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# INTRODUCTION

The Economic Policy Research Centre in cooperation with the Eurasia Partnership Foundation began to carry out a project "Monitoring of Georgian Trade Policy in the Context of Poverty Eradication" in March of 2008. Within the framework of the project the centre has studied and analyzed a ten month dynamics of trade balance of Georgia of 2007 and 2008, its influence on the current economic processes of the country, especially in the poverty reduction context.

The dynamics of the trade balance of Georgia and its influence on the economic processes is one of the mechanisms for diagnosing the economic situation of the country and the current economic processes.

At present it is obvious that a negative trade balance is irreversibly increasing again and making the economics considerably depended upon import that points out that in the country sectors oriented on a local market and export are not being developed that is directly connected with a poverty level and employment problems.

Hence the analysis and advocating of this subject will give us an opportunity to identify and prevent the expected dangers by means of discussions-dialogues with the government. Carrying out and advocating of this project will allow us to focus upon more concrete and perceptible problems overcoming of which might bring real changes in economics.

## 1. STATUS QUO

Alongside with those achievements evidently having been observed in Georgia's economics before the war and being a base of its success even today, current processes in the economic area can reveal such problems which in the end might hinder the progress of economics of the country.

One of the crucial themes is a constant growth of a trade deficit becoming more and more of enormous scale in the latest years. Accordingly the degree of dependence of the country upon import is increasing and because of such situation there is observed weakening of not only export sectors but other local sectors with a perspective of replacing import.

Worsening of a trade balance is a complex process and it is caused by many factors. Each factor has its own place and specific share though there are some of them having the most considerable influence on the current process.

On the one hand the growth of import is favored by a downward trend of trade tariffs that is a good tendency itself, because it will be a signal of simplifying and cheapening of trade. Though there should be realized the risk that such a policy reduces capabilities of a local production and increases the probability of a full saturation of the market with import production.

At the same time export capabilities in the latest two years were considerably affected first by an irreversible and sharp strengthening tendency of a national currency causing a rise in export price and decreasing its existed or potential resources, as to the import, on the contrary it was made cheaper and its volume bigger. Later (since November 2008) an unstable state created in connection with an exchange rate of a national currency had also a negative influence on a trade policy because it becomes impossible to make long term planning and realization of trade policy and its operations.

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<sup>1</sup> The Economic Policy Research Centre with the support of the Eurasia Partnership Foundation, is carrying out "Monitoring of Georgia trade policy in the context of poverty eradication". For the contents of the analytical material prepared within the framework of the project is only responsible the Economic Policy Research Centre.

Alongside with the other more or less important factors (scantiness of the Georgian export potential, the less financial stability of Georgian companies and significantly weak positions compared with their foreign analogues, difficulties in maintaining access to the existed markets and getting access to new markets, in outgoings and etc.) these problems are causing strengthening of the import instead of rising the export and replacing of the import by the export. It is confirmed by the official statistics and the tendency is obvious – in the course of time the Georgian export gets in the shadow of the import.

This problem is more important because it is directly connected with poverty reduction problems. Such strengthening of import positions hinders not only financial or institutional stability and further development of local companies but it also makes impossible to maintain already existed jobs, and moreover to create new jobs.

It equally concerns sectors and companies oriented on domestic demands as well as on the export. As service and goods oriented on domestic market as well as an export potential are most likely being created in the spheres with a high rate of employment.

For example in agriculture, which in 2007 generated about 13% of the whole domestic products of Georgia, it will be particularly painful to retain export and local positions because of the factor that 55,6% of capable of work population of the country is employed in it.

So from the point of view of the growth of a trade deficit a sharp change of a configuration of the export-import balance of the country is a long term problem of Georgia's economics that might be followed by negative results. Hence it is inevitable to make a sound analysis and proper preventive actions.

One of the main aims of the project is to see the poverty problems just in the light of this context, because the existed situation is very often observed and studied without foreseeing this factor that makes impossible to see and analyze poverty problems thoroughly.

The irreversible growth of a trade deficit of Georgia is intensifying the poverty problem more and more deeply, and its influence upon the current processes in economics of the country (here is meant a labor market as well as opportunities of creation of new companies, incomes and etc.) is also growing.

The influence of the export-import configuration change on a poverty level is not an instant process and it is not always revealed in a short period of life. Accordingly it needs to observe its dynamics and to analyze it in detail.

One of the main goals of this project is to reveal and estimate the connection existed between the change of the export-import balance and its influence upon the problems of growth and decrease of employment-unemployment and poverty level. By revealing of this relationship it will be possible to see and envisage the picture on the base of which the policy for solving of these two main problems must be worked out.

This analyze is important for revealing and focusing upon the sectors which in the context of current changes either are having new perspectives or are losing the existed positions.

## 2. TRADE TURNOVER 2006-2007

For visualizing and making an observation upon the trend in rather a long period it is probably desirable to survey data at least of the last two years, which are emphasizing some important moments.

Foreign trade turnover of Georgia in 2007 (except unorganized trade) was 6.457 billion dollars, that exceeds the analogous rate of 2006 by 39,9%. According to the information of the Statistics Department the export from the total volume of the foreign trade was 1.24 billion dollars while the import was 5.22 billion. The negative trade balance was a record value – 3.98 billion dollars (See table 1).

**Table1. Amount of foreign trade turnover of Georgia and its structure in 2006-2007**

	2006 (billion dollars)	2007 (billion dollars)	Growth (%)
Trade turnover	4 651	6 454	39,9
Export	993	1 240	24,9
Import	3 681	5 217	41,7
Deficit	2 688	3 976	47,9

Georgia has a negative trade balance with 100 partner countries with which a trade deficit is 4.12 billion and a positive trade balance with 23 countries (sum total of 146 million dollars).

In 2007 Georgia has more than a million dollar positive trade balance with 11 countries. These countries are: Canada (58.3 million), Armenia (51.3 million), Mexico (12.6 million), Gibraltar (8.3 million), Tadjikistan (4.2 million), Yemen (2.1 million), Algeria (1.6 million), Iraq (1.4 million), Belize (1.3 million), Philippines (1.3 million) and Afghanistan (1.1 million).

34.8% of the trade deficit falls upon CIS (the Commonwealth of Independent States) countries. A foreign trade turnover with these countries in 2007 was 2.32 billion dollars. The share of CIS countries in the foreign trade turnover is 36%, in the export 37.9 % and in the import 35.5%.

As to Europe the situation is the following: foreign trade turnover with 27 countries of European Union in 2007 was 1.8 billion dollars exceeding the corresponding rate in the previous year by 36%. From this export is 269 million dollars and import – 1.54 billion. The share of these countries is 28% of foreign trade turnover of Georgia, among them 21.7% of export, 29.5% of import and 34.8% of a trade deficit (See Table 2).

**Table 2. Amount of foreign trade turnover of Georgia and its structure with CIS and EU countries in 2007**

	CIS (million dollars, %)	EU (million dollars, %)
Trade turnover	2,32	1,80
Export	37,9%	21,7%
<b>Import</b>	35,5%	29,5%
Deficit	34,8%	34,8%

The trend is clear: in the foreign trade turnover of Georgia import is increasingly oppressing export, in the course of time the export is more and more getting in the shadow of the import. From the country is mostly exported raw material again and with great troubles (wine and citrus or metal scrap).

Against the background of such a hard situation of export the activity of import is getting stronger. Because of strengthening of import and oppressing of a local production export resources are decreasing.

There should be taken into account one more parameter: from 100 partner countries Georgia has a positive balance only with 23 countries, with other countries has a negative balance (last year the proportion was 17:83). Here a negative number is irreversibly growing that is another confirmation of worsening of an export-import balance.

A small scale of export is in the direct connection with a low level of producing products because the point is not only a small scale of producing export products but a high level of import. The constant growth of import shows that products produced in Georgia cannot supply a domestic market and it is a reason of unemployment. So for the main social-economical challenge of the country –poverty reduction it is important to concentrate attention on a low index of export and accordingly on a growing index of import and to make economic accents upon the import-export dynamics.

Such strengthening of import positions hinders not only financial or institutional stability of local companies and their further development but it also makes impossible to maintain already existed jobs, and moreover to create

new jobs. It equally concerns sectors and companies oriented on domestic demands as well as those oriented on the export.

As service and goods oriented on domestic market as well as an export potential are most likely being created in the spheres with a high rate of employment.

For example in agriculture, which in 2007 generated about 12.3% of the whole domestic products of Georgia, it will be particularly painful to retain export and local positions because of the factor that 55.6% capable of work population of the country is employed in it..

So from the point of view of the growth of a trade deficit a sharp change of a configuration of the export-import balance of the country is a long term problem of Georgia's economics that might be followed by negative results. Hence it is inevitable to make a sound analysis and proper preventive actions.

### 3. TRADE TURNOVER - 2008

The fact that Georgia's economy is greatly depended upon import and that export gets under its press is again proved by the statistics of the last 10 months of this year.

Foreign trade turnover of Georgia in January-October 2007 (except unorganized trade) was 6 billion 531 million dollars, that exceeds the analogous rate of the previous year by 29%. The export from it is 1 billion 352 million dollars (accordingly by 35.6% more), but import - 5 billion 179 million dollars (by 27.4% more) i.e. during 10 months in 2008 Georgia's negative trade balance is 827 million dollars by the end of the year it will presumably be over 4 billion.

In January-October of 2008 Georgia has a negative trade balance with 104 partner countries with which a trade deficit was 4 billion 35 million dollars (instead of 100 countries and 3 billion 182 million dollars as was fixed in January-October 2007).

In January-October of 2008 Georgia has a positive trade balance with 21 countries with a positive balance of 208 million dollars (instead of 22 countries and 115 million dollars as was fixed in January-October last year.

**Table 3.**

Foreign trade balance of Georgia

	Number of countries	FForeign trade balance
<b>Negative trade balance</b>		
2007 January-October	100	3 182.2
2008 January-October	104	4 035.3
<b>Positive trade balance</b>		
2007 January-October	22	114.5
2008 January-October	21	208.1
<b>Total</b>		
2007 January-October	122	-3 067.7
2008 January-October	125	-3 827.2

**Table 4.**  
The largest trade positions in Georgia's export

	January-October, 2007		January-October, 2008	
	1000 USD	% of total	1000 USD	% of total
Export – total	997 024.5	100.0	1 351 972.0	100.0
Ferroalloys	117 630.9	11.8	260 894.3	19.3
Iron-and-steel scrap	83 623.8	8.4	118 664.3	8.8
Copper ore and concentrates	79 212.5	7.9	111 918.0	8.3
Nitrogenous fertilizer	51 094.4	5.1	102 952.8	7.6
Automobiles	54 932.6	5.5	99 084.6	7.3
Gold processed or half processed	53 190.2	5.3	73 985.0	5.5
Cement	52 565.2	5.3	73 985.0	5.5
Ethyl alcohol not denaturized with concentration of spirit less than 80 volume percent and alcoholic drinks	42 477.8	4.3	43 976.9	3.3
Natural wine of grapes	22 745.0	2.3	30 568.5	2.3
Copper scrap	32 332.0	3.2	29 224.1	2.2

From a commodity group the first place in the export -ten belongs to ferroalloys - their share in January-October 2008 is 19.3%of export and 261 million dollars. The export of scrap ferrous metal is 119 million dollars that is 8.8% of the export. The third place belongs to copper ores. The share in export of copper ores belonging to the third place and the concentrated products is 8.3% and 112 million dollars.

The largest import commodity group in January-September of 2008 is oil and oil products the share of which is 13.1% and 679 million dollars. The next is a car import the share of which is 8.4% in the import and 435 dollars.

The third place is belonged to oil gases and gas hydrocarbons and to the commodity groups of therapeutic agents with 3-3% share, correspondingly with a sum of 157 million and 153 million dollars.

**Table 5.**  
The largest trade positions in Georgia's import

	January-October, 2007		January-October, 2008	
	1000 USD	% of total	1000 USD	% of total
Import – total	4 064 762.4	100.0	5 179 221.7	100.0
Oil and oil products	435 535.5	10.7	678 906.7	13.1
Automobiles	300 182.2	7.4	435 174.0	8.4
Oil gases and gas hydrocarbons	241 990.6	6.0	157 373.1	3.0
Therapeutic agents	119 093.4	2.9	153 075.8	3.0
Transmitting equipment for radio-telephone, radio-telegraph and broadcasting activities	83 672.8	2.1	134 799.9	2.6
Iron and steel bars	60 587.1	1.5	101 567.6	2.0
Wheat	99 966.7	2.5	90 378.7	1.7
Computers and their blocks	61 337.0	1.5	80 615.0	1.6
Manganese ore and concentrates	15 864.8	0.4	69 876.2	1.3
Wheat flour	21 475.8	0.5	67 715.9	1.3

Even a superficial analysis shows that in the export-import structure of the country the tendency has not changed: from the country raw material is mainly going out in production of which a minimal labor force is involved. In the list of imported commodity are mainly final products that don't need processing and only demands retail service.

In both cases an employment effect is very low. Accordingly the growth of import and development of export segments which are producing in a less degree are favorable for the employment decrease and the unemployment growth.

In general one of the most important factors hindering the future development of Georgia's economy is a growing trade deficit of the country, a deficit that sooner or later must have caused something that happened in November 2008 two days apart – 17% devaluation of national currency.

## 4. THE CORE OF THE PROBLEM

It is necessary to understand why a trade deficit is such an important problem, though it must be taken into account that the present situation of the country is connected with a structural choice of the income oriented economics.

Such a deficit itself has monetary and real dimensions. The monetary side of the problem is the influence of this deficit upon the rate of exchange. Theoretically self-correction of the rate of exchange is balancing trade: abundance of import raises demands on foreign currency and causes devaluation of the national currency that raises competitive capacity of products from the point of view of exchange rate and makes the trade balance.

A stable deficit can appear in different situations: in the USA where the national currency is also the world currency that is neutralizing a regulating effect of the rate of exchange; in those countries where the change of the rate of exchange is limited by a strict currency policy of the government using "currency shield" regime or monetary integration, as it is in European Union; in the countries, such as Georgia, where incoming flows of capital compensate the influence of a trade deficit on the rate of exchange and is maintained a high rate of exchange of national currency.

A real dimension of this problem is that a growing trade deficit implies non-competitiveness of national economics and a narrow economic base of the country that can be measured by labor inputs per capita. These inputs might be very low because of the following reasons undeveloped economics, an informal sector, a low level of potential activity (due to a demographic factor), a low level of employment and annual labor inputs of population of working age.

In general monetary and real dimensions of a trade deficit should be analyzed taking into account priorities of economic policy. It is interesting that this situation is like the present state of French economics whose trade deficit has been 39 billion Euros for already four years (2% of gross domestic product). It is due to the prices of the imported energy carriers, a high rate of exchange of euro, low wages in Germany and insufficient labor inputs. The interpretation of the above-mentioned deficit is a subject of polemics among economists.

### **WHAT ARE PRIORITIES OF GEORGIA'S ECONOMY?**

If priorities are carrying out modernization and reduction of poverty by means of direct foreign investments, then a monetary effect of the deficit will be neutralized and Georgia will have a high and stable rate of exchange again. Such rate will be good for attracting direct foreign investments as well as for buying capacity of population if it has profit, but in fact a high rate of exchange is not good for competitiveness of the local production and accordingly for employment and generation of local incomes. The country will be shut in the frame of a narrow economic base.

It must be added that the present balance between the positive and negative presses upon the national currency in a middle term period creates an unsteady situation. Taking into account that the deficit is very high (exceeding GDP –gross domestic product 24%-, that is 12 times more than in France) any change of the above-mentioned balance will cause a serious economic destabilization. As a consequence of direct foreign investments for getting rid of stabilization of a nominal rate of exchange a great amount of GEL causes a danger of inflation.

Except this the biggest defect of the economy unnecessarily oriented on import is weakening of a local activity the result of which is a poverty problem that recently has been in the focus of political life. In spite of it the aforesaid phenomenon has not been analyzed thoroughly and monitoring has not been carried out yet. Quantitative estimation of poverty cannot be managed because of inconsistency of the data.

## 5. POVERTY LEVEL

According to the existed data a poverty level is going down but it is higher in cities that are debatable taking into account an amount of money orders in cities. It is likely more correct that poverty is connected with a low level of employment in cities as well as in rural. The main form of employment in the village using the terminology of international organizations is "self-employment". In fact it is a small farming mostly oriented on self-feeding.

Self-employed people are 50% of economically active population. The number of employees has not increased yet and is only 30% of economically active population or 35% of the whole employed people. A regional analysis of labor markets, money orders and poverty have not been carried out yet, that would have revealed poverty traps in cities and rural.

Besides social and political results in the middle term period the main result will be a large scale unemployment that will cause the further decrease of an economic base of the country. Just because of this fact the agency Fitch Ratings was very careful in its estimation emphasizing a middle level of incomes and a narrow economic base of Georgia.

It should be noted that still in April when by Fitch Ratings Georgia was maintained a long term BB- rating with a stable perspective, the agency identified those risks which might become a source of problems in a short as well as in a long perspective.

Experts of the credit company are emphasizing that for a fast economic progress of the country there are dangers because of political and economic weaknesses including a foreign trade deficit. The fact that a permanently growing negative balance of trade is one of the most painful problem once again was confirmed by the world most authoritative rating agency.

In addition to the other factors it is also challenging that the agency Fitch Ratings predicted decreasing of the whole domestic products. Later the rating to decreasing was overviewed nevertheless the reason of which was the war situation with Russia and sharp worsening of economic indexes.

It was explicitly noted that among the economic weaknesses a negative trade balance has a permanently growing difficulty and it is directly connected with a poverty level and employment problems. Social tension is again considerable that might become a reason of intensification of a political situation in Shida (Inner) Kartli.

A low level of employment in Georgia is a ring of a chain of economic problems which always looks weak and is the most unstable element of the social-economic stability.

As production dynamics remains behind consumption it can be said that a production basis of the country is very narrow. It is an employment aspect of extra consumption reality. Of course it should be taken into account different labor intensities in different fields of production and that some not exportable fields, for example building, creates many jobs. But it is not so in other such growing sectors, as financial or communication sectors. This structural unemployment is only partly reflected in unemployment indexes.

It should be also envisaged unrecorded employment both in villages and big cities as well as the earlier emigrated population of working age that greatly changes the existed picture.

Emigration is a separate problematic block – a complex phenomenon that is explained by economic (a poverty motive and attraction of high life standards in other countries), as well as by sociological (emigrated Diaspora) and cultural factors (symbolically or economically attractive force of some countries).



For such small countries, as Georgia, a high level of emigration is a traditional reaction to unemployment. A migration loss in Georgia is more than one million (20% of the population), 2/3 of which is in Russia (the rest is in the USA, Greece, Turkey, Spain and the Ukraine).

Emigration and extra consumption makes the income oriented economics turn into a self-going economics. Of course there are opposite trends of production investments but such tendency has been weak so far which indicates that the income orientation is steady and stable and a risk of continuing such situation is bigger.

So Georgia has an income oriented economics. in the same 2006 there were the following incomes: money orders (800 million dollars), direct foreign investments (1.1 billion dollars), international guarantees (187 million dollars), capital incomes from privatization (312 million dollars) and about 100 million dollars as pipeline commissions. From external sources the whole income in 2006 was 2.5 billion dollars or 32.5% of gross domestic product (GDP). The same tendency is observed in 2007 and in the prewar period in 2008.

The income oriented situation in Georgia is governed by three forces: a self-going mechanism of a decreased economic base, emigration and unnecessary consumption; foreign help from the western donors which have long-term strategic interests in the country and direct flows of foreign investments.

## 6. A MIDDLE-TERM RISK

### WHAT RESULTS ARE EXPECTED IN THE MIDDLE-TERM PERIOD?

**It can be said that a big trade deficit is not a problem itself because at the same time resources are coming to finance this deficit and to relieve the disbalances caused by it and on the contrary a potential negative influence of the entered capital on a real rate of exchange is neutralized just by the trade deficit, but the fact is also that the biggest trade deficit has already caused devaluation of the national currency and the growth of other risks.**

Georgia's economy like a bicycle is rolling between these two misbalances. The problem is that this correlation is not stable and the drop of external incomes (what might happen for example if in the middle-term period a part of emigrants come back) or the decrease of a trade deficit) will cause macroeconomic fluctuations.

Besides in the period of a quasi-fixed rate of exchange coming of big capital flows demands a corresponding emission of GEL and makes grow of M2: in 2005 M2 increased by 26%, in 2006 – by 30%, but call for money has not been increased accordingly. This inflation press has already appeared: a price index is increased from 6.2% to 8.7% 2006, and in 2007 it was increased up to 10.7 %.

The problem is already tangible for population because prices are mainly going up on articles of final consumption. A high share of import controlled by a small group of traders can drop a competition level at these markets and cause nonmonetary inflation. Inflation will lessen an export potential and increase superfluous consumption.

In today's situation standard relative advantages and competitiveness are less. When there is a growing trade deficit the first diagnosis is the following: the rate of exchange of GEL is not optimal and is far from the balanced value. The "recipe" of it would cause more devaluation of GEL which is thought to be too stable though because of several reasons such approach is not recommended by the International Currency Fund and the World Bank.

These reasons are: Export structure, inability of a local agriculture and business to use correction of the rate of exchange, structure of banks assets, as well as social problems. Because of these reasons Georgia has to live with a higher exchange rate of GEL than it would be economically justified.

In the middle term period it is rather a serious challenge. At present direct foreign investments cannot change the situation as they are not really directed to the growth of effectiveness and they will not relieve an external press.

Sustainable development of the country should not be based upon a cheap labor force and price competition. For example tourist service compared to Turkey is not competitive. Some kinds of Georgian agricultural products under very low tariffs are not able to compete with the analogues from Turkey and other countries. Products of light industry have the same problem in relation to China and etc.

In answer to this challenge Georgia must create new relative priorities on the base of high-quality products and of high added value.

Except this the competitiveness of Georgia must be achieved by means of its agricultural products and tourist resources. As to transportation, transit and logistic service Georgia is already getting a profit due to its specific location.

Because of a deficit of a current report and an income oriented economy Georgia is very much depended upon foreign sources.

In the future gaining incomes from donors is more or less guaranteed by strategic investments in transit routes through. Such situation corresponding to big interests of the West has a risk of instrumentalization of the country by the USA or European Union. Besides the incomes coming in money orders are under a constant political risk that should be taken into account in relation with Russia.

The main factor limiting the economic development of the country is its narrow economic base that is connected with the Diaspora living abroad for a long time and is a characteristic feature for the income oriented economics. The situation is hardened by the unemployment problem, especially in a rural. Therefore it is necessary to promote really the accelerated development of market economics and to manage a potential emigration of the rural population that will be caused by an expected growth of productivity of economy in rural.

So in order that a narrow economic base not to become an insuperable hindrance for sustainable development in the middle term perspective, it is necessary to eliminate partial employment and provide the growth of production by improving an export potential which will be done by using direct foreign investments and establishing European norms and standards.

## 7. POSTWAR SITUATION

Problems which will be caused to employment by the postwar situation are a separate subject for discussion. According to the estimation of the World Bank and UN after the August events Georgia's economics will be threatened by recession.

By the prognosis of donors the situation before and after the conflict will be as following: If the annual growth before the conflict was thought 9%, now its volume will be dropped up to 3.5%. Inflation will be decreased from 10% to 8%, and current report deficit will be increased from 16.6% to 20.8%.

In the current year direct foreign investments will be less by about one billion dollars than it was planned (2.1 billion dollars) and will be only 1.2 billion. As to the budget which according to the preliminary plan should have been proficient, now it needs 480 million dollars as help from donors.

According to this research at best investments will be extended in building, real estate, retail trade and tourism. By the conclusion of donors before restoration of stability the transit function of the country will be doubtful. A deficit is also expected in budget incomes which must be replenished with the help of donors.

According to donors very soon unemployment will be increased by 100 000 and will reach 350 000 which is one fifth of the whole labor force.

Accordingly unemployment press upon the economic situation will be growing. Hence local employers and employees who were actively oppressed by import analogues before the pre-crisis period now will be in a more difficult state and they not only will have less incomes but they might lose their jobs .

## 8. TRADE ROLE

Both as Georgian as well as foreign scientists and specialists agree that foreign trade has a very important role in the speedy economic development. It is hard to estimate the role of foreign trade for developing countries, particularly for small developing economics.

What is a rate of participation of such countries in the world trade and in general in the world economics? Which structural and institutional factors have decisive influence on trade and development? What tendencies are being formed in this point of view in the modern world? How to define priorities to achieve speedy economic development by means of developing international trade?

With the aim of analyzing and monitoring of these problems the secretariat of United Nations Conference on Trade and Development (UNCTAD) worked out index of trade and development (TD-index), which is the best way to compare countries.

The role of Georgia in the world economics observed by the trade and development index of UNCTAD is revealing quite interesting results.

The index of trade and development serves the following three main aims:

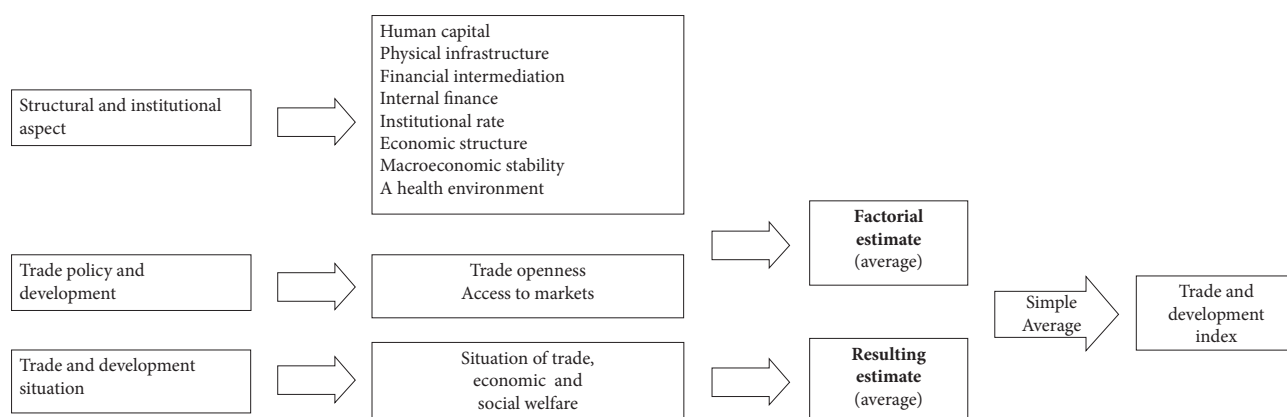
- ▶ monitoring of trade and development state;
- ▶ analyze factors acting on this state;
- ▶ At the national and international level working out such instruments of policy which will provide focusing of foreign trade on development and poverty reduction

In other words this index is intended to help countries, especially underdeveloped and poor countries, to define ways for effective integration in the world economics and gaining profit from international trade with the aim of economical growth, poverty reduction and welfare.

In the Scheme 1 there are given in detail methodological principles for calculation of the given index (TD).

TD index is received as a result of aggregation of three levels of 34 specific indices. On the first level from the above mentioned 34 indices 13 aggregated indices are being calculated; from which 9 characterize factors acting trade and development (factorial estimate) in the structural and institutional viewpoint, 2 – in the trade policy and development viewpoint. 12 and 13 indices are estimating the state of trade and development as a result (resulting estimate).

SCHEME 1.  
Conceptual frame of a trade and development index



Finally TD index is received as a simple average mathematical of factorial and resulting estimates (the third level of aggregation).

On the one hand these indices are describing the factors by influence of which the existed level of the trade and development in the country are achieved; on the other hand they are characterizing the state of trade and development.

The use of such wide number of economic indices confirms the fact that not only the liberalization of foreign trade does not give the opportunity of achieving a desirable level of trade and development. In report published in 2007 by UNCTAD there are clearly shown weak and strong points in trade and development of Georgia in relation to other countries.

The initiative of using this index did not arise long ago. The first such calculations based upon the data of 2005 were published in 2006. Then 110 countries of the world were participating. In November 2007 there were published new data calculated basing upon the indices of 2006. The calculations were directed by the Advisers Board presided by the Nobel Prize laureate professor Lowrens Klein.

## 9. THE PLACE OF GEORGIA

The higher a trade and development index is, the better the situation is in this sphere in the country. Therefore the growth of the index in a given period means widening of foreign trade and the growth of economics.

In order to analyze the state of trade and development of Georgia and to compare it with other countries there have been chosen four groups of countries (though are known other regional classifications of countries): developing countries, countries of south-east Europe and CIS, countries joined EU in 2004 (EU 10) and developed countries.

These four groups of countries were chosen purposely, namely developed countries were chosen due to the current status of our country; south-European and CIS countries were chosen because Georgia is a member of this group and has the analogous start conditions; new members of EU were chosen because it is necessary to compare Georgia with these countries, as the results achieved by these countries in the sphere of trade and development must be at least a "programme-minimum" for Georgia, as for the country oriented on European values; and finally comparison of Georgia's data with developed countries was made in order to show how far we are from the best indices of development.

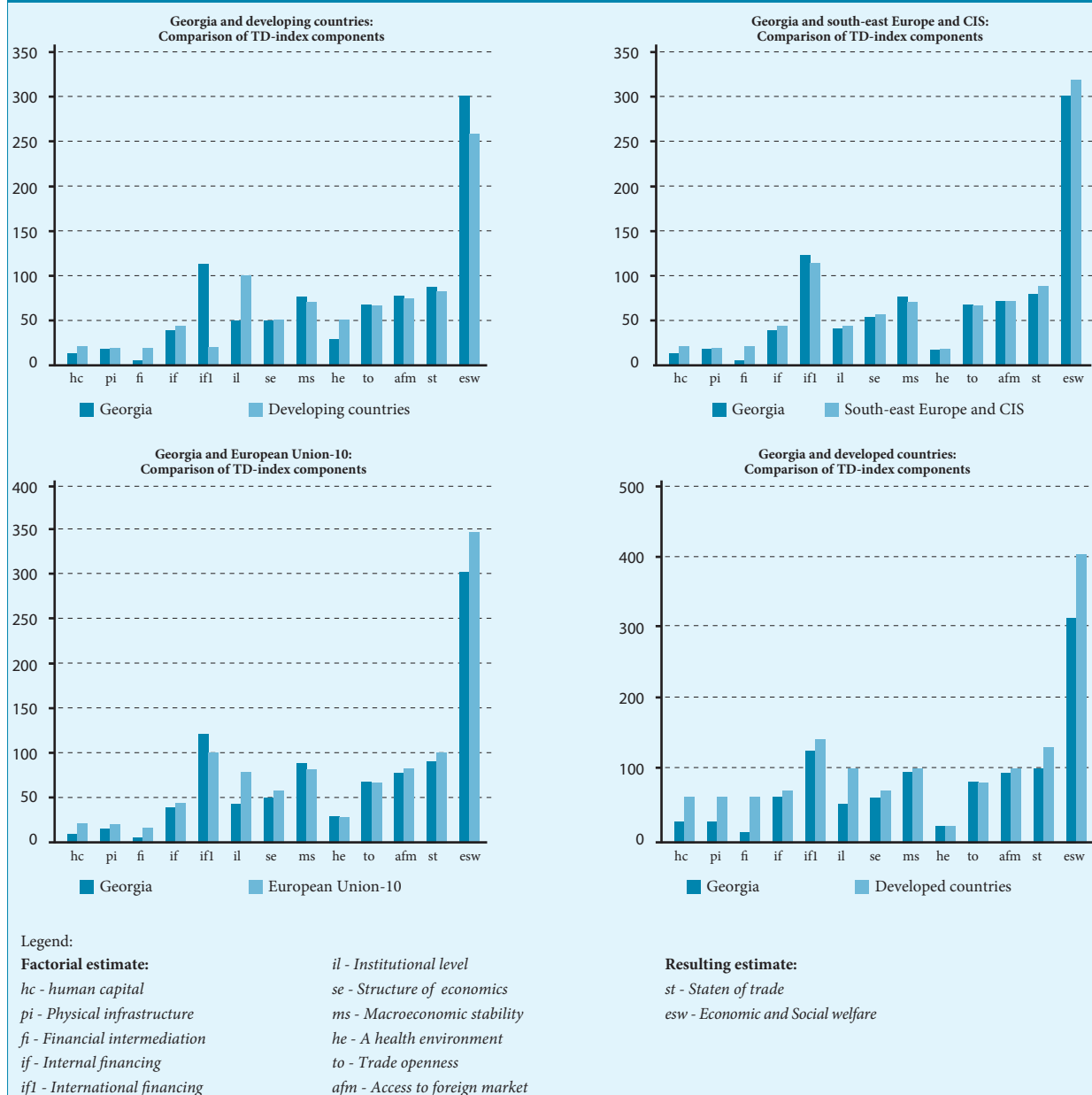
As it is seen from the scheme above structural and institutional factors defining a trade and development level are characterized by UNCTAD with the following indices: human capital assets, a physical infrastructure, financial intermediation, international financing, institutional quality, an economic structure, macroeconomic stability and a healthy environment.

The human capital assets are estimated by a ratio of gross health expenditures (state and private) and education state expenditures to the gross inner product. This indicator shows how healthy and qualified workers are involved in building national economic processes.

For Georgia it was 11, which is by 42 items less than the highest index, showed by Denmark which holds the third place by TD –index, Norway holding the 8th place and Island holding the 12th place. Among 123 countries Georgia shares 117-120 places with Ecuador (the 70th place by TD index), Ghana (the 96th place) and Bangladesh (the 102nd place) and only by 2 items surpasses Guinea (the 116th place) and Nigeria (the 121st place) and by 3 items – Pakistan (the 103rd place).

By the human capital index Georgia is behind all the post Soviet countries. The index in this group of countries ranges from 13 (Azerbaijan) to 35 (Belorussia). From the diagrams presented below it is clear that by human capital index we are considerably behind the average indices of developing countries (21) and south-European and CIS countries (26), European Union – 10 countries (36) and to say nothing of developed countries (42).

## Comparison of TD-index components of Georgia and different groups of countries



Because of insufficient statistic data we cannot estimate thoroughly the volume of health and education expenditures, though by empirical data they cannot afford such expenses. As to state expenditure, in 2007 health expenditure increased by 34.4%, and education expenditure –by 13.3%compared with data of 2006.

Despite it a very small share of the state budget comes on health – 5%, on education – 7%. In relation to gross domestic product these data are even less: in 2007 the share of expenditure on health in GDP is about 1.5 %, on education -2.2%. In view of the aforesaid it is clear in scanty financing conditions how important is to use foreign investments reasonably in the human capital producing process.

Estimation of a physical infrastructure is carried out by means of aggregation of three indicators: by percentage of a paved road to the total length of the domestic roads of the country, air freight activity (million tones over one kilometer) and telephone lines length (on 1000 inhabitants. These indicators characterize potential capacities of transport and communication, needed for trade development.

Aggregated indicators of a physical infrastructure for Georgia gave 16, that at a single glance is not so low compared to the average indicator of 123 countries. Though with these indicators in spite of its geopolitical and transit potential Georgia only equals developing countries and its indicator is sharply less than the average one of all the other countries: south European and CIS countries (the average indicator 29), EU -10 (32) and developed countries (45).

It should be noted that the development of an infrastructure, first of all development of roads has been the most important priority for Georgian government for the last few years. For 2006-2009 it has been planned to build and rehabilitate 400 km international and 340 km domestic roads that is already being carried out.

Considering this fact it can be supposed that the indicator of a physical infrastructure of Georgia will be considerably improved if statistics of the proper field is refined. It should be emphasized that in the state program of statistic works of 2008 there are not mentioned statistics of transportation and communication.

In order to define a quality of development of financial intermediation is used a ratio of a credit allocated to private sectors to the GDP, that came to 4 for Georgia. It is 27 times less compared with USA holding the first place and 12.8 times less compared with Germany which is on the second place.

In the post-Soviet countries this indicator is also low and is varying within the range 3 (Azerbaijan and Armenia) and 18 (Latvia). From this category of countries it is the highest in Latvia (18), in Estonia (17), in other countries within the range 3-11. This indicator is the lowest for South-European and CIS countries (where Georgia is included) and it is 8, while in the group of developed countries it is 51.

What perspectives are to raise a quality of financial intermediation? If we overview a branch structure of a gross domestic product, it is clear that financial intermediation is one of the fastest growing branch. It's true that its share in a gross domestic products is only 2%, but growing temps are impressive: in 2005 – 52.8%, 2006 – 36.9%, 2007 – 14.7%. In the same periods the growing temp of was in the range 9.4% - 12.4%.

For the last three years assets of a bank system have been increased by 2.8 times and constituted 42.4% of gross domestic products instead of 21.9%, as it was in 2005. The credit volume of economics by the banks in the same period was increased by 2.7 times and came to 26.6% of the GDP, in 2005 – 14.6%), deposits – by 2.4 times and came to 16.8 of GDP (in 2005 – 10.1%).

So by the three indicators having been described so far, the state of Georgia is not enviable, especially according to the human capital index. As to the other two indicators considering growing temps of building of infrastructure and the bank system, the situation is more hopeful.

From structural and institutional point of view the important components of a trade and development index are domestic and international finances.

Internal finances are described by such indicators as a ratio of gross domestic accumulation (gross domestic products minus final consumer's expenses) to gross domestic products. This indicator for Georgia was 41, i.e. by 4 points lower than the average in the countries of south-east Europe and CIS and by 11-13 points lower than in the rest.

As it is known high share of the final consumption in the gross domestic products points to a low life level of people, as a result of which population have to direct more part of their income to satisfy their current needs (if not the whole) and less – to save up. It is significant that in 2005 final consumption expenses in the gross domestic products was 84.3%, in 2006 and 2007 this indicator increased to 94.1% and 92.5% that is worth thinking.

International finances are considered as an aggregated indicator of the whole foreign debt service (in percentage with gross national income) and a short term debt (in percentage with the whole foreign debt). For our country it was 133 that exceeded the average indicator for the countries of all the groups (with the exception of the developed countries), that means a burden of a foreign debt.

The institutional quality of a country is characterized by indicators of a regulation quality and a corruption control. A regulation quality implies the government policy in relation to business environment, price control, development of foreign trade and production development. Indicator of corruption control, based on the results of sociological studies, implies a rate of corruption spread. High indicator points out a better institutional quality.

The average indicator was the lowest in the groups of south-east Europe and CIS countries (44); the highest (92) was in the developed countries. For Georgia this indicator was 38 and in fact only outran some post Soviet (Belorussia -27, Russia -34, the Ukraine - 35, Azerbaijan -36) and African countries (Congo - 15, Angola - 23, Zimbabwe - 25, Burundi - 31, Sudan -33, Nigeria - 33, Central African Republic - 35).

Judging by the mentioned indicator the state of our country is to be thought about, however according to the recent ratings Georgia has been just moved to the advanced positions. For example, by the World Bank rating for the simplicity of business management Georgia took the 35th place among 178 countries in 2006 and the 18th place in 2007. It's true that the simplicity quality of business management is characterizing only one component of an economics regulation quality - liberalization of business environment, but a role of this component is very important.

Alongside with the regulation quality the institutional quality is characterized with a corruption control indicator as well. An international organization Transparency International annually publishes ratings of countries by corruption sense indices. The later implies a rate of corruption sense by producers and analysts and estimates it by a ten-point system. Point 10 means nonexistence of corruption.

According to the data in 2006 Georgia among 163 countries took the 99th place with 2.8 point. In 2007 Georgia improved a corruption control index by 20 and moved to the 79th place among 179 countries and considerably left behind the countries included in the same regional group, such as: Armenia (the 99th place), Albania (the 105th place), Moldavia (the 111th place), the Ukraine (the 118th place), Russia (the 118th place), Azerbaijan, Belorussia, Kazakhstan, Kirgizia (the 150th place each), Turkmenia (the 162nd place) and Uzbekistan (the 175th place).

Based on the aforesaid facts it is doubtful that the institutional quality index adequately reflects the existed situation in Georgia. At any case in the future we might expect a considerable improvement of this indicator.

An economical structure of countries is estimated with such indicators as the share of the added value created in agriculture in the gross domestic products. This index is traditionally low in developed countries and high - in developing countries. For 123 countries it is in the range 25 (Guinea- Bissau) - 66.

For Georgia this indicator is 54, that is close to the average indicator for developing countries and south-east European and CIS countries. It is clear that the agrarian potential of Georgia is not sufficiently included in the economical growth, i.e. natural resources of the country (climate, soil, water and etc.) and priorities based on them have been less used so far.

From the viewpoint of a real perspective of development of the agrarian sector of Georgia's economics the dynamics of agriculture expenditures in the state budget expenditures must be thought of: 2005 - 1.8%, 2006 - 1.6%, 2007 - 1.1%, 2008- 0.9%. The volume of financing this branch in the absolute indicators is also decreasing. In particular, the agriculture expenditures in 2007 were 84% of the analogous indicator of 2006, and the finances envisaged for 2008 (49 million GEL) - 91.4%.

Here we encounter a certain contrast when we discuss the government 2008-2012 program "United Georgia without poverty", which promises effectiveness increase of agriculture and the growth of its products share in the whole export of the country during the future 5 years up to 25 %.

Macroeconomic stability is estimated on the base of a Consumer Price Index and current account balance (in percentage with gross domestic products). For different countries it changes in rather a large range; from 18 (Angola, Zimbabwe) to 108 (Oman, Mali).

With this index Georgia (84) came close to the countries of the West (a group of new members of EU - 81 and a group of developed countries - 89) and sharply exceeds the average indicators of countries in its regional group (south-east Europe and CIS -63).

Such a high indicator of the macroeconomic stability quality is a real achievement, because just since 2006 has begun the worsening of the both components of the mentioned indicator. It is clearly seen from the data presented below.

**Table 6.**

Dynamics of a deficit and inflation in Georgia, 2005-2007 according to the current report

	2005	2006	2007
Ratio of a deficit to the gross domestic product in percent	10.9	14.9	19.0
Inflation	6.2	8.8	11.0

Source: National Bank of Georgia

Comparatively good result presumably might be due to a higher level of inflation in other countries. The estimation of Georgia in this sphere in the latest period will be less hopeful.

A health environment, as a complex phenomenon, quantitatively is characterized with an aggregation of such indicators as access to fresh water (the share of people having access to fresh water), sanitary access (the share of people having access to adequate sanitary conditions) and the gross domestic products estimated by purchasing-power parity on a consumed energy unit. It is remarkable that this indicator is almost the same – in the range 14-17, for Georgia it is 16.

The situation of trade and development from the viewpoint of trade policy and development is estimated with such indicators, as trade openness (a level of penetration of foreign goods into a local market) and a level of access to foreign markets. By these indicators Georgia is in the equal position not only with south-east European and CIS countries, but with west European and developed countries as well.

An important role in it played the fact that Georgia had become a member of the world trade organization and in general liberalization of foreign trade. Analysis of trade and development of different countries shows that a component of trade liberalization is considerably defining TD-index of the developed countries. The share of a trade openness component in the TD-index is 15%.

Taking into consideration that most of the customs tariffs has become zero since the 1st September 2007, the next indicator of the foreign trade openness of the country will likely grow noticeably but unfortunately it cannot be said about the access to foreign markets.

Though it is true that EU elongated the right of using GSP+-regime for Georgia till 2011 and production of 7.2 thousand denominations will appear at European market customs free, it is obviously not enough. Firstly only producers of 10 denomination products (mostly nut, soft drinks, isotopes, greens, honey and Ferro-alloys) are exercising these privileges. Besides the main weakness of Georgian export is a non-tariff barrier, such as observation of technical, sanitary, photo sanitary and other standards of production.

Nowadays by UNCTAD estimation code of trade control there are a hundred different non-tariff barriers. Many countries began to improve a legislative base to overcome them in the 90-s of the 20th century. Georgia has too much to do in this direction.

As a result of the aggregation of the above mentioned factorial indications the received factorial estimation indicator (559) remained at the same level as in the previous year, though Georgia moved from the 69th to the 73rd place.

In order to receive a resulting component of TD-index, as it was mentioned before, are used indicators of trade and economical and social welfare.

The first of them is characterized with such indicators as the share of commodity export in the world commodity export, market concentration index for commodity export from the country and a ratio of foreign trade (export-import sum) to gross domestic product.

By this indicator Georgia which has 90 points and by 6 items leaves behind the developing countries, is left behind the other discussed groups of countries: south-east European and CIS countries – by 11 items, a group of new members of EU – by 18 items and developed countries – 33 items.

An indicator of economic and social welfare includes five components: welfare index, literacy level of population, expected lifetime, correlation between men's and women's incomes and the share of women in the total labor force. By this indicator Georgia has 299 points and surpasses the analogous average indicator of developing countries by 36 items, though is behind the average indicator of south-east European and CIS countries – by 33 items, new members of EU – by 96 items.



A total indicator of resulting estimation received by aggregation of indicators of trade and economical and social welfare was 390 and became worse by 7 items. As a result of it Georgia moved from the 45th to 51st place.

So besides the worsening of the trade and development index with a number of statistical data Georgia is considerably left behind the rest of the countries, that points out not only underestimation of the importance of export orientation of the country and the low integration of trade and development, but also the necessity of consecutive and complex settling of a number of factors effecting this process.

## 10. EXPECTING RELIABLE STATISTICS

A trade and development index is one of the visual examples showing serious requirements set before the national statistics, from which the world information system demands adequate data for international comparisons. Hence more and more responsibility is being placed upon the government, though many countries cannot realize the necessity of a reliable statistics organization and unfortunately Georgia is among them.

It's true that Georgian government has announced recently a plan of separation of the statistics department from the Ministry of Economic Development and establishing it as a separate structure but concrete terms and a model of realization of this plan has not been clear yet.

It is an undutiful fact that good administration depends on good institutes. From them statistical service is priority because not only good administration but also the successful functioning of the other institutes depend on it. A statistics system of any country is not only for this country, it is a part of a global information system.

Achievements or obstacles of this or that country is understandable and accessible for the rest of the world only in perfect statistics language. It's not inconceivable that the reason of Georgia's lagging of some indicators from the other countries of the world; especially from low developed countries was the lack of statistical data.

It is acknowledged that statistics is expensive luxury, but it is necessary for any country to define priorities correctly in this sphere at any stage of its development and to answer a question: what is more expensive for it: having good statistics or not having statistics? It is undutiful that the later is more expensive for the society.

It is remarkable that Georgia which is striving for integration with Europe is considerably behind the countries having been joined European Union recently by a number of indicators (human capital, physical infrastructure, financial intermediation, internal finances, institutional quality, structure of economics). Striving for decreasing the difference between these indicators in a proper sphere must become a guiding line for perfection of an economical policy of the country.

As it is clear from comparisons of the above presented data one of the serious reasons for lagging of Georgia in trade and development spheres is an inadequate estimation of human capital which started in the 90s of the last century. Economical and social cataclysms developed in the country especially sharply were reflected on the education system, though an effective strategy for overcoming the problems accumulated in this sphere in spite of certain attempts has not been worked out yet.

By the rough estimate for today the most active part of labor force of Georgia – approximately under the age of 45 does not have necessary education and professionalism, working skills and experience. Population over this age because of the lack of jobs cannot expose their skills and professionalism. This is just the reason that an active part of the population is emigrated abroad and only by sending money orders they can take part in the economic life of the country.

Underestimation of a human capital is one of the reasons of falling of economic policy. Inadequate estimation of an export capacity and a lack of real vision of directing it in the economic growth service is a second barrier of economic growth. An analysis of factors, defining TD-index, and indicators shows that a level of using relative advantages of the country, such as geopolitical, transit, agrarian and recreational potentials, is very low.

Export capacity must become a main force of development and a catalyst must be the access to markets of developed countries, for which international standards must be soon established and a national infrastructure of quality must be created. All these cannot be achieved without the will and attempt of government. One of the guiding priorities of the economic program must be encouraging attraction of local and foreign investments in export productions, the investments the solid share of which must be invested in local industry.

## 11. INDUSTRIAL EVOLUTION

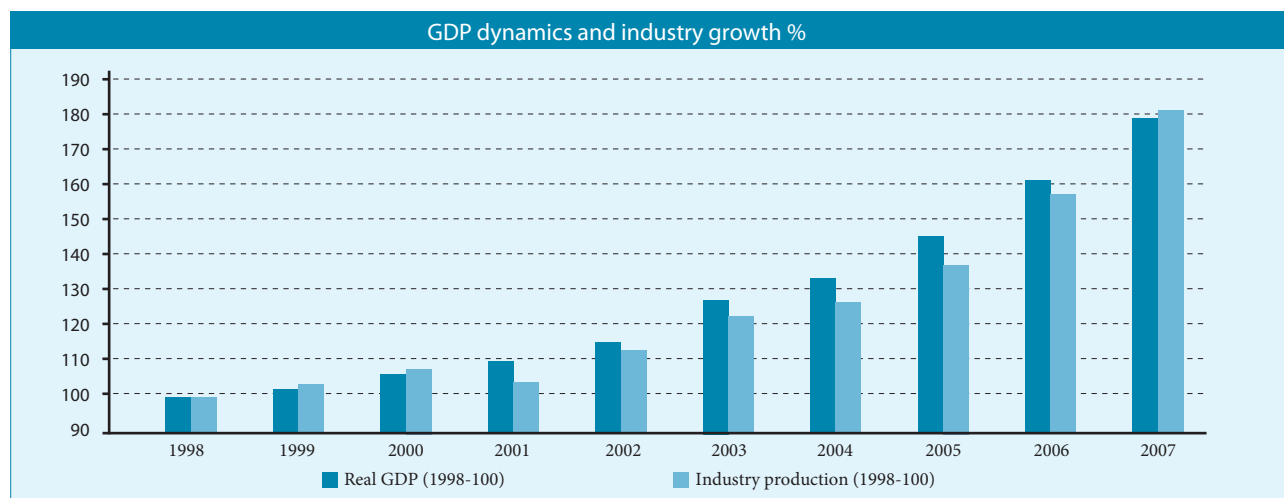
A problem of financing of Georgian industry and the next challenges is directly connected with both as reforms of trade policy, as well as the most acute problems of unemployment. In 2007 Georgian industry was rather dynamic; its annual growth temp 13.8% exceeded the whole economic growth (12.4%).

Such strong growth first of all implies current recovering process which during the last ten years in spite of impressive improvement is considerably lower than the level existed before the market economics transition period. According to the data of European Bank for Reconstruction and Development in 2007 it was only 61% of GDP of 1989 level. Among the countries studied by European Bank for Reconstruction and Development the lowest indicator has Moldavia (51%), Armenia and Azerbaijan (137% and 159%) is among the best ones in spite of the fact that they also underwent armed conflicts.

Despite a high rate of growth the industry sector has a very humble share in Georgia's economics. In economics rich with resources, as are Russia and Azerbaijan this correlation is obviously high, though it is quite high in rather small economics, as Estonia and Hungary, to say nothing of Czech.

Statistical comparison and actual data show that Georgia is using a very small part of its industrial potential. Compensation of the damage caused at the initial stage of the transition period has not done yet, when scrap metal has been the largest category for export.

The reason of it partly is that insiders and ineffective "red directors" took advantages of privatization and caught industrial assets. It happened in spite of relative advantages in some traditional industrial sectors of Georgia, connected with natural sources (fertile soil for producing agricultural products such as fruit, vegetables, wine, meat and milk; also underground mineral resources), with still cheap labor forces (despite that by the official data real wages in 2003-2006 were risen by 77%) and of course with ideal geographical location on the crossroad by which Europe is connected with dynamical economic zone- Asia.



Source: Statistics Department of the Ministry of Economic Development

## 12. SECTOR SCAN

An analysis of the present reconstruction process of Georgia's industry can be done by different components. According to the official statistics in 2007 70.1% of industrial production belonged to manufacturing industry, next in volume was supply of electricity, natural gas and water (21.4%) and minerals industry (8.5%). The last two sectors have a high unused potential. It can particularly be said about producing hydro energy that was defined as a priority sector. In this sector Georgia can easily become a large exporter, in neighboring Turkey quite impressive development of minerals industry.

As to manufacturing industry here the situation is different. In 2007 in this sector four subsectors were dominating (about 84% of the whole production): food, drinks and tobacco production (43%), crude and produced metal products (basically ferroalloys representing the first category of export commodity nowadays (17%), other mineral products not containing metal (mostly cement) (15%) and products of chemical industry (9%).

Watching the dynamics of each subcomponent we will see quite a big difference between food, drinks and tobacco productions and all the other sectors. Their rates of growth in 2005-2007 were the following: other mineral products not containing metal -171%, rubber and plastic - 94%, crude and produced metal products - 84%, chemical products - 61%, papermaking and printed production - 61 %, transport equipment - 59%, food, drinks and tobacco productions - 20%.

Considering a higher rate of rising prices on food products we can presume that this sector of Georgian industry practically has not increased, it even slightly decreased despite local consumption of food products is rather intensive, especially in relation to such products, as dairy produce, fruit and vegetables.

Weak development of the food production sector is a subject of serious worry. Partly it can be explained by the influence of embargo on Georgian wine and mineral water imposed by Russia. Unfortunately it more points to a deep structural crisis of Georgia's agriculture to overcome of which Georgian government has not represented any convincing complex economic policy yet.

Georgia's agriculture on which comes 55.6% of the whole employment by production volume and producing capacity have been "frozen" to such levels which correspond African countries (for example, milk annual production calculated on one cow according to FAO (Food and agriculture organization of UNO) is only 937kg, while in Armenia the corresponding indicator is 1965kg, and in Russia - 3221 kg).

In spite of the growing local demand in 2007 agriculture products increased only by 8% compared to the 1989 data while industry production in the same period increased up to 85%. The main problem of food industry is considerable improvement of the primary agriculture production. All the guiding agrarian manufacturing companies must either bring raw material from abroad or make investments in creating its own raw material base that will guide those financial and managerial resources in the other direction which they would have used in the main business.

The other impediment to the development of Georgia's industry is small expenditures on proper education. All the countries having good indicators (for example Slovenia and Baltic states) are basing and building their strategy of development upon high technological activities and are investing in this sector 4 times more than Georgia. Other countries such as, for example, Moldova which like Georgia is characterized with mass migration, has to spend the most part of its budget on the compensation of human capital export because knows that the most capable citizens with entrepreneurial ability are migrating.

The direct result of insufficient investment in human capital is speedy rise of labor compensation. The average monthly wage in industry is increasing. In 2004 it was 241 GEL(104 dollars); in 2006 it increased to 308 GEL (173 dol.), by the end of 2007 it became 396 GEL (236 dollars).

If education had not been a main impeding factor, the rise of labor compensation would have been considerably less. Firstly because in Georgia there is still secret unemployment on a large scale and number of employed in a formal economics is less than 1/3 of economically active population and 13% of the total population. So the growth of demand for labor force must have caused employment and not a rise of wages.

The second reason of this result is that today it is hardly found such economics where it is so easy to employ and dismiss people, as it is in Georgia.

Actual data show that education problem first of all concerns middle level management. In Georgia there is still elite having received a good education in the west, but there is not a middle level playing a strategic role in developed economics.

## 13. "DIETETIC" INVESTING

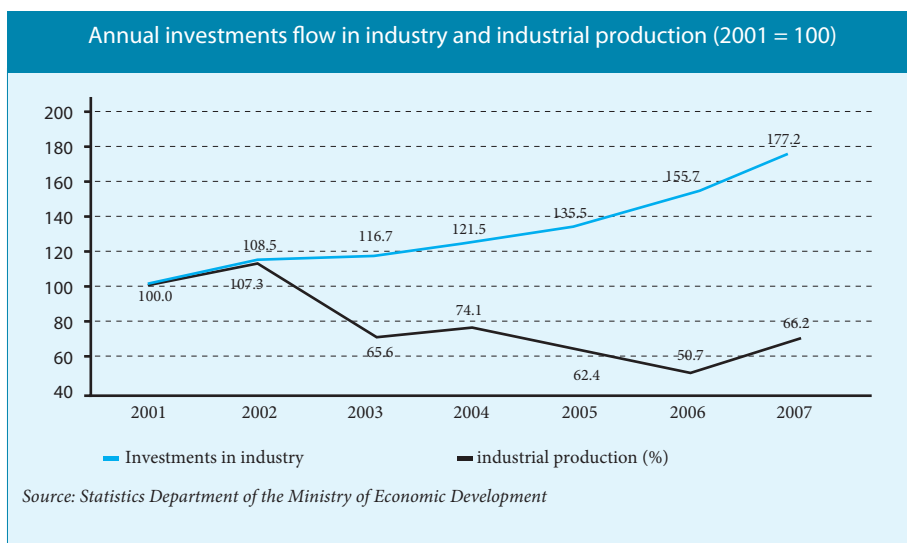
Alongside with proper labor force investments in machines and equipment and in other capital is a second main component of any industrial development because industry is more capital-intensive than other sectors, such as a service sector.

From this point of view the last statistic data are giving heterogeneous signals. In 2007 only 311 million lari investments was made in the fixed capital that is only 6% of all the investments made in Georgia. The growth of investments in industry in nominal representation in 2007 compared with the previous years came to 50%, but considering the growth of producers' price index the mentioned volume of investments flows in spite of the improved business climate will be less than it was in the beginning of the decade.

The first reason of a great difference between the dynamics of industrial production and the dynamics of investing in industry is that the current growth mainly implies a restoration process of economics because Georgia is still considerably behind the level of industry existed before the market economics transition period.

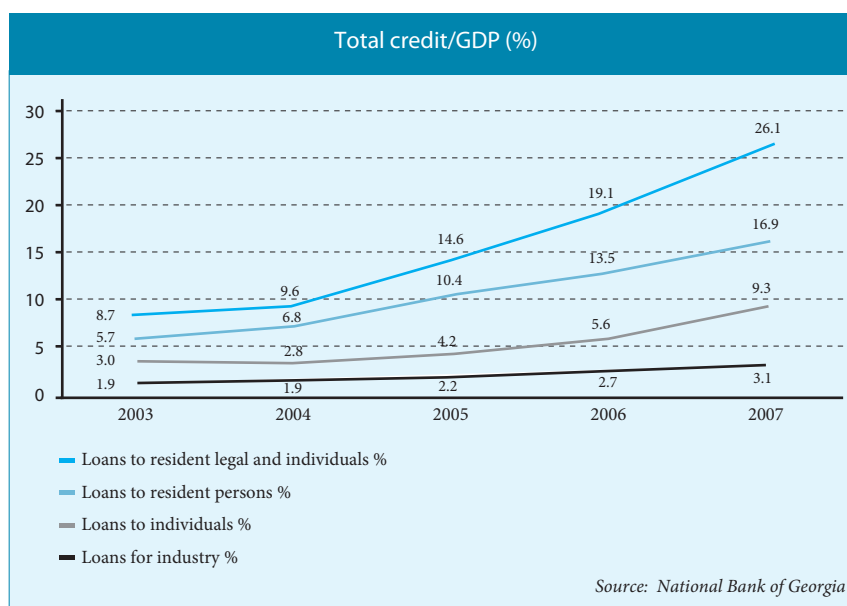
So far industrial companies have managed to put in action only unused powers and they made their small investments in "minimal» improvement of a production process. Practically buildings-facilities and the main infrastructure did not need any investments. Only machines-equipments were purchased in growing amounts, import of which increased considerably in 2007.

Reasoning from the above mentioned fact it is clear that the "free growth" period of industrial companies is coming to the end. Most viable industrial companies are already working with full power and by means of new powers are trying to satisfy the increased demand which is mostly created by a local market. From this viewpoint the rise of industrial investments might be the first sign of a new tendency.



## 14. CREDITING ZIGZAGS

The development of a bank system during the last 5 year is really impressive. According to the data of the National Bank of Georgia between the end of 2003 and the end of 2007 the demand of a bank sector in relation to resident legal and natural persons increased by 5.9 times – from 748 GEL to 4421 GEL, a ratio of the total credit to GDP increased from 8.7% to 26.1%.



Before discussing the dynamics of credit portfolio it is interesting to compare quantitative data of the Georgia's bank system with other transitional countries basing on EBRD figures. Among 20 countries having transitional economics by ratios of private enterprises local crediting to GDP Georgia was less impressive. Lower credits in this group only had Azerbaijan, Armenia and Kirgizia.

Based on the above mentioned it is necessary to analyze these figures with attention. The first ratio is not probably very important because many companies in Georgia and abroad loans money from external (not from the local) sources. The second reason because of which we should be careful is that the ratio of the total credit to GDP varies from country to country. This indicator is normal, as it implies a development level of countries.

The more developed the country is, the higher is the ratio of its credits to GDP. That's why there is no sense in comparing the ratio of credits to GDP for Georgia with the relative ratio for Slovenia as GDP of this country 11 times exceeds GDP of Georgia.

If we correlate GDP per capita and the ratio of credit to GDP and focus exclusively upon the ratio of household credit to GDP, that will exclude a big inaccuracy in finances attracted by industrial companies from abroad, we will receive quite a different picture: the bank sector of Georgia might be not less developed, but "too much developed" compared with the other fields of economics.

If GDP in 2006 had been 2.5 times more, the household crediting level would have been counted "justified". In 2007 we should have entered a zone of "redundant crediting" as credits in nominal term were increased by 103% and amounted to 9.3% of GDP, which is higher than it was for Russia in 2006 in spite of the fact that GDP per capita for Russia is 4 times more than the corresponding indicator for Georgia.

Table 8.

	Local credit to private enterprises/GDP (%)	Local credit to households/GDP (%)	The total credit to private loaners/GDP (%)	GDP per capita (USA dollars)
Estonia	78.4	38.7	117.1	12209
Latvia	77.8	38.0	115.9	8760
Croatia	68.7	38.2	106.9	9582
Slovenia	67.1	17.0	84.1	19218
Hungary	54.6	18.5	73.1	11127
Lithuania	47.7	17.9	65.6	8770
Bulgaria	47.4	16.6	64.0	4088
Kazakhstan	48.1	15.8	63.9	5221
Ukraine	44.9	15.3	60.2	2258
Czech Rep.	39.9	16.5	56.4	13896
Slovak Rep.	39.2	13.1	52.3	10250
Poland	33.4	15.6	49.0	8939
The former Yugoslavia Macedonia	31.0	9.6	40.6	3113
Russia	31.0	7.1	38.1	6874
Rumania	26.3	11.2	37.5	5617
Moldavia	27.9	2.9	30.8	988
Georgia	19.7	5.6	25.3	1721
Azerbaijan	12.4	4.1	16.5	2363
Armenia	8.7	4.1	12.8	1989
Kyrgyzstan	10.5	2.2	12.7	549

Source: EBRD

Statistical data are obviously reflected in everyday life, where are evidently observed signals of consumable trade boom. For example, car import that is mainly financed by consumable credits in 2002-2007 increased from 116 million to 370 million dollars, in 2006-2007 washers and refrigerators import increased by 112%. In Tbilisi it has become possible to purchase perfume and clothes with credits.

In the state of such dynamics of household crediting, characterized by fast growth, industry is not a strategic sector for banks. Though crediting of industry by the end of 2003 was 18 million GEL and by the end of 2007 it increased to 211million GEL, its share in the whole credit portfolio decreased by half – in 2003 it was 21.6% of bank credit on industry and four years later this in indicatop was 11.9%.

The analogous picture is in the component of crediting legal persons. in 2003 on industry was its 18.4%, in 2007 the share of this sector was only 18.4%. This indicator is much lower than the share of trade crediting (47.7%) and almost equals to the crediting share of building and immovable property (15.5%).

If we consider that this subcomponent only concerns legal persons and does not include hypothec loans for individuals having been grown considerably in recent years, we will see that banks are mostly focused upon financing commodity (import) and immovable property. It is not really a positive result, especially when Georgia is facing political and macroeconomic challenges on its way of improving its economics.

## 15. BANK PRESS

The bank sector of Georgia, that has increased very fast quantitatively but qualitatively nothing much has changed, now must go into a new phase of development. In order to take part in a long term sustainable development in Georgia it has to become more focused upon financing trade production and service at the world markets otherwise Georgia might be added to a long list of those countries (Chile in 1982, Mexico in 1994 or countries of south-east Asia before the crises in 1997) which experienced acute crises, mostly because of inadequate models of development of bank systems.

If we observe relation between banks and an industrial sector, we will see slight signals of starting qualitative evolution. For example, credits given industry are mostly denominated in GEL (in 2007 it amounted to 40% of credit portfolio, while in 2003 this indicator was 11%) that for creditors has a less risk of changing of exchange rate.

However there is not observed an important evolution in connection with the duration of a credit which is one of the main factors when we have to deal with long term investments. In 2003 48.8% of the loans to the industrial companies were granted for a credit period of more than one year, in 2005 loans of such category were 64.7% but then their share decreased and in 2007 their share was only 59.9%. In 2007 the share of industrial credits in the whole volume of credits with more than one year was not high - only 15.5% or in the whole credits of such category which amounted to 2 billion 34 million GEL it was only 315 million dollars.

In economic history are often arguing that one of the defining factors of banks desire, to finance industry, is their opportunity to attract long term resources. If such opportunity does not exist, banks wanting to finance industry might encounter a problem of incompatibility of their short time obligations (deposits) with long term assets (long term loans for financing long term investments in industrial companies. But in the periods of limited liquidity it might cause collapse of banks.

In continental Europe in 1980 before the big financial deregulation states were playing an active role in financing long term assets. They were either directly financing long term assets through the developed banks or indirectly by means of refinancing of long term portfolio of national banks. In balances of industrial companies credits were preferable compared with shares, because those companies had easy access to subsidized credits.

This model of continental Europe gave chance to economics of the appropriate countries to catch up with British and American economics fast. It is not surprising that in 1930s this model was systematically copied in Latin America (Bank of Development in Brazil, Agency of Economic Development in Chile, Financial Institute in Mexico), later in Japan, Korea and Taiwan. But in the course of time this model became a burden to state budgets that caused its gradual restriction and in many cases it was finally abolished. In some countries banks of development are playing an important role. A good example of it is German KFW.

Today in Georgia a subject of discussion is about a possible role of state in financing of "productive" economics. Moreover state's initiative is "cheap loan" and it is planning to widen it. Many people criticized these initiatives as a populist reaction to social problems that became a basis of political discontent. Of course it is impossible without it but among the decision makers there is some feeling that reforms of the second generation favoring investments and high-effective growth oriented upon creation of jobs must substitute less effective growth based upon consumption and unstable import.

In spite of the fact that analysts are permanently emphasizing the necessity of high-effective growth the idea of crediting productive economics with cheap loans is untimely and probably useless because first, despite the recent improvement of government the state has not achieved such level of effectiveness and neutrality which would be sufficient for answering especially susceptible challenges of subsidized crediting.

Second, the necessity of such schemes has not seen yet: a ratio of the commercial banks capital to the total credit allowed to a private sector is the best (according to the data at the end of 2007 it is 32.1%) that is giving banks the opportunity of financing long term credits from their capital. Besides for refinancing long term portfolios cheap long term resources of the international

financial institutes are easily accessible for them. These institutes themselves are ready to finance directly with loan and provide more industrial companies in Georgia with capital.

While discussing with representatives of commercial banks and international financial institutes they often express their concern that they wanted to finance more industrial projects but were unable to find sufficient number of good projects. So the problem is not with the obligations side, but with the assets side. Though the second side is not without pretensions: many industrial companies are complaining about having difficulties in getting credits and saying that a very few banks have experienced corporative bankers, let alone the existence of investment banks.

There is also a certain truth in it that leads us to the above mentioned problems in education. Because of the emigration of many talented people, when many Georgians are successful entrepreneurs abroad, Georgia is before "de-capitalization". Despite many good investment opportunities there are very few investment projects because there are very few qualified entrepreneurs.

Against such background it is not surprising that Georgian banks began to act like investment banks. Some of them are investing their share capital in their own client-companies: this process was rather noticeable in 2007 when capital investments increased from 49 million GEL (January) to 215 million GEL(December).

As banks are usually confining their investments comparatively by short periods, they will probably try to get profit by quotation shares of these companies at stock exchange. This might lead us to real development of a local financial market which today is very limited (in 2006 the total capitalization of a stock exchange was only 8.3% of GDP, while the proper indicator for Russia was 104%).

## 16. TO UNDO A KNOT OF CONTRADICTIONS

As it was seen there is institutional inconsistency between banks and industrial companies from the viewpoint of satisfying their expectancies. This inconsistency is observed in the report of the World Bank of 2008 "Doing Business": the rating of Georgia which in general is very good, by rating of receiving credit (the 48th position) and performing contracts (42) is middling and low by rating of closing business (105). Being encountered long impediments and rather high expenses in exercising their rights and bonding banks are beware of granting loans to industrial companies as they know that their accounting notwithstanding considerable recent improvements some doubts are cast upon it.

To overcome these problems it is probably necessary to encourage the systematic use of leasing machines and equipments in case of small and middle-sized industrial companies. In case of failure of leasing obligations by a leasing taker a company giving leasing does not have to go to court to return assets given by leasing, as they are the company's property and everything is dealt easily.

Nowadays the development of leasing in Georgia has been impeded so far because of defects of taxing, as it is taxed with VAT (value added tax) and this viable and simple financial instrument is made less attractive compared with financing the same commodity with a middle term credit as a profit of a leasing rent is taxed while a profit of a middle term credit is not taxed.

Besides it is necessary to change as fast as possible an approach of international financial institutes to financing of Georgia's economics. It is obvious that their benevolence to the banks financed by them is not safe. What is the use of financing so called small and middle-sized enterprises if they are mostly trade companies carrying out import?

Or why was real property being financed when at all the segments of the market when signs of a risk boom were noticeable? The recent events have shown that these question are legitimate must be answered.



At this stage it is reasonable for the international financial Institutions, taking part in financing of Georgia's banks, to focus upon activities generating external income and saving first of all on industry and agriculture, as well as producing and effectiveness of energy. As to the other activities their interference practically is not needed and they might only encourage the fast growth of banks which is not the obligation of international institutes.

Especially interesting might be the offer specific financial instruments connected with producing energy and energy effectiveness by international financial and double-sided chief institutes. They can share their experience of using high technological financial products (e.g. by financing carbon allowing to mobilize carbon credits which according to Kyoto protocol are given by industrial countries) with their Georgian partners and encourage to create a strong sector of private and individual producer providing different size of energy because hydroelectric potential of Georgia has still been left unused.

Of course it is more important to encourage investing of commercial banks in the shares of industrial companies directly or through investment funds creation of which at different stages was announced by several Georgian banks.

These institutes must be allowed "to come out" of the above mentioned investments in the course of time by means of quotation of industrial shares at the local stock exchange. A certain role can play foreign banks too. The best way out would be their combination with strong local institutional investors. But a serious worrying thing is a deficit of the current report that is directly connected with a boom of consumer purchasing and decrease of personal savings according to the data of the International Currency Fund personal savings that was 13.8% of GDP in 2005 decreased to 6.3% in 2007).

Hence considering the best international standards an obligation system of a private long term savings must be worked out as fast as possible. In this regard a pension's fund system of Chile is of particular interest. Without such system mobilization Georgia might fall within an unsafe macroeconomic space especially if direct foreign investments by which the current report deficit was financed up to now decrease in the same way as now in the post war situation in Georgia.

## 17. CONCLUSIONS

As studies of 2006-2008 dynamics and characters of foreign trade of Georgia has revealed a permanent correction of export-import of the country is in favor of the position of import.

The constant growth of a trade deficit has reached large scale recently and the country has become more and more depended on import, as a result of which weakened local sectors not only with export but import substituting perspectives.

Worsening of a trade balance is not caused by one factor. With its contents it is a complex process with many components. Each component has its own meaning and own share.

The growth of import was promoted by the tendency of nullifying of trade tariffs which is not a uniquely determined process. First it caused the decrease of trade processes and terms which undoubtedly is a good fact and second import became cheap and import operations were quickened.

However at the same time it is a fact that as a result of it under the conditions of more acute competition there appeared Georgian economic subjects oriented upon a local as well as export markets a solid part of which could not stand up to this competition and either decreased its market niche or lost at all.

Practically in Georgia was realized the risk that a customs tariffs policy produces decrease of opportunities of local production and increase of probability of a full satiety of a market with import production. At the same time the second expected effect of this intent by which nullify of customs tariffs should have encouraged import of technologies in the country and in the end should have strengthened export positions. This result is less noticeable today.

In the last two-three years the export opportunities have been considerably decreased by the irreversible and sharp strengthening tendency of the national currency because of which export was getting more expensive and its existed or potential resource was getting less, import was becoming cheaper and its volume was increasing. In this point of view export opportunities of the country have had serious permanent problems.

As to a sharp devaluation of the national currency in November 2008 this fact did not have any positive influence on trade policy of the country, export-import structure and encouraging of export because of several reasons: because of a postwar situation and a global financial crisis opportunities of Georgian export were anyway lessened and a change of a rate of exchange has not had a positive impact on it.

Besides the unstable situation produced in connection with the rate of exchange of the national currency and the expectation of the possible next correction were negatively reflected on the trade policy because long-range planning and performing of trade policy and operations become impossible.

Alongside with the other more or less important factors (insufficient Georgian export potential, less financial stability of Georgian companies and comparatively weak positions compared with foreign analogues, problems of maintaining access to the existed markets and new markets penetration and heavy expenses and etc) these problems make import stronger instead of increasing export and substituting import. It is confirmed by official statistics and a tendency is clear –Georgian export in the course of time turns out to be in the shadow of import.

The existed problem is important because it is in direct connection with poverty reduction problems. Such strengthening of import positions threatens not only financial or institutional stability of local companies but it makes impossible to maintain existed jobs and moreover to generate new jobs.

It equally concerns sectors and companies oriented both on internal demands, as well as on export directions. As service and goods oriented on a local market, as well as export potential are mostly created in the spheres where employment of the population is high.

So a sharp change of export-import balance configuration of the country from the viewpoint of the trade deficit growth is a long term program of Georgia's economy that might be followed by negative results. Hence it is necessary to make a thorough analysis and relevant preventive actions.

## 18. RECOMMENDATIONS

Considering that the market volume of Georgia is limited for more stability of Georgian companies, for settling a problem of a trade deficit decrease and unemployment it is necessary to carry out measures for encouraging export as well as for substituting import.

Taking into account that this problematic is many-sided it is necessary to strengthen activities in many directions which finally will relieve the situation and work out a new trade policy and a poverty reduction policy.

So it is desirable to make a number of decisions which will make Georgian production more competitive and stimulated.

From concrete recommendations should be noted the following activities:

- Deep research and to emphasize and support the branches which in middle and long term planning have real perspectives of increasing export, as well as substituting import;
- To put into real and proper action "green corridor" and "a principle of one window" in order to increase trade turnover and to decrease customs and other administrative procedures and their terms.
- To search and attract those foreign companies which will be interested in producing production in Georgia and using preferable terms with GSP+ and other states and taking the production to export markets;
- To put into action ceased paragraphs of the law "about food safeness" so that the production produced in Georgian enterprises will meet international standards and have an export potential;
- To introduce HACCP standards in Georgian enterprises which implies observation of sanitary and hygiene standards and is a necessary condition for producing export production;
- To work out and establish moderate and justified regimes of allowances for new investments projects and support (tax holiday, transfer of state property);
- To review labor code in order to defend the rights of employee more properly and restore disbalance between employee and employer;
- To reform statistics service thoroughly that will make possible to get reliable and perfect data, to give a real picture and exact prognosis;
- To establishing and support a private system of pension funds in order to give proper companies a chance to attract more money and apply it to economics of the country.

# NOTES

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