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The Essentials of Georgia's Economic Transformation

*Tsotne Iashvili**

Keywords

Economic transformation, post-Soviet transformation, institutional economics, Georgia

Abstract

The aim of this article is to examine Georgia's economic transformation and try to answer the question: Why Georgia is not able to have a stable and high economic growth? In this article, it will be an attempt to answer this question by taking into account the weak private sector in Georgia, as one of the main burdens of economic growth. The article attempts to analyse the economic transformation in Georgia. The reasons for its failure and consequences, also to estimate its possible impact on the nowadays economic situation in Georgia. The latter will be examined from the perspective of Institutional Theory. The article will try to answer the above-mentioned question and problems, taking into account the institutional changes in Georgia. The article explains the unsuccessful path of transformation and tries to connect its results to the current economic situation in Georgia.

I. Introduction

After the collapse of the Soviet Union, Georgia passed the painful path of transformation. But still, after 26 years the country couldn't reach a stable economic growth. From 1991 to 1995 Georgia had a negative economic growth

* PhD candidate in economics at Ivane Javakhishvili Tbilisi State University (Department of Macroeconomics). Researcher at University of Wrocław; tsotneiashvili@yahoo.com

(−21.1%, −44.9%, −29.3% and −10.4%, respectively, in 1991, 92, 93 and 1994)[1] and in 2007 met highest growth rate accounting for 12% but after the world financial crisis in 2008 it had declined by 18.64% and accounted for 2.3%. In 2009 the country even had negative economic growth, and the economy declined by –3.6%. During the past few years, annual growth was 3–4%.[2] With such an unstable and low economic growth Georgia will not be able to reduce the development gap with the EU member countries even after many years. Besides this, there is a threat that the country will face middle-income trap. Only after 25 years, in 2015 Georgia moved from lower-middle-income to upper-middle-income category and gross national income (GNI) per capita (Altas Method) accounted for 4.160 US dollars. But after one year it declined and accounted for 3830 US dollars.[3] If we observe the gross domestic product (GDP) per capita in the current prices of Georgian lari, it may seem that the country's economy is growing. In 2014 GDP per capita was 6491.6, and in 2015 and 2016 it accounted for 8550.9 and 9146.4, respectively. The main reason of this increase was the result of the general population census, which revealed that in 2015 the population of Georgia declined by 15% from 4 371 535 to 3 713 804.[4]

In order to reduce the development gap with the EU member countries, Georgia needs to have a stable economic growth not only in the short run but also in the long run. Despite other post-Soviet countries, for example, Poland, Georgia's private sector was and still is weak. Still, it is not one of the main drivers of economic growth. For instance, after the collapse of the Soviet Union, the key of success of Poland together with other factors, were thriving private sector and success of institutional reforms[5] also the growth of the export sector, strong domestic demand and improved productivity.[6] Speaking about Georgia, neither in the transitional nor in the post-transitional period it was able to create a competitive and strong private sector. As it can be seen, strong private sector and domestic demand play a significant role in economic growth.

1 "GDP Growth (Annual %)" (The World Bank) <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=1994&locations=GE&start=1991> accessed 15 May 2018

2 Author's own calculation based on The National Statistics Office of Georgia. <http://geostat.ge/?action=page&p_id=118&lang=geo> accessed 10 May 2018

3 "GNI per capita (Atlas method) (current US$)" (The World Bank) <https://data.worldbank.org/indicator/NY.GNP.PCAP.CD?locations=GE> accessed 10 May 2018

4 "General Population Census Main Results 2014" (The National Statistics Office of Georgia); < http://census.ge/ge/mosakhleobis-2014-tslis-sakoveltao-aghtseris-dziritadi-shedegebi-zogadi-informatsia/201#.Wwu1c0iFPIU> accessed 1 April 2018

5 Stanislaw Gomułka, "Poland's economic and social transformation 1989–2014 and contemporary challenges" [2016] Vol (16), Central Bank Review CBR, 19

6 Katarzyna Kolodziejczyk, - POLAND IN THE EUROPEAN UNION. TEN YEARS OF MEMBERSHIP [2016] Vol (40), Revista UNISCI / UNISCI Journal, RU 1

Georgia's economic transformation in numbers

There are three ways of transformation. The first one is 'The Shock Therapy', which has Polish origin. This tool requires sharp, revolutionary changes to transform the planned economy into the market. Mostly, Europe preferred to use this method. One of the bases of this decision was the 'Balcerowicz plan', which was launched in Poland. The second one is the 'Gradualism'. The gradualism is of Hungarian origin. The latter is concerning the evolutionary changes in the transition process to the free market. As for the third method of transformation, it is 'The Third Way'. Its origin is considered to be the Balkan countries. The main idea of this 'Third way' is the step-by-step gradualism, that is, 'Gradual Gradualism'. The gradual gradualism concerns privatisation of only small enterprises and firms.[7]

The shock therapy was adopted in Georgia. But before the explanation of the transformation process in Georgia, it would be better to overview the economic situation and macroeconomic determinants before and after the transformation.

According to the World Bank Data, during the period 1966–1988, in Georgia the GDP annual growth rate was positive and at this given period most of the year's growth rate was above 5% (see diagram 1).

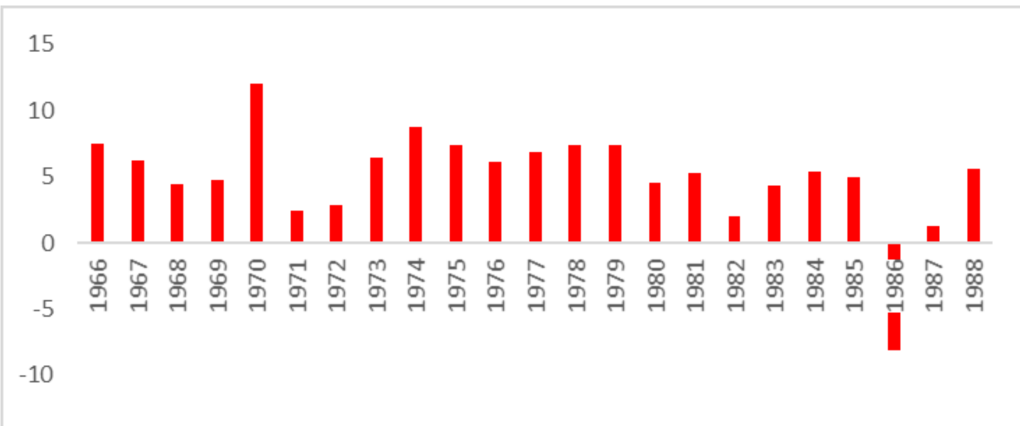

Diagram 1: GDP Growth (annual %)
Source: The World Bank Data

When the Soviet Union was going to collapse Georgia has begun to think about the independence, as well as the importance of economic reforms. Thus, the process of thinking about the economic reforms began in 1989. Since 1989, Georgia has passed several stages of economic reforms.

7 Vladimer Papava, Post-Communist Transitional Macroeconomics (1st edn, Tbilisi University Publishing House 2005) (in Georgian)

After the collapse of the Soviet Union, Georgia turned out to be in a difficult situation. The war and civil strife were making the process of transformation more severe. The country lost most of its production input markets and was unable to sell the goods abroad as well (in the former Soviet Union territory). Thus, all of these and the socio-economic problems turned into enormous economic losses. For instance, the country lost its real GDP by 80%; from 1990 to 1994[8] the industrial output declined by 83%, and agricultural output by 63%. Georgia lost most of its trade because the country was left without the key markets of former the Soviet Union. Accordingly, the government lost most of its revenue. The only solution for maintaining the governmental services and goods was foreign loans. Georgia started to borrow money from abroad. At the same time the National Bank, as well as newly formed banks (during the period of 1991–1999 there were not high requirements of minimum equity for establishing the bank. Simply saying, everyone could establish the bank with the minimum amount of money and capital) were borrowing money to support some local companies. As a result of these processes there was a huge amount of debt, which later on accelerated into huge inflation and then hyperinflation. According to the International Monetary Fund (IMF) report,[9] the inflation in Georgia during the period 1992–1995 was as follows (see Table 1, 2, 3):

The hyperinflation, of course, affected the exchange rate. Georgia was left without the main source of money. The only issuer of money during the Soviet times was the Central Bank of Russia, which refused to supply Georgia with rubles.[10] For this reason, the Georgian government invented temporary money – the coupon. This was a huge mistake. The people knew that this money was temporary so they had no trust in it. Besides the hyperinflation, the second reason for the depreciation of the coupon, as mentioned above, was the lack of trust. The coupon was introduced in April 1993 and in late 1994 it depreciated to almost 5 million coupons to the US dollar. It is not a surprise that after that huge depreciation the US dollars were widely used as a substitute for the coupons.[11]

As for the decrease of GDP. It is a fact that the decrease in real GDP in Georgia was highest among Ex-Soviet countries. In 1992 Georgian Economy, has been declined down to 44.9% (see Diagram 2):

8 Ministry of the Economy of Georgia, "Georgia: Economic and Social Challenges of the Transition" [1997] Vol (40), Problems of Economic Transition PET 3

9 International Monetary Fund, "Republic of Georgia Recent Economic Development" [1995] Vol (95/112) IMF country report IMF CR 1

10 Ministry of the Economy of Georgia, "Georgia: Economic and Social Challenges of the Transition" (n 8)

11 ibid

Table 1: Monthly Inflation in Georgia (1992–1993)

Month	Compared with the previous month (%)	Compared with the respective month of the previous year (%)	Month	Compared with the previous month (%)	Compared with the respective month of the previous year (%)
January/1992	29.1	176.3	**January/1993**	26.7	1434.9
February/1992	17.5	216.9	**February/1993**	37.0	1689.6
March/1992	197.8	787.9	**March/1993**	13.8	584.1
April/1992	48.6	826.9	**April/1993**	24.7	473.8
May/1992	−20.6	637.4	**May/1993**	31.8	852.1
June/1992	20.0	777.5	**June/1993**	31.3	942.1
July/1992	16.8	910.8	**July/1993**	39.8	1147.0
August/1992	6.0	970.0	**August/1993**	28.3	1409.0
September/1992	14.6	1033.0	**September/1993**	50.4	1881.8
October/1992	11.6	1097.8	**October/1993**	66.3	2853.5
November/1992	13.3	1202.1	**November/1993**	137.6	6068.0
December/1992	35.7	1176.9	**December/1993**	67.0	7487.9

Source: International Monetary Fund

Table 2: Monthly Inflation in Georgia (1994–1995)

Month	Compared with the previous month (%)	Compared with the respective month of the previous year (%)	Month	Compared with the previous month (%)	Compared with the respective month of the previous year (%)
January/1994	151.3	14702.3	**January/1995**	13.8	3691.9
February/1994	34.7	14690.5	**February/1995**	0.1	2717.9
March/1994	52.2	19690.5	**March/1995**	−0.3	1745.9
April/1994	83.7	29063.1	**April/1995**	0.2	906.8
May/1994	45.6	32115.8	**May/1995**	0.7	596.4
June/1994	7.5	26268.3	**June/1995**	−0.6	543.9
July/1994	5.8	20234.3	**July/1995**	4.1	621.8
August/1994	69.72	26798.5			
September/1994	257.5	63819.3			
October/1994	−7.7	35381.0			
November/1994	0.8	14950.0			
December/1994	−7.1	8279.1			

Source: International Monetary Fund

Table 3: Annual Inflation in Georgia (1992–1995)

	1992	1993	1994	1995
Annual average (%)	887	3125	18922	160

Source: International Monetary Fund

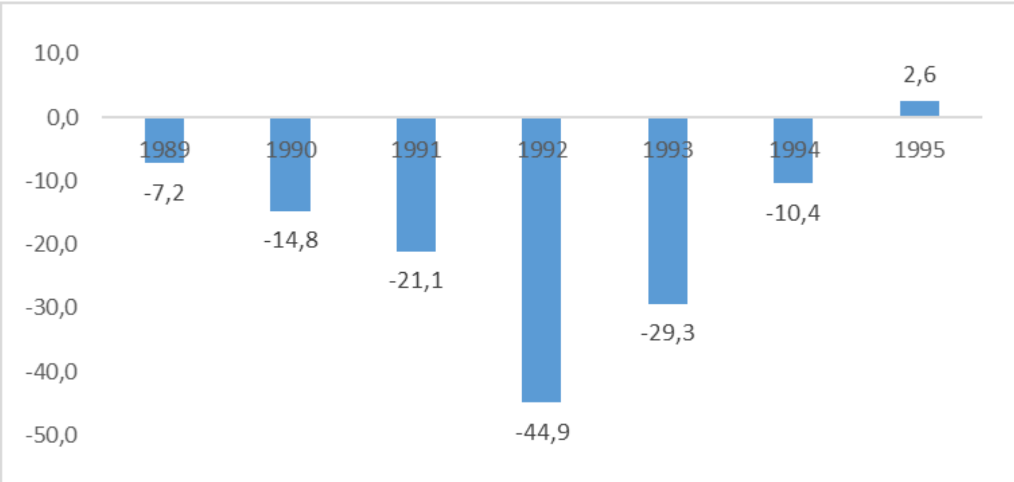

Diagram 2: GDP Growth (annual %)
Source: The World Bank Data

Why did the transformation process fail and do its results still affect the economy?

During the transformation process, the principal goal is to reach the macroeconomic stability, which means the positive level of output and reaching lower stable prices. These issues are important when launching the shock therapy.

As it was mentioned above Georgia started to use the 'Balcerowicz plan' – the shock therapy.

'Shock therapy' generally involves the application of strict fiscal and monetary controls, including an elimination of subsidies through price liberalisation, reduction of the budget deficit, control of money supply through restrictions on credit emission and short-term restraint of income growth. The plan developed by former Polish Minister of Finance, Leszek Balcerowicz, was applied in Poland. It is considered to be a model of the essentials of shock therapy. The plan comprised the following measures:

1. raising prices to the world market level, accepting the inflationary effects of such an action;
2. constraints on income growth in inflationary conditions;

3. restrictions on money supply and considerable increases in interest rates;
4. encouragement of saving, by increases in interest rates on cash and other deposits;
5. reductions in the budget expenditure by a reduction in government investment and elimination of subsidies to unprofitable enterprises;
6. issuing of government bonds to finance the state budget deficit;
7. regulation of the tax system and its unification;
8. establishing a single rate of exchange for the zloty and establishing convertibility of the zloty in the domestic market;
9. introducing a common customs tariff in order to restrict imports and stimulate exports;
10. providing social assistance to the population within the limits of budgetary prudence;
11. a break-up of monopolistic enterprises and rejection of state intervention in the activities of competitive enterprises.[12]

The first 'act' of the plan was fully fulfilled in Georgia. This reform of prices started in early 1991. In the beginning, only prices of some goods were liberalised, but in the late 1992 prices of almost all goods and services were liberalised. The average retail price index for 1992 was 913.1% higher compared to the level in 1991. Regulated consumer prices in 1992 were 68 times more than the prices in 1991. In the case of bread, the increase was 100 times.[13]

As for the second 'act', adjustments of minimum wages and social welfare payments for inflation were increasingly made in 1992. It was done six times in 1992, but only once during the year 1991. In 1992 wages increased by 13.14 and 17.94 times. No strict regulating measures were taken in Georgia by means of which it might have been possible to limit increases in the wage fund (as was done in Poland, where 2% overspending on wages attracted a penalty for an enterprise of 200% of the overspending; and if the overspending was more than 2% the penalty was 300–500% of the overspending), but the increase in wages and social welfare payments fell well short of the price increases.[14]

Items three and four did not work. The interest rates on the short-term deposits were increased as well as on the ten-year maturity deposits. These acts did not prevent the hyperinflation, and also could not stop the money supply

12 Vladimer Papava, "Georgia Economy from "Shock Therapy" to "Social Promotion" Communist Economies & Economic Transformation" [1996] Vol (8) Communist Economies & Economic Transformation 252

13 ibid

14 ibid

increase. As it was mentioned above the main reason (together with other key factors) was that there was not a proper and strong institution that could provide a monetary policy. Georgia had its own national bank, but it was not a primary money supplier. Later, the Central Bank of the Russian Federation refused to provide Georgia with rubles, so the country issued a temporary money – coupon. This was a mistake. Only in 1995, the Central Bank of Georgia invented its own official currency – lari. Only after that, the monetary policy started to work, and the country could manage and control the money supply.

The fifth 'act' was also not carried out. The government did not reduce the investments proportion in the whole government expenditures. There was a slight decrease, but it was not sufficient.

The sixth one was not fulfilled as well. The government issued its first bonds in late 1992, but selling started only in 1993. This did not help to reduce the budget deficit. The main reason behind this was the lack of trust. In Georgia, there was the difficult situation, civil strife, war and uncertain future. In the situation like this, it is difficult to trust the government, and it is hard to believe that it will reimburse the bonds. This was the first time the country issued the bonds and it should be taken into consideration that there were no proper financial markets to buy and sell securities.

According to Vladimer Papava, (Papava V., 1996 pp 257–254) the seventh stage of the plan was fulfilled. Item 7- reform of the tax system by the requirements of a market economy was commenced in 1991, so Item 7 of the 'Balcerowicz Plan' may be regarded as broadly fulfilled. But there is one fact that has to be taken into account. During the tax reforms with the advice of the IMF value added tax (VAT) was created in the agriculture sector also. To administrate this type of tax is difficult. It needs special technologies to manage it fully. The creation of this kind of tax during the early transformation period was a mistake. It requires more transactional costs to administrate. The government revenues from this tax will not be high enough as it is supposed to be.

The eighth, ninth, tenth and eleventh 'acts' were not carried out as well. Overall, we can say that only acts that were fulfilled more or less successfully were the first, second and seventh, three out of the 11 acts.

Overall, it is possible to say that the 'Balcerowicz plan' was not fulfilled in Georgia. What was the main reason behind it? The answer could be found in the institutional theory of economics. Also, the answer to the remaining results of the transformation can be explained using the institutional theory.

According to Peter M. Lichtenstein,[15] during the transformation process, the old formal and informal rules and routines are being changed. Of course, that

15 Peter M. Lichtenstein, "A New-Institutionalist Story about the Transformation of Former Socialist Economies: A Recounting and an Assessment" (1996) Vol (30), Journal of Economic Issues JEI 243

requires time. Sharp changes usually required by the shock therapy lead to output decreasing. The reason behind it is expectations and old routines and institutions. During the transformation process, the old expectations and routines are still working. So it needs time for all changes to be done. According to him, a successful transformation should include these three steps:

1. Macroeconomic stability should be reached. Fiscal and monetary policy tools should be used. The dual banking system must be launched.
2. When macroeconomic stability is reached and formal institutions are being changed, the next step should be privatisation and creation of the bankruptcy legislation.
3. The third stage is the longest and it concerns liberalisation of the prices, free foreign trade, free movement of human capital and creation of all the necessary governmental institutions that are needed to keep and run free market economy properly.

The main problem in Georgia was the issue connected with the institutions. Institutions can be divided into two, the formal and informal institutions (**FI**s and **II**s). FIs are presented in the written laws and they represent the desired or existed IIs. These two institutions intersect. The intersection is called natural formal institutions (NatFIs). This means that FIs are close to human behaviour and their mindsets.[16] During the market economy, the share of **NatFI**s in all **FI**s is higher. During the communist command economy, the picture was the opposite. The share of **NatFI**s is relatively low in the whole **FI**s.[17] The latter means that the FIs that were functioning during the Soviet Union were 'against' the 'Normal' human behaviour. And this is not related only with the economic thinking. The relationship of institutions can be seen in figure 1.

The later-mentioned issue was one of the main reasons for creating the shadow economy in Georgia. Its scale reached almost 80%.[18]

After the collapse of the Soviet Union, Georgia started to launch the shock therapy, which, as mentioned above, required sharp changes. First of all, it demands the collapse of all former Soviet FIs. Of course, that requires time. It can be said that theoretically in Georgia free market-based institutions were created, and officially they started to work. But the results of their work started to affect the economy positively after some years. The process lagged in time. All of this was not according to the shock therapy. Besides that, in Georgia, there was a

16 Vladimer Papava and Nodar khaduri, "On the Shadow Political Economy of the Post-Communist Transformation". [1997] Vol (40) Problems of Economic Transition PET 251

17 Vladimer Papava (n 7)

18 Vladimer Papava and Nodar Khaduri (n 16)

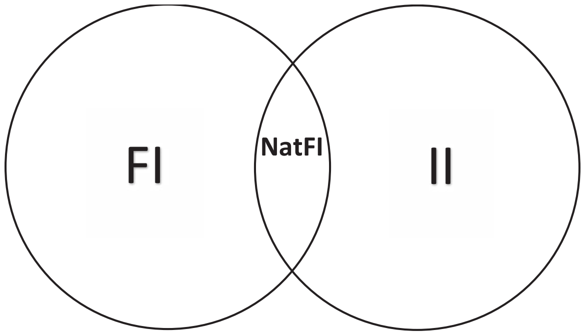

Figure 1: Formal, Informal and Natural Formal Institutions.
Source: Papava V. and Khaduri N. 1997. On the Shadow Political Economy of the Post-Communist Transformation. *Problems of Economic Transition*.

National Bank and country-created two-staged banking system. Still, these institutions were experiencing the lack of monetary tools. Even more, because of the lack of the market economy experience, the National Bank of Georgia, the FI, which was supposed to help the transformation process, made a huge mistake and launched temporary money – coupon.

After the collapse of FI, creating new, market-based institutions needs time and even more time is needed for their effective work. Before this process, as it was mentioned above, the IIs and old routines are working. Most of the IIs were 'against' the Soviet FIs. All of this represented in the high scale of the shadow economy. Still, even there are proper Formal Institutions, there are ruled by the people, who represent the left side of the Venn Diagram – the Informal Institutions. During the Soviet Union, the IIs were 'against' the Soviet FIs and the share of **NatFI**s was small, but it cannot be said that these IIs were close to Adam Smith's economic man. As Vladimer Papava states in case of human capital the post-communist reflection was and still is strong. Homo transformaticus still has not become Homo Economicus, as well as 'Post-Deltsi' are not yet entrepreneurs.[19]

Let us consider how the classification of institutions is being changed in the transformation process: The change of the structure of society is primarily related to FIs. If the changes are expected, the existing FIs are often replaced by new FIs that are better suited to the new reality. But if the structural changes in the country are unexpected, old FIs are destroyed and they cannot be replaced with new FIs faster. One of the reasons is the lack of knowledge that is needed to run the different institutions. The emerging vacuum, which appeared after the FIs are being collapsed, is filled with the IIs. Overall, a result of these actions is the

19 Vladimer Papava, "NECROECONOMICS AND POST-COMMUNIST TRANSFORMATION OF ECONOMY", [2001] Vol (15) "Company Imperial" Ltd., CI 3

share of shadow economy, which was rapidly growing from 1993 to 1995 and reached almost 80%.

During the transformation process, the area of IIs increases, while the area occupied by the FIs decreases.

It can be said that Georgia was not ready for the shock therapy. The first reason was the lack of free market-based FIs, the lack of knowledge of how to administrate these institutions and the lack of tools for the institutions. The second reason was the IIs, which during the transformation process took the place of the FIs. These IIs and routines were related to the shadow economy, so they were far away from entrepreneurial thinking. The primary goal for them was to gain as much as they could. The latter reflected in selling all the properties and capital, rather than making investments.

Overall, during and after the transformation process it was impossible to create a strong private sector. In this case, the main burdens were on the government. Due to the situation, the government was forced to take a step forward and try to help the economy to develop.

Conclusion

As it can be seen above, one of the main reasons for the failure of the transformation process was the case related to the institutions. Georgia was not ready for the shock therapy. There were not created the Formal Institutions on time and the ones which already existed. They were experiencing the lack of knowledge and tools. Neither the IIs made a positive contribution to the economy. During the Soviet times, the IIs were one of the main reasons for the shadow economy. They were 'against' the formal Soviet institutions, and that is why the share of **NatFI**s was so low during the command economic system. Accordingly, after the collapse of the Soviet Union, the IIs continued to act like they used to before. Instead of becoming one of the driving forces for the economy (for instance, like in the case of Poland) the private sector of Georgia became a burden for economic growth. During the transformation process, besides the fact that in Georgia the new FIs were created, the old Soviet Union routines and old expectations were still working. To change the IIs, routines and old expectations requires even much more time. That was one of the most significant problems in the transformation process. Even nowadays, Georgia could not manage to create a strong private sector. The country is experiencing the lack of entrepreneurs. The entrepreneurs who are independent are not dependent on the government, are not afraid to take a risk and have the long-term economic and business plans.

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