

FINANCIAL AND INVESTMENT ASPECTS OF STABILIZATION OF THE GEORGIAN ECONOMY IN THE CRISIS PERIOD

Malkhaz Bakradze, PhD Candidate

Grigol Robakidze University, Georgia

Abstract

The global economic crisis originated from the financial crisis when banks and financial institutions took the unreasonable high risks and mass bonuses in order to receive high profits. The author of these words is the President of the USA Barak Obama. Like worldwide, in Georgia the global financial crisis most of all effected the financial sector and became the basis for significant changes. The analysis of the few-year struggle against the results of the financial crisis shows several fundamental deficiencies of the existing international regulation framework and risk management practice and can impact potentially on any jurisdiction and bank system. Basel III document published by the Basel Committee on December 16, 2010 is just designed to eradicate such deficiencies. The financial crisis has also intensified the irregular reduction in leverage and existence of close relations between the institutes. The dynamics of procyclicality and system risks together with the particular risks typical for the banks shows the necessity of consideration of the aggregated risks of banking and financial sector in whole. The disagreed approach to the risks became the reason of the global crisis. The Group of Twenty will start to operate the new framework in 2013 and it will be introduced step by step until 2019. In spite of the transitional provisions, the introduction of Basel III is a very difficult task. According to McKinsey & Co. publication, Basel III will have significant impact on the European banking sector.

Keywords: Investment, banking, crisis, capital, growth

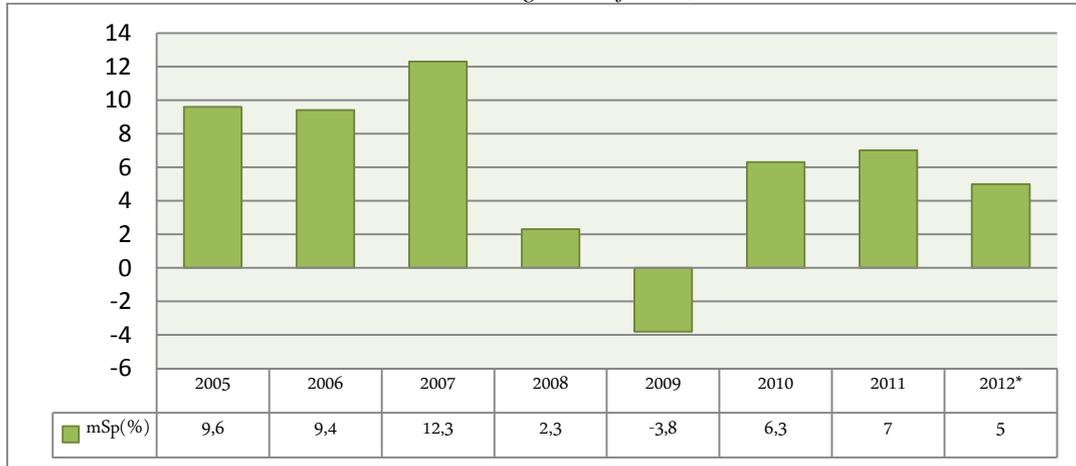
Introduction

The global economic crisis could have resulted in the development of the economy and the living standards of the population which in its turn leads to social level in the society. If we add the internal and external political instability, it is very difficult to judge a country's investment environment and the improvement of the roads, but it is necessary in the field of traffic analysis and some possible directions for reference. The government is actively trying to convince the international community of its own, and in particular the stability of the economy and its attractiveness as an investment, but significant population shifts in the direction of the times - so far have not been forthcoming. Investments have been very much in fact. Almost all the politicians on the spot or inappropriate users of this term (especially during election campaigns), realizing that you cannot survive without investment Georgian production, could increase employment, cannot be achieved through socio-economic and political stability. At the same time, foreign investors are focused primarily on the investment climate which is determined by an independent expertise of the investment efficiency.

Following the worldwide tendencies, in 2008, the development of the Georgian economy consisted of two different phases. In the first half of 2008, the high rates of the foreign direct investments (FDI) flows and growth of financial activity still maintained, but in the second half of 2008, the real gross domestic product (GDP) decreased by 3.2% compared

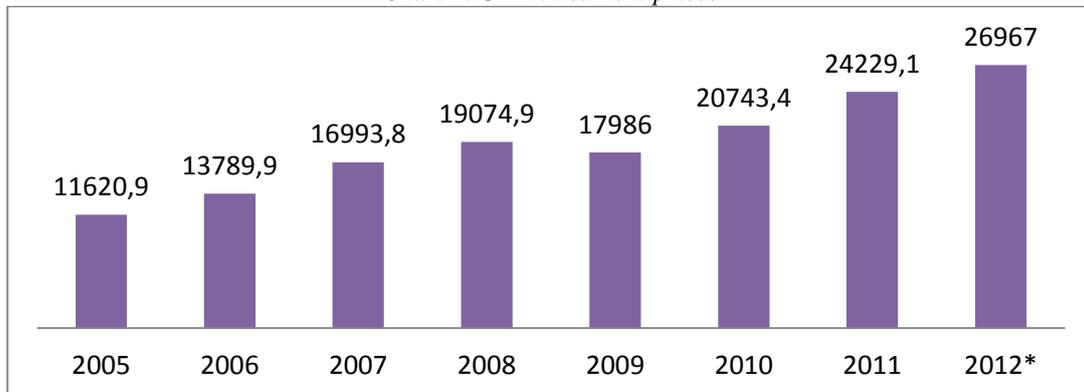
with the same period of the past year while in the first half of the year the actual growth was 8.7%. Such sharp drop was mainly caused by the paralysis of the economy resulted from the hostilities which took place in August of 2008, whereby in the third and fourth quarters of the year the real decline in the economy was 3.9 % and 2.5%. This situation was also aggravated by the problems of searching resources from abroad for commercial banks due to the exacerbation of the global financial crisis, the increase in the interest rates and slowdown of the credit activity. Finally, in 2008, the real growth of the gross domestic product was 2.3%.

Chart 1. Real growth of GDP, %



In 2008, the negative GDP was not fixed though, this index sharply declined compared with the previous years. The maintenance of the positive growth pace was mainly conditioned by the development of the sectors related to the budgetary financing. From the analysis of the stricture of GDP expenditure, we can see that in 2008 the growth of GDP was due to the final consumption.

Chart 2. GDP in current prices



The total consumption expenditure made up almost 100% in the GDP and compared with the previous year the total consumption growth was equal to 20.2 %. The greater part in the total consumption went to the households where the consumption increased by 16%. More than doubled growth was fixed in the general government expenditure which increased by 32% compared with the same indicator of 2007. As it has been mentioned above, in the second half of 2008, the foreign direct investments sharply declined, thus affecting on the component of the gross capital formation.

In 2008, this component amounted to 5148.8 mln. GEL or by 5.5% less than in the previous year. As a result, the share of the gross capital formation in one year decreased from 32% to 27%. In 2008, the trade gap significantly increased. The decline in the trade turnover was observed from the second half of the year but finally, the annual trade gap increased by about 1 bln. GEL (by 21%). The export growth was minimal – it grew by 166 million GEL

only and amounted to 5469.1 mln GEL. The import growth was more impressive: in spite of the decrease by 212 mln GEL in the second half of the year, the annual growth was 1160 mln GEL and amounted to about 11 bln GEL. Hence, as a result of the particular great trade gap in the first half-year, its share in the GDP compared with the previous year did increase from 28.2 % to 29.0% [3, 11-12].

Table 1. Current prices (in mln GEL)

	2005	2006	2007	2008	2009	2010	2011'
Gross domestic product in market prices	11,621	13,790	16,994	19,075	17,986	20,743	24,229
Final consumption expenditure	9,794	9,794	12,972	15,732	19,596	19,075	19,898
Households	7,720	7,720	10,804	11,953	14,582	14,600	15,418
General government	2,014	2,014	2,116	3,718	4,936	4,399	4,371
SHMAKO	61	61	52	61	77	75	109
(+) Gross capital formation	3,892	3,892	4,255	5,448	4,952	2,343	4,478
Fixed capital formation	3,261	3,261	3,524	4,370	4,099	2,755	4,009
Stock change	630	630	731	1,077	853	-412	469
(+) Goods and service export	3,922	3,922	4,532	5,303	5,459	5,349	7,250
Goods export	2,666	2,666	2,956	3,479	3,587	3,163	4,390
Service export	1,256	1,256	1,576	1,824	1,873	2,185	2,860
(-) Goods and service import	5,993	5,993	7,863	9,848	11,140	8,801	10,945
(=) Gross domestic product in market prices	11,621	13,790	16,994	19,076	17,986	20,743	24,229

2009 was particularly difficult for the Georgian economy. The real decline of the national gross domestic product was 3.8%. During 2009, the Georgian economy was in the post-crisis state. The impact of the hostilities and the global financial crisis that took place in the second half of 2008 manifested itself especially in the first half of 2009. This grave economic background was aggravated with the political tension. All this caused the unprecedented real decline of the Georgian economy in the second quarter of the year – by 10.1%. Though in the second half of 2009 the process of decline in the GDP stopped (that mainly is explained by the economic drop in the relevant quarters of the previous year or the “basis effect”) and in the fourth quarter for the first time after the year-and-a-half period a small positive growth trend (0.4%) was observed in the economy, the trend of the fixed negative rate of the annual growth was inevitable. The decline in the nominal GDP was even greater – due to the negative deflator it made up 5.8%.

From the GDP analysis by sectors we can see that the most negative impact on the national economy had the trade sector (-2.5 percentage points). The significant decline was fixed in the processing industries, construction and communal, social and personal service sectors. The positive growth rates of added value were fixed only in some sectors where the highest went to the health sector (0.33 percentage points). Noteworthy is that the positive growth rates were fixed mainly in the budget financed sectors.

The analysis of the almost 6% decline in the nominal GDP of 2009 from the aspect of demand enables to make several significant conclusions. First of all, noteworthy is that in the GDP reference equation, in spite of the negative import, the positive Georgian GDP and

import correlation in 2003-2009 was 0.96%. Such dependence was due to the fact that in 2003-2008 one of the driving factors of the national economy, the foreign direct investments, conditioned the growth of import from 4 bln GEL to 11 bln GEL. The import growth was reflected both on the final consumption growth and the investment expenditure. Therefore, during the economic development period, the negative effect of the import growth was balanced by the growth of the goods and service intended for the final consumption, investment expenditure and re-export. Subject to the foregoing, the sharp decline of the foreign investment flows during 2009 played the deciding role in the stagnation of the final consumption rates and decline in the gross capital formation (investments). According to the annual data, the final consumption decreased by 1.9%, the export declined by 2.9% and the value of the investments and import decreased by 56 and 21 % accordingly.

Therefore, based on the analysis of the demand, we can conclude that the decline in the national nominal GDP considerably resulted from the decline in the consumption, namely, general government, final consumption and investments. The latter mainly caused the decrease in the capital inflow resulted in the import decrease. The certain share of decrease in the major GDP components was expressed in the import decrease that mitigated the reduction in the GDP [4,17-19].

In 2011 was fixed the considerable growth of the Georgian economy. The annual index of growth of the real gross domestic product was 7 %. The economic growth attained to the highest rate in the second half of the year. In the third and fourth quarters the real GDP increased by 7.5 and 8.8% accordingly. Excluding the seasonal factor effecting the GDP we can see that the economy was growing in each next quarter compared with the previous one. Therefore, according to the correlated data, the economy was growing much more intensively in the first and last quarters of the year (by 2,4-3.0%) than in the second and third quarters (by 1.3-1.8%). Based on the GDP dynamic analysis by sectors, the major share in the economic growth of 2011 was contributed by the processing industries and trade sectors. In addition, noteworthy is the considerable growth of the sector of financial activity and its high contribution to the GDP growth in 2011 (0.6%). The agrarian sector, after some years of decline increased by 5.5 % in 2011. The following sectors showed the high growth rate and accordingly, made the considerable positive contribution in the economic growth: construction, state government and transport. The share of added value growth in other sectors was comparatively small in the total growth. The annual decline was fixed only in the mining industry due to the decrease in the demand for the minerals in the international markets. Noteworthy is that the growth of national economy was caused by the growth of the private sector activity, like in 2010. In 2012 the prolongation of this trend of growth and maintenance of its dynamics by sectors is anticipated.

In 2011, the nominal GDP increased by 16.8 % compared with the previous year while GDP deflator increased by 9.2%. The final consumption category increased nominally by 12.6%. According to the 2011 data, the gross capital formation increased by about 39%, and the goods and service export – by 22%. The import increased by 22% and made up 55% in the nominal GDP that is a rather high index. The real final consumption produced a result of the exclusion of the consumer price increase, increased by 3.7% during the year. Compared with the year 2010, the real consumption growth rate in the beginning of the year was low (up to 1 %) and in the second half it considerably accelerated and made up 7%. The general government expenditure in 2011 was lower than the indices of all quarters of 2010, except for the Q4. In total, in 2011 (as a result of the expenditure in the last quarter of the year) the state government bodies nominally spent by 1.4% more and in the real terms by 6.6% less than in the previous year. Such reduction in the expenditure is explained by the policy aimed at the fiscal consolidation.

In general, the growth of the final consumption in 2011 is the result of the increase in its largest part - the consumption expenditure of households. A rather high (38.6%) growth of

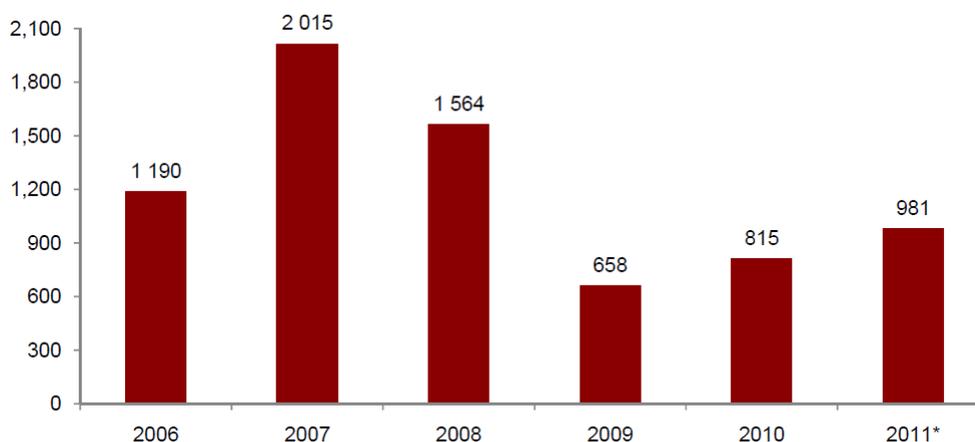
the gross capital formation was caused by the annual 33% growth of the fixed capital formation. At the same time, compared with 2010 the rate of increase in the stock and supplies doubled and this index in terms of the current prices became equal to the similar value of the year 2007. In 2011, the gross capital formation exceeded the same value of 2007 by 14%. Taking into consideration the factor of rise of prices, it is obvious that the capital growth fixed in the past year in the real terms does not exceed the pre-crisis rate, though when assessing the importance of this fact noteworthy is that in 2007 the economic boom attained to its peak. It should be mentioned that during the total post-crisis period, the real economic growth was mainly due to the export and capital formation growth. As it has been mentioned above, during the past year the real total final consumption, unlike the previous years, considerably increased as well. In general, the contribution to the real economic growth in 2011 was made by all three discussed categories of use of the GDP where the contribution of gross capital formation and goods and service export is again higher.

Noteworthy is that in 2011, the growth of the gross national income (GNI) of the country was higher (17%) than as a result of the total consumption (13%). As a result, the national savings increased and this index exceeded the national income by 13% [6, 17-20].

Foreign direct investments

The foreign investments implemented in Georgia in the first half of 2008 were characterized with the growth tendency and increased by 35.5 compared with the similar index of the previous year and amounted to 942 mln US dollars. Unfortunately, such rate of the growth did not continue and, on the contrary, in the second half of 2008 the investments sharply decreased compared with the index of 2007. This was caused by the risk situation resulted from the hostilities and, of course, the investors wanted to channel their funds to the more politically stable countries. This was a great shock for the Georgian budget but the state was more aggravated by the world crisis beyond the control of Georgia. The global financial crisis has swallowed up the wealth of many billionaires and millionaires worldwide hence resulting in the decline in the investing. The direct investments are shown in Chart below:

*Chart 3. Foreign direct investments in Georgia in 2006-2011**



As we can see from the Chart above, in 2006-2007, the foreign direct investments were growing due to the stabilization of the situation disturbed after 2003 and the increased confidence and investment interest in Georgia. Unfortunately, this growth stopped in 2008. In 2009-2010, the investment growth was observed though not at the level of 2007.

Based on these data, we can find out that the crisis and the war had a rather big negative effect on Georgia. One can say that the war was the main reason of the loss of investor's interest towards Georgia but the main factor was that the investors themselves were hit by the crisis and the world economy in general only now begins to transit gradually

to the growth regime. My point is that the world still experiences different financial fluctuations and some analysts predict that in spite of overcoming the crisis, the world can immerse in a deeper crisis again [11].

To whom, in what form, for what term and under what conditions shall the governmental investments be “delivered”? On mature reflection, the best implementation of the above mentioned three properties of investments will be only in the banking sphere, i.e. we have defined the initial point of investments – the commercial banks, that is the banks will accumulate the financial resources as well as the tendered investment projects and provide their further priority placement. The priorities will be determined by the specially developed methods where beside the main priority of the maximum efficiency, other priorities will be taken into account: commodity-forming and resource-saving character, dependence on the imported raw material, regional diversification, social aspect (employment size, employment of IDPs and general employment, etc).

At the same time, we shall keep in mind that the funds are state-owned and are subject to the refunding; therefore, we shall take into account the mechanism of denationalization (privatization) and the interests of all players of the investment process: the state, commercial banks, entrepreneurs and employers! Just in this field the safeguarding role and function of the insurance system shall reveal itself with the best responsibility and strength.

During the crisis period, the particular value is attached to the monetary policy of the cash aggregate control, namely, the unreasonably high remuneration. At the same time, the anti-crisis activities require the active support from the side of population. Where can we seek a possible solution? Our proposals are as follows:

1. To determine from the very first day the reasonable rated wages at newly operated enterprises (even at the subsistence level or at best, much higher than the value of a consumer’s basket);
2. To pay only the partial (e.g. 50-60%) wage in cash for a certain period (see the explanation below);
3. To remunerate the remained part of the wage in kind of the registered securities of the enterprise which will be placed in the special pension and investments funds on the registered base.

The essence of these activities is very simple: all employees shall be given the right and obligation to concern themselves with their income. The state pensions paid from the tax revenues shall be replaced with the individual pension deposits further invested in the securities. The labor force shall have the free option of transition to the new system while young employees will be automatically included in this system once they begin to work. As a result, we will considerably reduce the social expenses of the state, on the one hand, and on the other hand, the government will not be obliged to set and pay the leveled and scanty pensions.

It will be desirable to cover the majority of population with this system, except for those people who will simply have no time to accrue the sum for security of their worthy old age. The participants of the so called cumulative (private) system will not pay any profit-sharing fee and the pension funds will be the ownership of future pensioners. At the same time, depositors will be free to place those funds with this or that company or to invest them in the open security market, but with some restrictions (regarding the industry or region). The employees will transfer 10-20% of the wage to the own authorized insurance (pension-investment) account and will receive income from the accrued deposit and the right to dispose it as they will.

Upon attainment to the retirement age, any employee will be entitled to withdraw the total sum or get it by portions, mainly on the monthly basis. The very important factor will be that in case of accumulation of the sufficient funds in the pension deposit, an employee will

have the right to retire before the attainment to the age of 60-65 years and to continue the work after the attainment of the retirement age.

Whereas the investment of pension funds will be in the hands of private companies, it will be necessary to establish a special supervision agency thereof. This activity also requires the wide advertising and informational campaign in the mass media (especially via television) for explanation and promotion of priorities of the private pension and investment and insurance systems and certain companies.

Conclusion:

Consequently, we will achieve the following objectives:

- 1) The cash aggregate will be considerably, reliably and reasonably limited, thus making the positive effect on the inflation process;
- 2) The available additional resources will be used as a new investment source;
- 3) This activity will generate a powerful resource impulse for the effective development of the national financial market as well as all conditions to urge the population to make their savings in the securities in the open free market;
- 4) On the assumption of the continuity and cyclicity of the flow of funds, the national banking and insurance spheres will get the strong impetus to secure the process of economic efficiency and repayment of state-owned funds;
- 5) The motivation of employees for a higher quality of their work in the own companies will be improved as their future wellbeing and additional income as investors will depend on the output of the enterprise;
- 6) The proportional saving of the state social expenses will be possible;
- 7) The reliable system of social security of population based on the sustainable domestic source will be created.

In case of even gradual success of those activities, the public confidence in the government will arise, thus creating the stable basis for the support of future reforms to be carried by the government. The proposed mechanism of stimulation of the investment environment of the national economy and social guarantees is based on the practices of the countries having the considerable experience in this sphere: Germany, Chile, Argentina, Poland and others.

For example, let us refer to the Chile's experience. In the first year of the reform, the sums accumulated on the pension accounts of Chilean citizens amounted to about 300 mln US dollars and thereafter were increasing constantly: by 2001, this sum exceeded 35 bln US dollars. Consequently, there was formed the industry of management of those funds that, in turn, changed the situation in the stock market. In 1981, its capitalization amounted to 2.67 bln US dollars and by 1991 – attained to 20 bln US dollars. Parallel, by the end of the first year of the reform the amount of trade in bonds increased tenfold and in 1987 – decupled again as well as in 1998. Noteworthy is that at that time more than a half of the demand for such securities was provided by the pension funds. The appearance of the “pension” money in the stock market improved its (market) liquidity and stability; its “volatility” was significantly reduced as compared with other countries of Latin America. The appearance of new players in the stock market became the motivating factor of the demand for securities from the management companies. If in 1985 a medium management company held the stocks of two companies only, in 2000, this index was 107. In addition, the activity of pension funds representing minoritarian but well organized investors has had the beneficial effect on the corporate management. The management companies in Chile are obliged to vote for independent directors at the shareholders meetings and to inform the government about those managerial decisions which violate the rights of minoritarians. In turn, the Chilean enterprises which are seeking to get the pension resources in kind of investments make their business maximum transparent [1, 46-48].

References:

Dznelade G. Socioeconomic Results of Global Crisis in Georgia and Ways of Its Prevention (in Georgian language), Bulletin N 114, 2009.

<http://www.csrdg.ge/upload/editor/file/biuletenebi/114/ekonomikuri%20krizisi.pdf>

Meskhia Y. Global Crisis and Georgian Economy (in Georgian language), 2009.
<http://www.tetrebi.org/?p=3647>

2008 Annual Report of the National Bank of Georgia.

2009 Annual Report of the National Bank of Georgia.

2010 Annual Report of the National Bank of Georgia.

2011 Annual Report of the National Bank of Georgia.

April 2012 Bulletin of the National Bank of Georgia.

www.caucasia.geurasia.org/?p=11463&language=ka

www.economy.ge

www.en.wikipedia.org/wiki/Great_Depression

www.geostat.ge

www.itex.ge/tbilisipropertyauctions/public/Pages/OldTbilisi/OldTbilisi.aspx

www.nbg.ge

www.mof.ge

www.profi-forex.us/news/entry4000000221.html

www.presage.tv/?m=society&AID=4095

www.presage.tv/?m=bp&AID=7251

[www.ru.wikipedia.org/wiki/Мировой_финансовый_кризис_\(2008—2011\)](http://www.ru.wikipedia.org/wiki/Мировой_финансовый_кризис_(2008—2011))

www.voanews.com/georgian/news/US-economy-142166383.html