საქართველოს სტრატეგიისა და საერთაშორისო ურთიერთობათა კვლევის ფონდი
GEORGIAN FOUNDATION FOR STRATEGIC AND INTERNATIONAL STUDIES

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ON THE POLITICAL ECONOMY OF ECONOMIC SLOWDOWN IN GEORGIA

MERAB KAKULIA

EXPERT OPINION

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Downturn in Economic Growth

Throughout the first three quarters of 2012, the Georgian economy was developing rather dynamically: the annual real growth rate of the Gross Domestic Product (GDP) over this period comprised an average of 7.5%. Construction, manufacturing, financial intermediation and hotel and restaurant sectors were distinguished by high economic activity.[1]

In the third quarter of 2012, slowdown of economic activity began and evolved into a sharp decline in the real GDP growth rate towards the end of the year. In the fourth quarter, the economic growth rate decreased to 2.8%. In the sectors where high economic activity was recorded in the first three quarters of the year, growth rates particularly fell in the manufacturing and construction industries.[2]

The decline of the Real GDP annual growth rates further deepened in the first quarter of 2013. According to GeoStat's preliminary assessment, this figure had consistently been decreasing since January and in March comprised just 0.4%.[3]

Overall, the Real GDP growth rate in the first quarter, in contrast to the corresponding period of the previous year, fell to the lowest mark in the last three years - 2.4%. The sharp fall in annual growth rates was evident in the manufacturing, hotel and restaurant and financial sectors while a decline was recorded in the construction, energy and transport sectors.[4]

According to GeoStat's preliminary assessment, the Real GDP annual growth rate significantly increased to 4.5% in April 2013 which raised some hope of improving the economic performance; however, in May, the figure again fell dramatically - to zero.[5]

What Caused the Economic Slowdown?

The economic slowdown in Georgia, as stated above, began in the third quarter of 2012 when the election campaign was entering a decisive stage. This process was further intensified following the defeat of the ruling party – the Unified National Movement – in October's parliamentary elections and the coming to power of a new government. Therefore, it is not surprising that the international financial institutions and rating agencies largely associate the decline in economic activity in Georgia with the election campaign and the change of government.[6] Nevertheless, the role of the aforementioned political events in the decline of the GDP growth rates has yet to be fully determined and requires additional study in order to develop ways to improve economic performance.

Prior to assessing the impact of the election campaign and the change of government on economic growth, it is expedient to offer a brief overview of the macroeconomic reasons which have directly instigated the economic slowdown in Georgia.

Decline in Investment

The fall of economic growth rates has largely been caused by a significant decline in foreign direct investment (FDI) whose total volume in the last three quarters (third and fourth quarters of 2012 and the first quarter of 2013) decreased by 35% in comparison to the corresponding period of 2011-12. It is noteworthy that during this period, FDI decreased in essentially all major sectors.[7]

Evidently, foreign investors perceived the uncertainty associated with the parliamentary elections and the change of government quite intensely which was manifested in the "wait-and-see" behavioral model.

The ascension of the new government to power also weakened the activity of local investors since following the elections the government radically changed its approach towards Georgian business which had previously been determined by "rules of the game" based on elite and political corruption.[8]

The decrease in investment is indicated by a significant reduction of the import volume of investment goods.[9]

The decline in investment was clearly reflected in National Accounts: the annual growth rate of Gross Capital Formation has sharply decreased in the third quarter of 2012, its volume in the fourth quarter declined by 2% in annual terms and in the first quarter of 2013 - by almost 16%.[10]

Delay in Infrastructural Projects

Along with FDI, infrastructural expenditures of the budget have been a key factor in economic growth in Georgia over the last years. Despite fiscal consolidation policy pursued by the government in 2012, large expenditures were allocated, primarily to finance infrastructure projects, which played a significant role in maintaining high rates of GDP growth over the first three quarters.

In last year's fourth quarter and the first quarter of 2013, the funding of such expenditures was suspended. One of the principal reasons has been the new government's review of procurement procedures which was brought about by the non-competitiveness of previous tenders and serious irregularities revealed in the activities of winning companies.[11] The disruption of infrastructural expenditure, clearly, contributed to the weakening of economic activity.

Weakening of Demand

Decline in investment and the suspension of infrastructural projects had an obvious negative impact on aggregate demand. In addition, the expenditures incurred by the government on goods and services significantly decreased: in the first quarter of 2013, their volume, in contrast to the previous year's corresponding period, decreased by 49.6%.[12] The decreasing trend in state consumption continued in this year's second quarter.

An important factor in the decrease of economic growth is the decline of consumer demand. Despite the fact that directly following the elections (in October-November 2012), the Consumer Confidence Index (CCI) increased sharply, which points to a positive perception of the change of government, towards the end of the year it fell again with a similar abruptness. In January and February, consumer attitudes improved once again, although in March, the CCI fell again.[13] The above indicates that Georgian consumers developed a less optimistic attitude following the parliamentary elections which manifested in their weakened propensity to consume.

The reduction in consumer demand is partially confirmed by loan statistics: the annual growth rate of the total volume of loans issued to households by commercial banks sharply declined: in the first quarter of 2013 the figure comprised an average of 17% which in the previous year's corresponding period amounted to 36%.[14]

The reduction in consumer demand is also evidenced by a decline in import which is largely associated with the decrease of fuel and food imports. Beginning in November 2012, the import volume has been decreasing in annual terms on a monthly basis. The annual decrease in import reached its peak in March 2013 when it amounted to almost 10%.[15]

The weakening of household proneness to consumption is also indicated by an increase in individual deposits. Prior to the parliamentary elections, their growth rate began decreasing and in September amounted to an annual 7%. Subsequently, the formation of such deposits accelerated: in the first quarter of 2013, the annual growth rate comprised an average of 18%.[16]

Strengthening of Political Risks

All the macroeconomic reasons which directly caused the decline in GDP growth in Georgia are more or less connected to the parliamentary elections and the change of government although the impact of political risks associated with these events on economic performance varies. The breakdown of key political risks allows us to better see their influence on the economic slowdown.

Political Uncertainty

Political uncertainty implies the anticipation of domestic political instability by investors. In the context of Georgia, this is caused by the incompatibility with the president of a government formed by the parliamentary majority in a presidential republic which the aspiration towards “cohabitation” repeatedly declared by both parties has failed to outweigh.

The risk of political instability has been perceived as more intense until the acting President retained the power to dissolve the parliament and, before the new parliamentary elections, staff the government at his sole discretion. After the President was stripped of this right following constitutional amendments (March 2013), political uncertainty, as such, has largely neutralized.

Despite the above stated, the President continues to pose a rather serious inconvenience to the new government as evidenced by his attempts, during his numerous overseas visits, to discredit the new government and weaken the confidence in it. The new government's extremely negative assessment of any and all reforms undertaken by the previous government has also merited divergent perception on the part of foreign investors.[17]

Post-election Political Shock of Business

The new government immediately rejected a highly vicious practice followed by the previous government in its relationships with business entities - a significant part of the leading Georgian companies in various fields, which were formerly either controlled by relatives and friends of high-ranking officials in the previous government[18] or regularly performed informal "tasks" assigned by the previous government, has been enjoying significant advantages over the years: "winning" privatization auctions, "prevailing" in state procurement tenders, benefitting from the actual tax immunity, retaining a dominant position in the market, etc.[19] Moreover, they actively participated in the expropriation by the government of politically "unreliable" businesspersons which manifested in the appropriation of confiscated assets.

Following the elections, the status of the aforementioned companies changed dramatically: under the new government, they instantly lost all privileges; in addition, criminal prosecution of former officials which patronized numerous business entities began.[20]

All of the above proved shocking for the aforementioned companies which, clearly, negatively affected their economic activity. The quantitative assessment of such a shock effect is rather difficult and requires a separate study; nevertheless, official statistics of the business sector provide at least some idea of its magnitude. In the first quarter of 2013, enterprise turnover grew by 6% in contrast to the corresponding period of the previous year while in the first quarter of 2012, as compared to the preceding year, the growth rate of enterprise turnover exceeded 42%. It is noteworthy that over the same period, the turnover growth rate of large companies decreased tenfold while that of medium-sized companies reduced five times and small companies – four times.[21] As can be seen, the change of government had the most profound impact on large companies.

Regulatory Uncertainty

It is important to distinguish between political uncertainty and policy uncertainty.[22] A principal form of the policy uncertainty is the regulatory uncertainty which implies the possibility of adverse changes for investors within the current regulatory framework.

According to a recent study by the World Bank's Multilateral Investment Guarantee Agency (MIGA), among the political risks existing in developing countries, investors are most susceptible to regulatory uncertainty.[23] Thus, it is no surprise that some international observers largely associate the cautiousness of foreign investors towards Georgia during the pre-election and, especially, the post-election periods with possible changes in the regulatory framework.

The Regional Director of the Fitch rating agency, Charles Seville, considers the amendments to the Labor Code initiated by the government a conspicuous example of regulatory uncertainty.[24] This notion is not shared by the former EBRD Director for the Caucasus, Moldova and Belarus, Paul-Henri Forestier, who believes that, on the contrary, the changes in the Labor Code will render Georgia's investment climate more attractive.[25] In our opinion, the original draft of the amendments to be introduced to the Labor Code was indeed detrimental for investors as confirmed by a very recent study published by PMC.[26] Although, the amendment of the Labor Code is not the only factor. The problem of regulatory uncertainty should be examined in a wider context.

As is known, the economic policy professed by President M. Saakashvili's government was founded on Libertarian doctrine and preached the superiority of the free-market and the principle of "minimal government;" however, in reality, it did not shy away from authoritarian style of governance, property rights infringement or blatant state interference in the economy.[27] Nonetheless, through an efficient communication strategy, the previous government managed to establish a reformatory image on the international arena. Against this background, among the influential circles of investors and donors, doubt was conceived that the new ruling coalition, which comprises ideologically different forces and, was, for many years, in irreconcilable opposition to Saakashvili's regime, will demonstrate political will to retain and develop the positive (in their opinion) trends which it has inherited. Unfortunately, the new government has so far failed to develop an effective communication mechanism.[28] Nevertheless, foreign experts well aware of Georgia's economy believe that the business climate in the country has not only not deteriorated but is developing for the better.[29]

Regulatory uncertainty is further fueled by occasional early statements issued by the government regarding amendments to the regulatory system when details are not yet fully clear or politically agreed upon within the ruling coalition. This was the case in regard to the Labor Code which was followed by complex and protracted discussions with stakeholders.[30] At the same time, influential members of the government expressed substantially different views regarding the original draft of amendments to this law submitted to the Parliament. Ultimately, a more balanced version of the Labor Code amendments was adopted by mutual concession.

Another example of regulatory uncertainty is the new draft Law on Free Trade and Competition which was developed at the end of 2012 and repeatedly discussed by experts; however, its adoption has been pending for seven months.[31]

Such examples contribute to a sense of the instability of the regulatory framework among investors, some of whom do not exclude the possibility of adverse changes to other legislative acts, including the Tax Code.[32]

Institutional Uncertainty

Policy uncertainty in Georgia also touched upon the institutional framework for investment promotion. Shortly before the elections (in July 2012), a two-tier system for investment promotion (both foreign and domestic) was established in the country, comprising the National Investment Agency and the State-created JSC Partnership Fund. The former is a "front office" which signifies that all investors may address the National Investment Agency which will provide them with relevant assistance; if the investment project requires co-financing, the issue is then passed on to the Partnership Fund for further review.[33]

Upon coming to power, the new government announced the establishment of a three new investment funds, namely: the Sovereign Fund, which will be established on the basis of the Partnership Fund, the Agricultural Development Fund and the private Co-investment Fund.

The Sovereign Fund, according to available information, is in the process of establishment, although no legislative acts or draft laws on its status and operation, as well as its relationship to the National Investment Agency are known to date. We know only that the Sovereign Fund "will bring together state assets and implement strategic projects," assume the function of "international diversification" and ensure support to "youth (innovative) projects" and management of "other future funds."[34]

The Rural and Agricultural Development Fund was established as early as late last year and two projects are already being implemented under its auspices (the Supporting Spring Work for Small Landowner Farmers and Preferential Agricultural Credits projects), although the legal status and sources of funding of this Fund have not yet been fully clarified and raise certain questions.[35]

With regard to the private Co-investment Fund, the entity has not yet begun its operation while available information relevant to the subject is so limited that it does not provide a substantial perception of the operation mechanism of this Fund.

All of the above gives rise to institutional uncertainty which has been repeatedly highlighted by international financial institutions, individual experts and analysts.[36] Such uncertainty in investment policy does not contribute to the strengthening of investor confidence.

Breach of Agreements with Investors

The breach of agreements with investors laid down by the previous government can be considered as one of the forms of policy uncertainty to which, according to MIGA's study mentioned above, foreign investors are exceptionally susceptible (after regulatory uncertainty).[37]

Unfortunately, all more or less large FDI carried out in Georgia in recent years were accompanied by clandestine and, in some cases, informal agreements under which the Government of Georgia took certain obligations in favor of investor. These obligations, besides providing benefits under the current investment regime, enabled the foreign investor to enjoy additional advantages. For example, in order to ensure rapid return on investments by energy companies, relevant tariffs were significantly increased.[38]

After the new government came to power, the issue of the expediency of the breach of such obligations was raised which, obviously, caused the discontent of active foreign companies.

For Accelerating Economic Growth

Against the background of the significant slowdown of economic activity, earlier predictions of GDP growth rates in 2013 made by international financial institutions and rating agencies came under suspicion. The EBRD has long since decreased its forecast from 5% to 3%,[39] the International Monetary Fund (IMF) - from 6% to 4%[40] and Fitch Ratings - from 5.5% to 3%.[41]

The Government of Georgia is not in a hurry to revise the official forecast for Real GDP growth (6%), although the Ministers of Economic Development and Finance stated that the forecast is no longer realistic.[42] It can already be said that hope of a significant acceleration of economic growth in the second quarter of the year is unfounded as evidenced by the fact that, according to GeoStat's preliminary assessment, the average real growth of the Gross Domestic Product in January-March 2013 amounted to just 2.3%.[43] Therefore, it is unlikely that over the remaining period of the year (third and fourth quarters) such high rates of GDP growth will be achieved that will ensure an annual growth rate of at least 5%. It is noteworthy that in July the National Bank of Georgia (NBG) decreased the economic growth forecast for 2013 from 6% to 4%.[44] Thus, it is advisable that the government revises the official forecast in a timely manner and introduces relevant corrections to the country's budget.

At this stage, the principal task of the government is to prevent the economic slowdown from escalating into a recession which is a real threat that already exists. The solution of the given task calls for the neutralization of key negative economic impacts of the transitional period (transfer of power) in a relatively short period of time. In this context, in our opinion, three things are particularly important: restoration of investor confidence (both foreign and local), depoliticization and decriminalization of business and strengthening of fiscal stimulus in the economy.

Restoring Investor Confidence

The restoration of investor confidence essentially implies altering their behavioral model of "wait-and-see" which will require overcoming political uncertainty, on the one hand, and policy uncertainty, on the other.

Political uncertainty is gradually neutralized which is manifested by a decline in the risk of civil tension and political instability. The new government and the Parliament enjoy a considerable level of trust from the majority of citizens which, against the backdrop of systematic exposures of criminal acts committed by the previous authorities, contributes to the weakening of the real opposition (former ruling party). However, outside the country, criminal prosecution of former government officials is seen as a trace of selective justice and a threat of the "Ukrainization" of Georgia.[45] Therefore, the new government is in need of proper communication channels in order to immediately rebut these suspicions.

The community of foreign investors and donors also requires a thorough explanation of the fact that following the presidential elections in 2013, the constitutional model in the country will change and the election of the new president, whoever he or she may be, will not have any significant impact on the policy of the country's executive branch. It should also be noted that the statement of the current Prime Minister on his prompt retirement from politics following the presidential elections[46] will not contribute to the restoration of investor confidence since at this stage the Prime Minister is perceived as the guarantor of political stability in Georgia.

The neutralization of policy uncertainty, first and foremost, implies the clear formulation of the new government's values, strategic goals and ways for their achievement and their presentation at the international level. Notwithstanding the fact that the governmental program For a Strong, Democratic, United Georgia[47] reveals the priorities of the new government, the document, due to its format, lacks a strategic vision and systematicity; moreover, the governmental program openly indicates that the state "should determine the development strategy at the level of the main objectives and relevant indicators … within the framework of the development of strategy all functions required for sustainable development and social welfare will be defined." Elaboration of such a strategy has been delayed which prevents foreign investors from properly perceiving the initiatives of the Georgian Government in terms of legislative amendments. Thus, in order to restore investor confidence, an urgent task is the elaboration of a medium-term development strategy (up to and including 2020). In our opinion, this should not be a lengthy document, although it should clearly reflect the new government's value system and key principles of the country's development model as well as the Economic Reforms Agenda.

The elaboration of a medium-term development strategy, as stated above, will simplify the overcoming of regulatory uncertainty; however, it will be unable to completely neutralize the problem. Investors must be confident in the fact that the existing regulatory framework, which is convenient for them, will not be subjected to drastic changes; and if it is, this will not occur unexpectedly and in detriment to their interests.

Therefore, it is advisable to develop a communication format within which possible changes in the regulatory framework will be communicated to foreign and local investors. It is recommended that this function be *fully* assumed by the National Investment Agency which will require its institutional strengthening. In addition, the current Law on the National Investment Agency, which no longer meets modern requirements, should be revised.

In order to restore investor confidence, it is essential to overcome institutional uncertainty which primarily implies the establishment of transparent and efficient institutions supporting investors.

The new government has made a decision to reorganize the Partnership Fund and establish the Sovereign Fund on its basis, although the institutional framework of this Fund is not yet known. Given the high investor interest towards this reform, it is recommended that the government accelerate the drafting of relevant legislation, its review with stakeholders and its timely adoption. In our opinion, two issues are exceptionally significant: what will be the role of the Sovereign Fund as a partner for both local and foreign investors? and what relationship will it have with the National Investment Agency? We believe that the existing institutional links between these two entities should be maintained.

Investors, and especially local investors, are also interested in the legal status and funding sources of the Rural and Agricultural Development Fund since this Fund is currently the key tool for promoting long-term investments in the agricultural sector. We believe that the government should pay more attention to the development of the Fund as an institution, including the improvement of its legal status, provision of “autonomy” from the Ministry of Agriculture and operational transparency.

As for the third - the private Co-investment Fund, although it is not part of the state investor support system, but as this fund is established under the auspices of the government and its volume, according to the Prime Minister’s statement, will amount to USD several billion,[48] it may become a rather powerful factor for investment in the country. Therefore, it is difficult to over-assess the significance of promptly clarifying its institutional structure and mechanism of operation.

In order to overcome policy uncertainty, it is fundamentally important to ensure that investor support is “rule-based” or investors should be able to enjoy only those benefits provided by the existing investment regime. Any type of clandestine or informal agreements on the receipt by an investor of additional benefits at the expense of the state or its citizens, as was done by the previous government, should be prohibited. At the same time, the new government, where possible, must take into account the obligations assumed by its predecessor regarding investment projects already implemented or in the process of implementation in order to avoid infringement of investors’ interests.

Depoliticization and Decriminalization of Business

In order to speed up economic growth, it is essential to free large business entities of the state of post-election political shock which they have experienced following the cancellation of exceedingly fallacious “rules of the game” practiced by the previous government.

Due to the loss of privileges and elite guardianship, these companies found themselves opposite significant challenges: sales for their vast majority fell sharply, some were even forced to close and others faced the threat of expropriation, including due to tax debt.[49] Given the fact that the majority of these companies are large enterprises, distinguished by a relatively high technological level and skilled labor force, their paralysis will be prohibitively costly for the country's economy. Therefore, the issue of preserving of the economic activity of these companies remains on the agenda, but how can this be accomplished?

In our opinion, the process must simultaneously follow two directions:

Firstly, the responsibility of the companies' management and real owners, including politically motivated individuals and their friends and relatives, should be dissociated. In this case, these enterprises will receive a chance to continue their operation and their owners, if necessary, will be subject to criminal prosecution for involvement in elite corruption schemes or embezzlement of another's property. This way, it will become possible to depoliticize the activity of these enterprises.

Secondly, if companies reveal an economic offense, including tax evasion, for which management is directly liable, it is recommended to develop a flexible mechanism for the decriminalization of these offenses and the deferral of tax liability. Thus, it will be possible to avoid enterprise sequestration and the suspension of their activities.

Given that these companies are sufficiently competitive and occupy a dominating position on the market, the shifting of which would take time even under conditions of flawless competition, they should not be faced with artificial barriers during participation in state tenders.

Fiscal Stimulus in the Economy

The restoration of investor confidence, as well as the depoliticization and decriminalization, even in case of the demonstration of strong political will, require a certain amount of time. However, Georgia's economy is in immediate need of a stimulus, especially as there has been a clear trend of deflation for over a year, one of the triggers of which is weak domestic demand.[50] The new government's active social policy, reflected in the growing dynamics of social spending in the budget,[51] has seemingly failed to balance the negative macroeconomic effects of delayed infrastructural expenditures and decline in government consumption (procurement of goods and services) and have a substantial impact on domestic demand. Consequently, if the government does not accelerate the funding of infrastructural projects, regarding which numerous statements have been issued, and increase state procurement, it will be exceedingly difficult to overcome the economic slowdown and avoid recession.

According to available data,[52] in 2013, 8.4% more funds will be invested in infrastructural projects as compared to the previous year. The same data indicate that 42.5% of the aforementioned expenditures should have been made in the second quarter of 2013 which significantly exceeds similar expenses incurred during last year's corresponding period. The multiplicative effect of these costs, if their incurrence is not hindered (albeit due to a delay in the implementation of a corresponding tender), is expected to become apparent in the second half of the year which gives some basis for optimism regarding an increase in economic growth rates.

It is noteworthy that the downturn in the economic growth rates against the background of a deflation trend will create considerable problems in terms of revenue mobilization in the budget which will clearly raise the issue of expenditure-cutting. This is unlikely to affect the implementation of social obligations assumed by the government which cannot be said of other budgetary expenses. A substantial diminution in budget expenditure, in case of a delay in FDI, could sink the economy into a recession. Thus, it is expedient that the government consider an increase in the budget deficit especially that even the International Monetary Fund is not against it.[53]

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