

Georgia: From Hyperinflation to Growth

Civil conflict and political turmoil followed Georgia's declaration of independence from the Soviet Union in April 1991. The ensuing breakdown in law and order undermined the government's authority and—coupled with accommodative domestic financial policies and severe economic shocks stemming from the breakup of the Soviet Union—led to one of the worst cases of hyperinflation on record.

By early 1994, Georgia was at the brink of collapse. Output had dropped precipitously; hyperinflation had eroded public finances and incomes; and international reserves had been depleted. The revenue-to-GDP ratio was about 2 percent, among the lowest ever recorded. Faced with serious shortages of food and supplies, the country had to rely on foreign grants and loans to meet its most basic needs.

In mid-1994, the authorities took steps to address these problems and put Georgia back on a sustainable growth path. Their bold reform efforts centered around a stabilization program predicated on the pursuit of tight financial policies and the liberalization of prices, trade, and the exchange system. In addition, the early implementation of structural reforms was expected to facilitate the development of a vigorous private sector.

The IMF has supported Georgia's reform efforts through its systemic transformation facility, a stand-by arrangement and, since February 1996, an enhanced structural adjustment facility arrangement. World Bank support and assistance from the European Union (EU) and other bilateral donors, together with debt relief or standstill (that is, suspension of payments during negotiations for debt restructuring) granted by external creditors, have also contributed to

the successful implementation of the reform program. In particular, food aid provided under EU and U.S. auspices was an important source of budgetary revenue and played a crucial role in Georgia's stabilization program.

During 1995, Georgia began to reap the benefits of the reform program launched in 1994. Following four years of output collapse, real GDP increased, led by agriculture, trade, transport, and construction. The exchange rate stabilized and inflation declined (see chart, page 2). The introduction of Georgia's new currency, the lari, in September 1995 resulted in a reversal of the rampant currency substitution that had characterized the earlier coupon era. This, together with continued financial support from the international community, allowed the central bank to boost its international reserves considerably.

Developments in the first half of 1996 were also encouraging. Output growth accelerated, inflation continued to decline, the exchange rate remained stable, and international reserves strengthened further, suggesting that the reforms have started to take hold (see table, below). Furthermore, substantial progress was made in nor-

malizing relations with external creditors, through the conclusion or active negotiation of bilateral debt-rescheduling agreements with several states of the former Soviet Union.

Progress in curbing inflation has been particularly impressive. Average monthly inflation fell from the hyperinflationary level of 62 percent in the first nine months of 1994 to about 4 percent in 1995, and further to 1.8 percent in the first half of 1996. This remarkable achievement resulted from a sharp fiscal adjustment, accompanied by the pursuit of a tight monetary policy aimed at stabilizing the exchange rate.

Georgia made major strides toward fiscal adjustment during 1995–96. The advances rested largely on a tight expenditure program, but lately also reflected a gradual improvement of revenue from the extremely low levels that prevailed before the reform program. As a result of these efforts, Georgia's overall fiscal deficit was reduced substantially during this period. Among the more drastic adjustment measures taken were the elimination of most tax exemptions, a 30–35 percent reduction in the number of civil

Georgia: Basic Indicators

	1992	1993	1994	1995	1996	
					Jan.–June ¹	Projections
Real GDP	-44.8	-25.4	-11.4	2.4	10.0 ²	10.5
Consumer prices (period average)	887.0	3,125.0	15,606.0	163.0	52.0 ²	40.0
Fiscal balance ³	-25.4	-33.6	-20.0	-7.2	-5.3	5.0
Official reserves	0.7	1.0	41.0	157.0	165.0	150.0

¹Preliminary actual figures.

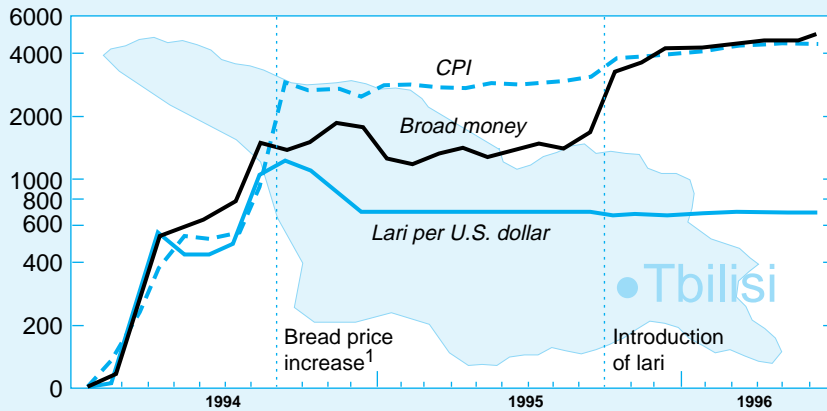
²Over same period in 1995.

³On accrual basis, excluding grants.

Data: Georgian authorities

Georgia: Prices, Exchange Rates, and Broad Money

(Index January 1994=100, Log Scale)



¹The price of bread was increased 285 times in September 1994 and by another 40 percent in December 1994.

Data: National Bank of Georgia and Georgian Department of Social and Economic Information

servants, and the immediate increase in the statutory retirement age by five years. The authorities also initiated reforms in the tax and customs administration and launched one of the most far-reaching health care reform programs of all of the former states of the Soviet Union.

Despite encouraging developments during the first half of 1996, the fiscal situation remains fragile. Revenues are still very low, and expenditures have been compressed to an unsustainable level. Against this background, improved tax administration offers the best hope to increase revenue in the short run.

A combination of tight financial policies, termination of government-guaranteed gas imports, and elimination of soft loans to state enterprises has reduced demand pressures. As a result, the current account deficit has narrowed markedly, to about 14 percent of GDP in 1995, from 36 percent in the previous year. Imports and exports are estimated to have fallen sharply in 1995, reflecting the continued impact of the disruption of tradi-

tional trade patterns and, more generally, the ongoing structural changes in the economy. The export decline appears, however, to have bottomed out. In view of the low level of wages, competitiveness has not yet been jeopardized, despite the marked real appreciation of the lari against the U.S. dollar.

Georgia has made substantial progress on the structural front, but needs to accelerate reforms in certain areas to avoid compromising growth and stabilization prospects. Price liberalization is nearly complete, after the liberalization of the price of bread in June 1996; the trade and payments system is essentially free of restrictions; privatization has proceeded rapidly; and considerable progress has been achieved in establishing a market-oriented legal framework. Relatively slow progress in restructuring enterprises and the energy sector and in creating an efficient land market—which allows land to be sold and pledged as collateral—has created bottlenecks for growth.

Banking sector reform is advanced, on the strength of revamped banking

legislation and improved banking supervision, payments system, and bank accounting. Georgia has sharply reduced the number of its banks; confidence in the banking system is building; and bank deposits have started to grow, albeit by small amounts. Nevertheless, much remains to be done to encourage financial intermediation, develop financial markets, and establish a sound banking system.

Close collaboration between the IMF and the Georgian authorities has enabled the IMF to play a leading role in the international effort to rehabilitate Georgia's economy. The authorities have continuously welcomed and solicited policy advice from IMF staff. Also the IMF's Monetary and Exchange Affairs, Fiscal Affairs, Legal, and Statistics departments have provided substantial technical assistance. Georgia will continue to need technical assistance from the IMF in the near future.

With improved political stability and the restoration of law and order, low wages, and a liberal foreign investment law, Georgia has begun to create a favorable climate for investment. Notwithstanding the initial success of its reform program, however, Georgia's economy will require further progress in stabilization and the continued steadfast implementation of structural reforms to consolidate its hard-won gains since 1994 and pave the way for sustained growth. The challenges ahead will be to strengthen Georgia's public finances and complete ongoing structural reforms—particularly in the energy and banking sectors—so that Georgia can facilitate the growth of its private sector and attract much-needed foreign investment. Given Georgia's fragile public finances, external assistance will continue to be essential to ensure the sustainability of reforms over the next few years.

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