shares to foreigners via workers and managers; however, the program of "case-by-case privatization" directly to foreign investors has so far failed. Total foreign ownership of Georgian medium and large enterprises is probably considerably less than 4 percent. Georgian investment funds were a notable failure—due to public mistrust after the experi-

ence of pyramid schemes—and acquired only 4 percent of the 7 percent of shares bought through voucher auctions (i.e., 0.3 percent of all shares). It seems that the main result of privatization so far has been to transfer a rather small part of Georgian industry to its workers and managers. Although most activity now seems to be in the private sector—a World Bank survey from the summer of 1996 found that half the population receives its main income from private sector activity—this is due more to the development of new enterprises than to privatization.

The main lesson to be drawn from this is that discounts demanded by buyers are currently huge. The effectiveness of voucher privatization was limited by the minimum prices set at special voucher auctions. The buying of more than forty-five shares for one voucher was not allowed, and thus nearly half of the shares offered attracted no bids. The average discount on shares that did sell was still very large. Vouchers traded at about US\$ 5 compared to a nominal value of US\$ 30, and the average voucher bought twenty-nine shares, resulting in a discount to the nominal price of shares of approximately 88 percent. Moreover, this was for the more attractive sections of Georgian industry, and offered in an attempt to make voucher privatization successful. Discounts were high for a number of reasons: because much of the population was too poor to consider doing anything with their vouchers except selling them immediately; because there was justified skepticism on the general worth of surviving Georgian industry; but above all because information available on companies was inadequate and control rights insecure. The true value of enterprises clearly varies widely and has little relation to nominal valuation, which was based on book value in 1993, before extensive pillaging and debt accumulation. Existing managers have incentives to overestimate the value of poor enterprises to persuade investors to come in, or to underestimate the value of good enterprises to allow themselves to buy shares cheaply. The rights of outside investors to impose their will against that of existing insiders has yet to be firmly established.

The government seems to have no response to these problems, and thus privatization has effectively stopped. Cash auctions continue, offering shares at a reserve price of 150 percent of nominal value. Since the first cash auction they have sold 0.8 percent of the shares offered. The twelfth cash auction attracted no bids at all. There are some plans to reduce prices but they still face political opposition. A new law on privatization, soon to be passed by Parliament, seems to contain little new. It will require the approval of a special commission under the president in order for enterprises to be sold at less than book value. If real progress is to be made, the

discounting process must be made much more automatic and less discretionary. It will have to be accepted that the value of most enterprises to investors is considerably below the nominal value of their shares.

Revenue from privatization could arguably be increased by delaying the privatization of many enterprises for some years until incomes in Georgia are higher and credit more easily available. Yet the costs of this in terms of continuing mismanagement and inactivity of enterprises would be very high. Seventy-eight percent of remaining state shareholdings have already been transferred for management, either back to the sectoral ministries and departments that controlled them in communist times, or to other state companies. This is not an encouraging sign of commitment to private ownership, nor will it reassure private investors in these companies that they can exert control rights. It is clear that capital is coming into Georgia, whether from foreigners or repatriated flight capital, but the majority seems to be invested in small new enterprises or in real estate. If this money is to be attracted to privatization, the transparency of company accounting needs to be improved, possibly with a revised law on accountancy. Control rights need to be much more securely established, including through the establishment of share registries and transferability with the development of a stock market. Few minority shareholders now feel they have real stakes in their enterprises, but if foreign investment is to increase, portfolio investment by foreigners, not just direct investment, has to be encouraged. The MSPM has decided to increase the charter capital of seven already privatized enterprises because of what it considers to have been fraud during the original privatization. Some of these cases are now the subject of court action as existing investors find their shares diluted. The new privatization law should limit such retrospective revisions to three years from the date of privatization, but this is not likely to fully reassure investors.

The other main problem for privatization is the nature of inherited Soviet industry. The total value of shares issued in medium and large enterprises is US\$ 1.490 billion. The largest ten enterprises account for an extraordinary 71 percent of this valuation and the largest four account for 57 percent. If the top ten enterprises are excluded, then 37 percent of the rest have been privatized. Apart from Chitura Manganese, part of which was sold at voucher auctions, insignificant shares of all the largest enterprises have been sold. Their apparent dominance of the economy does raise questions about regulation and encourages politicians to think of them as strategic assets that should not fall into the hands of foreigners. More accurately, their relative size is a result first, of the overspecializa-

tion inflicted on Georgia during the Soviet era, and second, of the collapse of much of the rest of industry. Some of these enterprises will be hard to dispose of as the investments required for restructuring are huge. In some cases, investors could perhaps be attracted, but groups in the government are reluctant to lose control. In January, instead of the expected tender for management of a majority share of the Madneuli copper-mine complex, the tender was reduced to one for management of a smaller company controlled by Madneuli, and this has still not happened. More encouraging is a bolder decision made in April to try to sell off the shares of the Maudi textile plant with a reserve of only half their nominal price. The revenues are to be given to Maudi as a credit at 12 percent interest, and in addition, the enterprise's debts to the budget and special state funds are frozen until 2000. This may also be the result of effective lobbying, but restructuring does seem more likely to happen in the private sector, and with the temporary removal of the debt burden.

To meet the World Bank requirements, the Ministry of State Property Management decided to sell 273 state enterprises in one no-minimum-price auction from July 21 through July 31. The form of the auction is closed and the minimum bid is 1 lari (US\$ .75). Thus, everyone who decides to participate in the auction will become an owner of shares in an enterprise he/she likes, proportional to installments.

### ***Restructuring***

Attempts at restructuring the large state-owned enterprises have begun. A state commission was established at the end of January to come up with plans to restructure Chiatura Manganese. At the beginning of February, a presidential decree charged the management of the Rustavi Metallurgic plant together with the MSPM and the administration of Kvemo Kartli to prepare proposals on the restructuring of the plant. At the beginning of April two units and the thermal power supply of the plant became separate companies, albeit owned by the metallurgic plant. All workers were laid off to be rehired under different contracts, and up to 2,800 currently on leave will apparently not be reemployed. Yet while enterprises remain under state control this will inevitably be a slow, and political, process, subject to energetic lobbying.

There is very little evidence of restructuring so far in the private sector, but there are clearly significant obstacles. First, not enough has been privatized. The large remaining state shareholdings in private companies may impede owners who hope to raise new private capital or who must make

difficult decisions on reducing employment. Second, the ownership structure that has resulted from privatization so far seems to be quite dispersed and to consist mainly of existing workers and managers—not a recipe for radical decision making. A World Bank study of twenty-one enterprises in the summer of 1996 concluded that privatized companies had started to improve their financial performance by laying off workers, improving their marketing, and changing their product lines. The majority of state-owned enterprises had attempted less restructuring and were in worse financial condition. Still the evidence is far from conclusive and the situation is worrisome. The Czech Republic, though at a much later stage of reform, has recently demonstrated how a lack of attention to macroeconomic restructuring can undermine very impressive macroeconomic achievements.

The Post Privatization Development Center, established with World Bank and TACIS assistance, has been renamed the Center for Enterprise Restructuring and Management Assistance, and is finally ready to start working. The main limitation on its activity seems likely to be the still small number of privatized large enterprises that have both viable futures and managements ready to contemplate radical change rather than the resurrection of old trading arrangements. Other actions planned by donors to assist restructuring include assistance with the adoption of securities trading rules. A law establishing standards on disclosure, trading, and listing should be passed later in 1997. This is likely to be a condition of the next tranche of World Bank structural adjustment lending. Open share trading might start to put long overdue pressure on managers.

The most effective immediate spur to management action would be to put bankruptcy legislation to work. There have still been no forced bankruptcies, although the new bankruptcy law has been in effect since the beginning of the year. Bankruptcies and the voluntary shedding of unnecessary assets and activities would also have a strong positive effect on other businesses by putting new assets onto the market where they could be bought and operated by more dynamic entrepreneurs. Private sector firms are understandably reluctant to test the bankruptcy mechanism, as the current state of the legal system could make the process costly and unpredictable. There apparently remain contradictions between the bankruptcy law and other company laws. Uncertainty is also such that members of the government have expressed concern that bankruptcy could be used by insiders as a way of obtaining valuable assets cheaply. Nevertheless, as most firms remain state-owned and most debts are still to state organizations, it is probably up to the government to force the first case. The State Tax Inspectorate has announced plans to bring a bankruptcy

action against a number of debtors, but the published list contains so many of the most promising enterprises in Georgia (including Kaspi Cement, Bagrationi Champagne, and the Tbilisi wine factories) that it would not be surprising if these cases were settled before coming to court.

### *Electricity Sector Privatization*

Electricity sector privatization is also subject to delays. The sector has been divided into three parts: generation, transmission, and distribution. Generation and distribution are to be privatized, while transmission is to remain under state control as Sakenergo. Valuation of the generation and distribution companies was supposed to be finished by April 1, but has been postponed until at least June 1. Valuation of the larger generators may take even longer, and the exact mechanism for their sale has not yet been defined.

Distribution companies will be the first to be privatized. In the first stage, 30 percent of the shares of the distribution companies of Abasha, Lagodekhi, Tsalenjikha, and Chiatura will be offered at a special auction. The effective privatization of distribution companies actually started in the middle of 1996, as state distribution companies established smaller private firms, fourteen in Tbilisi and ten in Kutaisi. The experiment was not a success in terms of improving collection rates and these have now been abolished. It remains to be seen whether a more comprehensive privatization process will find more competent collectors: the viability of the rest of the sector depends on this.

The main problem is collection from households, which remains at about 30 percent of the amount billed. The rise in household tariff rates from 3.3 tetri per kilowatt hour to 4.5 tetri per kilowatt hour was postponed until the beginning of July. Pricing still raises very serious problems. It is possible that higher prices may encourage greater nonpayment. To avoid this, the legal and technical means to cut off nonpayers must be established, and basic tariff structures must be perceived as fair. There will be considerable resentment if, for example, well-connected state enterprises continue to get special treatment. Although raising electricity prices is not normally regressive, in that the rich do use and pay for disproportionately more, there is also a case for a "lifeline tariff" with low charges for consumption up to a certain level and much higher prices for using more. If the distributors were allowed discretion in operating such systems themselves, tariffs might become less of a political issue. Initial attempts at electricity distribution privatization in Hungary, for example, raised very little money because investors lacked confidence in future tariff regulation. Prices paid for generation companies will also depend on investors' assess-

Table 16

**Distribution of Agricultural Land (hectares)**

Land category	As of January 1, 1997	Percent	As of April 1, 1997	Percent
Total agricultural land	2,988,600		2,988,600	
Privatized	726,700	24.3	748,500	25.0
Leased	470,300	15.7	553,500	18.5
Not distributed	1,791,600	59.9	1,686,600	56.4
Arable	781,100		781,100	
Privatized	406,900	52.1	412,300	52.8
Leased	198,300	25.4	235,000	30.1
Not distributed	175,900	22.5	133,800	17.1
Perennials	284,600		284,600	
Privatized	187,900	66.0	190,600	67.0
Leased	31,000	10.9	37,500	13.2
Not distributed	65,700	23.1	56,500	19.9
Hayfields	148,000		148,000	
Privatized	48,000	32.4	55,100	37.2
Leased	20,500	13.9	31,000	20.9
Not distributed	79,500	53.7	61,900	41.8
Pastures	1,774,900		1,774,900	
Privatized	83,900	4.7	90,500	5.1
Leased	220,200	12.4	250,000	14.1
Not distributed	1,470,800	82.9	1,434,400	80.8

Source: State Department for Land Management.

Note: The table excludes Abkhazia and South Ossetia, but includes Achara, although there has been no land privatization in Achara.

ments of the competence and independence of regulation, as politically motivated tariff and rule changes can ruin long-term investment decisions. A law on electrical energy that will define the functions of the Electricity Regulation Commission is still awaiting discussion by Parliament.

### **Land Privatization**

Privatization of land is also proceeding extremely slowly. In Georgia 12.4 percent of land is now privately owned. Only Georgian citizens may own agricultural land, and there has been no privatization of urban and commercial land. An additional 22,000 hectares of agricultural land were privatized in the first quarter, bringing the total from 24.3 percent to 25.0 percent of all agricultural land [see Table 16]. The least privatized cate-

gory is pastures. However, 919,000 hectares of this are in mountainous areas for which there is little demand, and 600,000 hectares affected by erosion cannot be used. Most of the land that is close to villages and needed for livestock is privatized or leased. Excluding pastures, a more impressive 54 percent of the good quality agricultural land has been privatized. The most notable lagging area is Achara, which has only just started to prepare its land reform.

In addition to what has been privatized, 18.5 percent (553,500 hectares) of agricultural land has now been leased out by local authorities; 140,000 hectares is leased to 40,000 individuals and 413,000 hectares to 1,330 companies. How many of the companies are privately owned is not recorded. Effective beginning in July, all long-term leases should be transferable and offered on the basis of competitive price bidding, rather than the very discretionary system still in place now.

Undistributed land generally lies idle or is merely subject to local grazing arrangements. In addition, much of the land that is nominally privatized is unclaimed or unused, often because of problems in obtaining supplies and irrigation, and sometimes because of hostility toward outsiders using land. Agricultural production figures are improving, but the scope for increasing production by better use of land seems to be huge. There is still no effective land market, which severely restricts efficient usage and economic growth in general. The problem is the expense of creating an accurate land register. World Bank estimates put the likely cost at about US\$ 42 million. The World Bank plans pilot registration schemes in Mtskheta and Gardabani to be funded by a concessionary loan of approximately US\$ 6 million. Revenues from this registration could then be used to fund other areas, but the process would take a very long time. French and German companies have proposed faster schemes to register all land, but sources of financing remain uncertain.