TO DISCUSSION OF POST-CRISIS DRIVERS OF GEORGIA’S ECONOMIC GROWTH

DOI: 10.17261/Pressacademia.201519951

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Keywords: Economic growth, Post-crisis model, Georgia, SMEs

JEL Classification: E20

ABSTRACT

Statistics evidence that drivers of pre-crisis model of economic growth in Georgia (foreign direct investment and financial/banking sector development) are constrained. The modification of pre-crisis to post-crisis model consists of further reorientation from consumption to investment component of GDP and diversification of investment sources. FDI have to be accomplished by internal (private) investment, the main generator of which are SMEs. SMEs gather small private savings and transfer them to private investment. SMEs might play a greater role in country’s economic growth.

1. INTRODUCTION

In global times it is important to have national specific model-strategy-policy of economic development and economic growth. In different countries drivers of economic growth are different. Since Keynesian Revolution manipulation of government expenditures to stimulate or to restrict aggregate demand/aggregate expenditures and GDP growth has become common for most government policies all around the world. Other Keynesian strategies widely used by fast growing countries are to rely on foreign trade (for example, European economies) and FDI (foreign direct investment). Some macroeconomic policies are focused on extension of domestic demand. For instance, since 2008 Chinese, Indian and Turkish apparel firms have shifted production from shrinking global markets to expanding domestic consumption and markets. A limited set of growth strategies is available for small emerging economies such as Georgian one. These countries usually face limited budget resources, they orient on FDI growth but they also can enter world and/or regional markets with niche products. The last strategy may be very beneficial when it is available for any business - large, small or medium, no matter the size. The fact is that in globalized world not only the largest global companies and investors but small businesses and individual entrepreneurs can play a larger role (Manyika et al.,2014).

The paper contributes to a broad academic discussion on the topic of economic growth in emerging country and more specifically, on post-crisis drivers of economic growth in Georgia.
The aims of the article are defined as follows: (1) to observe economic growth operating strategy in Georgia; (2) to identify the main sources (drivers) of economic growth in the country; (3) to develop recommendations for further modification of growth model through drivers diversification.

The main message of the article is that a modified growth model for post-crisis Georgian economy is needed. The model favors diversified investment-led growth which includes both FDI and private investment. Small and medium enterprises (SMEs) generate most part of private (internal) investment.

The applied research method is a well-known Keynesian aggregate expenditures (AE) model that is \( AE = C + I + G + X_n \) where \( C \) is consumers’ expenditures, \( I \) is investment expenditures, \( G \) is government spending and \( X_n \) is net exports (exports minus imports).

The paper provides quantitative and qualitative analysis of each of four major components of GDP in Georgia, tracking current trends against past experience. Analyses are based on wide statistical data and surveys, conducted by international organizations and by the authors.

The rest of the paper is organized as follows. The next section explores the basics of economic growth models for Georgia. The third section examines key macroeconomic fundamentals of Georgian economy. Analysis of components of Georgian operating economic growth model is the topic for the fourth section. It includes statistical observation of last trends in consumer expenditures, investment, government spending, and net exports. The fifth section considers elaboration of foundations of pro-growth post-crisis model summarizing the surveys conducted by international organizations and the authors. Last section provides a summary.

2. ECONOMIC GROWTH IN GEORGIA: REVIEW OF MODELS

Georgian scientific community discusses prominent proposals how to achieve sustainable economic growth. National strategies and priorities change as soon as top officials change their offices. Large-scale, all-encompassing program of Saakashvili’s government named the Economic Liberty Act (Government of Georgia, 2011) was replaced by more pragmatic but less liberal and not worked up to the end strategy of the new government. The crucial difference between these two programs consists in different understanding of role of market and government in economy. That is, more market and less government vs. less market and more government. In fact, the discussions are held on a standard platform that consists of neoclassical and new Keynesian theories. Using a simple neoclassical production function, growth can be decomposed into the contributions of capital accumulation, labor force growth, and total factor productivity growth. Based on Keynesian aggregate expenditures (AE) model that is \( AE = C + I + G + X_n \) where \( C \) is consumers’ expenditures, \( I \) is investment expenditures, \( G \) is government spending and \( X_n \) is net exports (exports minus imports), four major components of GDP are evaluated in terms of their constrains and future perspectives.
The World Bank formulated proposal as saving orientation policy, “The low saving rate in Georgia is a key impediment to sustaining adequate investment and rapid economic growth” (Georgia Rising, 2013; p.7-10, 16-19). Another recommendation proceeds from assumption that Georgia has the potential to increase sustainable and inclusive growth through strengthened focus on private sector-led job creation (Country partnership, 2014; p.1-9). This program has twin goals - private sector development that generates employment and provides income opportunities for the bottom 40 percent of the population. In another version economic growth is projected at an average of 5.5 percent a year over the medium-term, on the back of improving trade and investments (Georgia: Adjusting, 2014; p.11-12).

The World Bank sent the clear message to the government of Georgia, “The central challenges today for the government of Georgia is to find sources of long-run economic growth, particular through private sector development” (Fostering, 2013; p.15).

Paradoxically, despite the differences in general understanding of foundation of modern economy, short-run economic growth strategies are not so different. In particular, emphasis was and is still made on development of a single sector of Georgian economy in which the country has or may have a comparative advantages, for example, wine and tourism (Kakulia, 2007; Cordonnier, 2006; Shmidt, 2007; Economic Growth; 2007; Cordonnier, 2010; Samson, 2008). And actually in all programs the priority is still the policy of attraction of foreign direct investment (FDI), “Growth was fueled by high foreign direct investment before the global economic crisis of 2008, a period of easy finance worldwide” (Country partnership, 2014; p.1).

There is no doubt, that each of these plans has a real base to be put into life. In this article it is not going to be discussed their strengths/weaknesses (see, for example, (Cecire, 2009b; Cecire, 2010; Livny, 2009). As the economic reality shows, the question of drivers of economic growth model is still open to discussion.

3. METHODOLOGY AND DATA

3.1. Georgian Economy Macroeconomic Landscape: Statistical Retrospective

To define the drivers of economic growth, analysis of past economic trends is needed. Table 1 presents Georgian statistics on key macroeconomic fundamentals. The observation is done for the last seven years or the time from the beginning of global financial crisis of 2007.
Table 1: Georgian economy – key macroeconomic fundamentals

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth rate</td>
<td>12.3</td>
<td>2.3</td>
<td>-3.8</td>
<td>6.3</td>
<td>7.2</td>
<td>6.2</td>
<td>3.2</td>
</tr>
<tr>
<td>GDP per capita (at current prices), USD</td>
<td>2314.6</td>
<td>2921.1</td>
<td>2455.2</td>
<td>2623.0</td>
<td>3230.7</td>
<td>3523.4</td>
<td>3596.6</td>
</tr>
<tr>
<td>GNI per capita, PPP (current international $)</td>
<td>5470</td>
<td>5630</td>
<td>5440</td>
<td>5730</td>
<td>6140</td>
<td>6760</td>
<td>7040</td>
</tr>
<tr>
<td>Inflation rate (CPI), %</td>
<td>109.2</td>
<td>110.0</td>
<td>101.7</td>
<td>107.1</td>
<td>108.5</td>
<td>99.1</td>
<td>99.5</td>
</tr>
<tr>
<td>Unemployment rate, %</td>
<td>13.3</td>
<td>16.5</td>
<td>16.9</td>
<td>16.3</td>
<td>15.1</td>
<td>15.0</td>
<td>14.6</td>
</tr>
<tr>
<td>Exchange rate, USD/GEL average of the same period</td>
<td>1670.3</td>
<td>14902</td>
<td>16705</td>
<td>17826</td>
<td>16860</td>
<td>16513</td>
<td>16634</td>
</tr>
<tr>
<td>FDI, million USD</td>
<td>215.0</td>
<td>1564.00</td>
<td>658.4</td>
<td>814.5</td>
<td>1117.2</td>
<td>911.6</td>
<td>941.9</td>
</tr>
<tr>
<td>FDI, total as % of GDP</td>
<td>16.5</td>
<td>11.1</td>
<td>6.3</td>
<td>5.8</td>
<td>6.2</td>
<td>3.9</td>
<td>5.6</td>
</tr>
<tr>
<td>FDI growth rate, %</td>
<td>+69</td>
<td>-22</td>
<td>-58</td>
<td>+24</td>
<td>+37</td>
<td>-18</td>
<td>+3</td>
</tr>
</tbody>
</table>


In the period before the global financial crisis of 2007 (in 2004 – 2007) GDP grew by 9 percent in average. In observed period from 2007 through 2008 the Georgian economy was a post-Soviet success story with double digit growth rates (GDP growth rate 12.3 percent in average) and rocketing FDI inflows (9.4 percent in average), flourishing banking and financial sectors. Successful FDI and financial/banking sectors policies were the catalyst of economic growth in the country. From the end of 2008 and during 2009 due to the global financial crisis/global recession waves reached the developing world and August war with Russia, the situation changed. Thanks to international support and financial aid Georgian economy did not suffered recession in the ways as developed economies were effected. In 2010 -2011 Georgian economy experienced recovery with FDI and GDP growth rates 6.3 percent and 7.2 percent, respectively. 2012 was quite successful as well.

Thus, as statistic evidences Georgia achieved robust economic growth between 2004-2012, averaging 6.1 percent annually. The growth was supported by structural reforms and increased FDI rather than by net job creation. Relatively low growth in 2013 (3.2 percent) is explained by “post-election policy uncertainty and weak budget execution encouraged a wait-and-see behavior among businesses and consumers and impacted growth” (World Bank; 2014). The environment changed at the end of the year and in the fourth quarter of 2013, real GDP grew by 7.1 percent (National Bank, 2013; p.16). Eleven months average of 2014 GDP growth rate was 5 percent (GeoStat).

3.2. Statistical Observation of Components of Georgian Operating Growth Model

Unfortunately, Georgian statistic on GDP by categories of use provides too general information (Figure 1). For instance, “final consumption expenditures of households include expenditures for purchasing consumer goods and services and also other consumption of goods and services in kind, produced for own use” (Geostat).
This means that the volume of expenditures is artificially extended. Despite this fact, the past trends are clear. Consumer expenditures, both households and government, generate the major part of Georgian GDP while the net exports have negative value at least in course of the observed period.

**Figure 1: GDP by categories of use, %**

Table 2 provides more detail information about households’ incomes and expenditures in Georgia.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Incomes of the Population, Million GEL</th>
<th>Total Expenditures of the Population, Million GEL</th>
<th>Savings of the Population, GEL</th>
<th>Savings of the Population, as % of GDP</th>
<th>Total Expenditures of the Population, as % of GDP</th>
<th>GNP per Capita, PPP (Current International $)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>5121.6</td>
<td>5505.6</td>
<td>-384</td>
<td>-</td>
<td>32.4</td>
<td>5,470</td>
</tr>
<tr>
<td>2008</td>
<td>6536.4</td>
<td>6673.2</td>
<td>-136.8</td>
<td>-</td>
<td>35.0</td>
<td>5,630</td>
</tr>
<tr>
<td>2009</td>
<td>6904.8</td>
<td>6736.8</td>
<td>168</td>
<td>0.9</td>
<td>37.5</td>
<td>5,440</td>
</tr>
<tr>
<td>2010</td>
<td>7790.4</td>
<td>7413.6</td>
<td>376.8</td>
<td>1.8</td>
<td>35.7</td>
<td>5,730</td>
</tr>
<tr>
<td>2011</td>
<td>8533.2</td>
<td>8320.8</td>
<td>212.4</td>
<td>0.9</td>
<td>34.2</td>
<td>5,140</td>
</tr>
<tr>
<td>2012</td>
<td>9705.6</td>
<td>9430.8</td>
<td>274.8</td>
<td>1.1</td>
<td>36.0</td>
<td>6,760</td>
</tr>
<tr>
<td>2013</td>
<td>10882.8</td>
<td>10686</td>
<td>196.8</td>
<td>0.7</td>
<td>39.8</td>
<td>7,040</td>
</tr>
</tbody>
</table>

Source: Compiled and calculated by the authors; source of data: Geostat, World Data Bank.

From statistical evidence (Table 2) (indicator is GNP per capita in PPP of current international dollar) Georgia is low-level middle-income country. Another remarkable fact is that while per-capita incomes rose substantially since 2004, real GDP in 2012 was still only 78 percent of its 1990 level and Georgia remains one of the lowest income countries in the Europe and Central Asia region. In particular, in 2011, the level of per-capita GDP in Georgia was at 77 percent of the average level of non-resource rich CIS countries, 41 percent of Turkey, 25 percent of the EU-10 countries, and 13 percent of industrial countries (Georgia Rising, 2013; p.3-4). Despite this, above 1/3 of GDP is generated by expenditures and the last years the upward trend is observed.
As in any typical low income country, Georgian population savings are low and during some periods dissaving is observed, for instance, in 2007-2008, the years of global financial crisis. Thus, saving cannot be considered as a potential significant source of internal investment and GDP growth. Besides, the analysis of labor market shows that household’s income and private consumption are under the pressure of unemployment. Particularly, labor statistics depict quite stable but paradoxical situation in the labor market in terms of employment and unemployment rates. Firstly, there is a gap between statistical data and real situation in the labor market. Actual unemployment significantly exceeds official statistical data because it includes all types of “hidden” unemployment which has been increasing (Papiashvili, 2013). Secondly, at least from 2006 (and there is no reason to expect that the situation was different before) the share of self-employed was higher than hired or more than a half of all employed were self-employed (Geostat).

In other words, despite the successful FDI policy and impressive GDP growth in 2006-2007 and the 2010-2011 recovery, there is still a limited pool of job opportunities available. This statistical phenomenon is usually called as “paradox of growth” (Papiashvili, 2013).

So, in the nearest future it is unrealistic to expect economic growth in the country driven by domestic consumption. As it was mentioned, Georgian government has relied on FDI as the most significant part of investment and source of GDP growth. Since 2007-2008 global financial crisis, consumption and business activity in Georgia have been constrained by weak FDI (Table 1) and the slow global recovery. Specifically, according to the McKinsey Global Institute, in 2007 financial flows among the G-20 were about 18 percent of their GDP while in 2013 only 4.5 percent or shrunk by about 60 percent. Most of the decline was between developed economies, most notably within Europe. Cross-border lending to emerging markets fell by more than 80 percent from 2007 to 2012 (Manyika et al., 2014; p.28). Thus, the lack of financing available from international credit markets caused FDI flows to Georgia to shrink – about halved during 2009-2010. Unfortunately, “downside risks to global growth remain. Chief among them is a renewed increase in financial market volatility, especially in emerging market economies” (World Economic, 2014; p.48). Additionally, external shock such as tighter financial conditions in the United States, financial contagion and trade disruptions from geopolitical events, and slower-than-expected emerging market growth make unpredictable FDI sustainable flow.

Summarizing these trends, economists recognized that since 2007 things have changed and a new trend, New Normal, has been forming (Davis, 2009; Gross, 2009). New Normal concept describes new economic reality when advanced economies are growing very slowly. Therefore, from global perspective Georgia has to expect further deterioration of FDI flows and foreign trade.

Banking and financial sectors were another driver of Georgian GDP growth during pre-crisis period. These sectors are strongly linked to international financial markets due to the fact that most Georgian banks are foreign banks (for example, in 2013 from 21 Georgian banks 20 were foreign ones or foreign controlled (Bulletin, 2013; p.25). Not surprisingly, deterioration of international environment negatively affected Georgian banking and financial sectors as well.
Like in any emerging country, Georgian government has limited financial resources, despite the fact that according to the World Bank evaluation of budget deficits, fiscal policy is broadly appropriate. In 2013 budget deficit accounted 2.9 percent of GDP comparing to recommended level of not more than 3 percent (Table 3). Since 2010, the years of recovery, government debts, total and external public debts and budget deficits were quite high that have discouraged many infrastructure projects and negatively contributed to economic growth in the country (National Bank, 2013; p.17). Finally, the recession and lower demand in international markets contracted Georgian exports, decreased imports and increased trade deficit (Table 3).

Table 3: State Budget and International Trade in Georgia

<table>
<thead>
<tr>
<th></th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports, total as % of GDP</td>
<td>31.3</td>
<td>28.8</td>
<td>29.8</td>
<td>34.9</td>
<td>36.5</td>
<td>38.2</td>
<td>18.0</td>
</tr>
<tr>
<td>Imports, total as % of GDP</td>
<td>58.2</td>
<td>58.6</td>
<td>48.9</td>
<td>52.7</td>
<td>55.5</td>
<td>57.9</td>
<td>48.9</td>
</tr>
<tr>
<td>Trade balance as % of GDP</td>
<td>-39.1</td>
<td>-37.6</td>
<td>-31.3</td>
<td>-30.8</td>
<td>-33.7</td>
<td>-34.5</td>
<td>-30.9</td>
</tr>
<tr>
<td>Export / Import Ratio</td>
<td>23.8</td>
<td>23.7</td>
<td>25.2</td>
<td>31.9</td>
<td>31.0</td>
<td>30.3</td>
<td>39.9</td>
</tr>
<tr>
<td>Foreign debt to GDP, total as % of GDP</td>
<td>15.1</td>
<td>22.9</td>
<td>28.1</td>
<td>36.1</td>
<td>37.3</td>
<td>41.0</td>
<td>43.9</td>
</tr>
<tr>
<td>Budget deficit, as % of GDP</td>
<td>-4.8</td>
<td>-6.5</td>
<td>-9.2</td>
<td>-6.7</td>
<td>-3.6</td>
<td>-2.8</td>
<td>-2.9</td>
</tr>
<tr>
<td>Total public debt, as % of GDP</td>
<td>25.5</td>
<td>31.2</td>
<td>41.0</td>
<td>42.4</td>
<td>36.5</td>
<td>34.9</td>
<td>34.5</td>
</tr>
<tr>
<td>External public debt, as % of GDP</td>
<td>16.8</td>
<td>23.5</td>
<td>31.7</td>
<td>33.6</td>
<td>28.8</td>
<td>27.6</td>
<td>27.0</td>
</tr>
</tbody>
</table>

Source: Compiled and calculated by the authors; source of data: Geostat

The commodity structure of Georgia’s exports has also not changed much over the last decade, with resource-based products such as metals and minerals still dominant. More generally, exports have played insignificant role in driving growth.

Additional constrain for FDI flow and foreign trade is uncertain and unstable global economic and geopolitical situation, local/regional conflicts, international sanctions against Russia. The last Russia-Ukraine conflict, two countries that are one of the main CIS investors and trading partners for Georgia, further deteriorates both political and economic situation in the region, escalates tensions, elevates risks for investment climate, deteriorates regional and international trade and FDI flows, creates new challenges and geopolitical risks for Georgian economy.

Figure 2 sums up. From year to year GDP growth in Georgia was driven by different components that included consumers expenditures, investment (mostly FDI), and net exports.
3.3. Elaborating the model

Obviously, elaborating the model of growth, two things should be taken into account. On one side, in Georgia the main pre-crisis drivers of economic growth remain constrained that causes pre-crisis model to be inefficient. Moreover, because of negative global and regional economic and political trends, at least in medium term Georgian economy would not benefit from mass FDI or even tackle low FDI and GDP growth. On another side, there is no need to reinvent bicycle. To build entrepreneurial and innovative economy, based on stronger and more durable and sustainable economic growth, Georgia needs a modified model of economic growth and development. The modification consists of further reorientation from consumption to investment component of GDP growth. That is, the model should include a combination of both external and internal sources of growth with further emphases on the last one or FDI should be complemented with internal investment to form the core component or driver of GDP. Internal investments are generated by domestic businesses. It is worth to note, that (1) the original area from which entrepreneurial activity is born, is SME sector; (2) 95-96 percent of all registered Georgian enterprises are small and medium size enterprises; (3) SMEs development is based on self-financing or private investment. To complete the research, we conducted survey. The survey was conducted among firms in Tbilisi in June – July of 2014. Respondents were selected through convenience sampling.
180 questionnaires were distributed and 116 of them returned; response rate is 64.4 percent. We had a good response rate because many of selected companies were our students’ families small firms. 20 questions related to the development of small business in Georgia were asked. Our respondents are young (78.4 percent are younger than 41), educated (59.5 percent got university diploma, 29.3 percent have Master degree and 6.0 percent have Ph.D. degree) people. Most of them (81.0 percent) works as managers for small firms (number of hired workers is less than 20) in different sectors of economy, mostly hotel and restaurant business (22.4 percent), trade (16.4 percent), transport and communication (6.9 percent), etc, that in general corresponds to the distribution of SMEs according to the economic activity in the whole country. Answering the question “Over the past two years, which way of finance do you use more intensively?”, 56.9 percent of respondents respond of using internal finance, that is personal and friends savings. At the same time, most respondents (62.1 percent) believe that banking loans are still very important at startup as well growth stages.

The survey conducted by the World Bank (Enterprise Survey, 2013) includes all enterprises and shows even more pessimistic picture. Specifically, in Georgia the main enterprise financing source for investment is internal finance (about 73 percent) among all other sources (trade credit financing, bank financing, equity and sale of stocks, etc.). In working capital external financing constitutes around 20 percent, one of each three firms have bank loans (Enterprise Survey, 2013; p.11). The last indicator includes all firms, no matter the size, but it should be corrected taking into account the fact that bank loans are available mostly for large companies due to huge value of collateral needed for loans. In Georgia collateral is more than 200 percent of loan amount. In 2013 share of SMEs in gross loans was 20 percent or about two times less comparing to of corporate (38 percent) (National Bank, 2013; p.57).

Therefore, the conducted surveys evidence that SMEs gather small private savings and transfer them to private investment, wherein entrepreneur spirit and talent, stimulus and incentives of SMEs owners and managers work as a multiplier in this transferring. Thus, SMEs might play a greater role in country’s economic growth.

4. CONCLUSION

When direct effects of the last global financial crisis of 2007-2008 were not much destroying, indirect effects created much more challenges for Georgian economy. The financial crisis exposes the weakness in Georgian growth formula. Economists agreed that pre-crisis GDP growth was heavily depended on FDI and financial/banking sector development (Georgia Rising, 2013; Country partnership, 2014). With the drop in FDI, Georgian economy has become vulnerable to external forces and shocks. When shocks materialize, external sources for Georgian economic growth become more and more unpredictable and vulnerable.

Elaboration of the post-crisis growth model is based on several principles. First of all, internal forces/drivers of growth have to be exploited more intensively. From sectoral decomposition of growth (tourism, agriculture, etc.) focus should be moved to economic components of GDP – household consumption, investment, government expenditures, net exports.
Brief statistical analysis has shown that (a) household consumption was and is weak and it is under the pressure of unemployment; (b) government expenditures are limited; (c) net exports is weak, regional and geopolitical situation as well as slow growth in main trade partners negatively affect Georgia international trade and form downward trend.

The modification of pre-crisis model to post-crisis model consists of further reorientation from consumption to investment component of GDP growth. That is, the model should include a combination of both external and internal sources of growth with further emphatisies on the last one. In other words, sources of investment should be diversified. FDI must be accomplished by internal (private) investment, the main generator of which are SMEs. SMEs gather small private savings and transfer them to private investment, wherein entrepreneur spirit and talent, stimulus and incentives of SMEs owners and managers work as a multiplier in this transmission. Thus, SMEs might play a greater role in country’s economic growth.

There is no alternative or a trade-off between FDI and SME private investment, it is their synergy. SMEs development can create friendly business environment for FDI. Nowadays SMEs are hidden source of economic growth in Georgia.

The new growth strategy would require regulatory and institutional reform but they are the subject for future research.

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