

**Leonid Grigoriev and Marcel Salikhov,
Institute for Energy & Finance**

“Vremya Novostei”, August 22, 2008

The Conflict in South Ossetia and Georgia: War vs. Development

The recent tragic events in the Caucasus have not only a geopolitical significance, on which Western political analysts have mainly focused, but have a huge humanitarian component as well. Most Russian analysts are talking about this aspect of the conflict. Our task is to evaluate the economic aspects of the situation in Georgia, the reasons behind this local conflict and its consequences.

The Economic Collapse in the Early 1990s

All the countries of the former Soviet Union went through very difficult times in the 1990s; the crisis of the transition period was much longer than it was in Central and Eastern Europe. Civil conflict specialists point to the role that impoverishment plays – the threat of losing one’s previous status and a loss of hope as the reasons behind creating a coalition so that sides in the conflict use for survive. The full implementation of these “classical” rules took place in this case – national conflicts followed huge crises. For obvious reasons, the most difficult crises occurred in those countries that could not overcome internal civilian strife. Georgia was not very lucky in this case. The blatant nationalism of Georgia’s first post-Soviet leader Zviad Gamsakhurdia resulted in the separatism of national minorities, which was almost unavoidable. The proponents of independence put Georgia’s economic development at the bottom of their list of pressing tasks. Thus, the source of the current problems of Georgia and its neighbors emerged in the first few years after the breakup of the Soviet Union. One of Gamsakhurdia’s first decisions as president was an absurd ban on trade with Russia, which plunged heavy industry into a crisis. Georgian industry suffered to an even greater extent than other former Soviet countries.

It was difficult to manage independent finances in the country when centralized subsidies were done away with for education and science. Such a potentially profitable service sector – like Georgian culture, which is still highly valued in Russia – lost its market in one stroke. Georgian culture, together with tourism, could have generated revenue even after the transition crisis in the former Soviet Union, and not only in Russia. The system also fell apart in Georgia of allocating financial resources for tourism, and this supported agriculture while imports of tropical fruits to the Soviet Union were limited and when Turkish and Spanish beaches were not yet opened to Russians.

The conflicts in Abkhazia and South Ossetia completed the crisis. Georgian GDP plummeted by 72% in 1991-1994 compared to 1990. Some hundreds of thousands of Georgian refugees complemented to colossal economic and political problems. The

combination of a general crisis in the territory of the former Soviet Union, armed conflict and mistakes by the country's leaders led to the situation in which the economy could not hold out. The main result was the loss of a huge part of the population. Georgia lost more people in comparative terms than any other country of the former Soviet Union – its population shrank to 4.4 million from 5.5 million. The most active and able-bodied part of the population left the country in search of work. The movement of people into the trade and service sectors, and into agriculture as well, amid a difficult crisis created the illusion – partially statistical – of employment, but it did not establish an adequate income. The lack of a sector that would provide for productive employment literally forced people to find work in more affluent neighbouring countries in order to survive.

Georgia's "Rose Revolution" gave the younger generation of politicians the chance to try to revive the country. They started relatively successfully as Georgians were very happy to see the government bring basic order to the country and economic growth. The country's GDP grew an average of 9% in 2002-2007, but even this sharp growth brought the economy to only 65% of the pre-crisis levels. Almost all political observers say that the level of personal consumption grew and public and social services were stabilized in this period, which were largely destroyed during Gamsakhurdia and Shevardnadze.

Georgia has made significant progress, but one cannot skip stages of development and the fast rate of emerging from a crisis should not be confused with the achievements of steady development. Georgia, with a GDP per capita of \$2,400, is 140th in world GDP per capita between Guatemala and Paraguay. GDP per capita grew from \$800 in 2002 because the Georgian lari strengthened against the U.S. dollar to 1.6 lari/\$1 in 2007 from 2.1 lari/\$1 in 2002. This basically means that Georgia has emerged from the crisis, but has very moderate prosperity. Even if all of the country's GDP is used for consumption, this is only \$200 per month per capita, while a highway patrolman has a legendary salary of \$1500.

Georgian exports have only grown to \$1.24 billion from \$650 million in the past few years amid GDP of \$10.3 billion, while imports have soared to \$5.2 billion in 2007 from \$1.8 billion. Georgian export is not very large in volume and concentrated in several key segments – metals, semi-processed gold, alcoholic beverages and fruits. Georgia imported fuel for a total of \$1 billion in 2007; cars and equipment for \$1 billion; iron and steel products for \$400 million and electric equipment for \$400 million. Georgia's trade deficit was 40% of GDP, which proves that the growth is not sustainable. Georgia's balance of payments deficit was 20% of GDP in 2007, one of the highest in the world.

Main economic indicators of Russia and GUAM countries

	Russia	Georgia	Ukraine	Azerbaijan	Moldova
GDP (1990 = 100)					
1997	61	35	42	46	38
2007	105	65	72	163	54
Population, mln					
1990	148.6	5.5	51.5	7.2	4.4
2007	142.2	4.4	46.1	8.6	3.8
to 1990 ., %	-4	-20	-10	19	-14
Industrial production (1990 = 100)					
1997	46.5	15.2	49.6	26.5	43.7
2007	77.7	30.3	101.7	82.8	55.1
Foreign trade, bln \$					
Export	355.2	1.2	13	6.1	1.3
Import	223.1	5.2	17	5.7	3.7
Current account, % GDP	6	-20	-4	29	-10

The Georgian economic miracle was not yet based on the country's own production, but on foreign injections. In this case, each country sells some part of its resources or products – machinery, oil, gold or beaches. Georgia found itself in a situation where it could sell the important service - its favourable position between Turkey – and more specifically the European Union – and the energy resources of the Caspian Sea. This would have been an extremely profitable operation except for the geopolitical aspects. Many Western politicians wanted to isolate this oil and gas transit corridor from Russia, its companies and interests. Pipelines were not drafted as business ventures, but as political decisions long before Russia emerged from its transitional crisis, which lasted a decade until 1999.

It seems that the Georgian political leaders could not psychologically find the correct tone for their relations with the autonomous republics it was only fighting separatists instead of looking for compromises. Neither Russia nor the breakaway provinces were offered any kind of normal role in developing business; instead much was done to cultivate general paranoia in the region. This was the stimulus to strengthen the army and flex the country's muscle while the economy was still very weak. If the conflict with the breakaway republics had not broken out, then the Georgian economy could have recovered within the next 10 to 20 years. Georgia could have used its vast human resources, put the unemployed to work in the service sector. Even if it could not entice its emigrants to return, it could have reached a relatively good level of development.

It is easier for the Western media and analysts to ignore the sharp contradictions that exist between the conflicting sides, and just deal with the geopolitical peculiarities between the United States and Russia. In reality, the people living in the two breakaway regions found themselves on their own for almost two decades. This is the period of time comparable to that Cyprus has been divided and twice as long as Kosovo has had a separate existence. New property relations and interests emerged and life somehow went

on. The Russian passport – regardless of its “protective” role – became an important way to travel around the world. There is nothing new in this. Romania gave its passports to countless Moldovans, and no one had much of a reaction to that.

Any rational plan of coexistence should have started with trade and rebuilding transport and other communication links. Opening railway routes from Sochi to Yerevan and raising capital for coastal services (outside of the conflict over political control) could have gradually returned confidence for ending the war.

The breakaway provinces were apprehensive about Georgian nationalism and began to rely on Russian possibilities to stabilize the situation, which resulted in a stalemate. The Georgian leadership saw the future path of resolving territorial problems in an alliance with a more powerful global player. Tbilisi did not take into account that this alliance included the U.S. and its interests, which by no means included destabilizing the situation in the Caucasus.

Georgia, by getting significant resources, could have created the effect of prosperity, and put its neighbors in the situation of watching its development from the sidelines, and then participate in it. But this would have required certain wisdom and a great deal of patience in mutual actions with local political leaders. The conflict probably approached after Russia opened its borders to the breakaway regions for transport and economic development. In viewing the breakaway provinces as simply separatists, and ignoring the losses and suffering of the people living in these regions, Georgia in the end seems to have convinced itself of the need and possibility for decisive action.

The Economic Conflict and War

History shows us that countries that are rapidly developing may not adequately assess their achievements, the sources of their good fortune or their future paths of development. As a rule, the possibility of immediately having both “guns and butter” is temporary and artificial. Georgia received significant material and financial resources as the construction of two oil and gas pipelines from Azerbaijan to Turkey pushed economic growth. This project received 75% of all fixed capital investment in 2004. Revenue from the two pipelines should already be approximately \$50 million-\$60 million annually if both pipelines are fully loaded. Revenue was \$24.5 million in 2007 amid a transit volume of 28.5 million tonnes. This is non-tax revenue for the government and a “perpetual mobile” for the budget.

The fast growth in Russia and the EU gave a strong stimulus to money transfers home by Georgians living abroad. The Central Bank of Russia estimates money transfers by migrants from Russia to the CIS at approximately \$12 billion, but we suggest that this amount is grossly underestimated. World practice shows that resources sent through unseen paths makes it possible for intermediaries to see large incomes and, it seems, the governments of recipient countries as well. According to the Central Bank of Russia, private individuals sent \$664 million from Russia to Georgia in 2007, while the National Bank of Georgia has estimates of the transfers at \$545 million. Actually, this amount is probably much higher. At least 600 thousand Georgian citizens moved to Russia after the

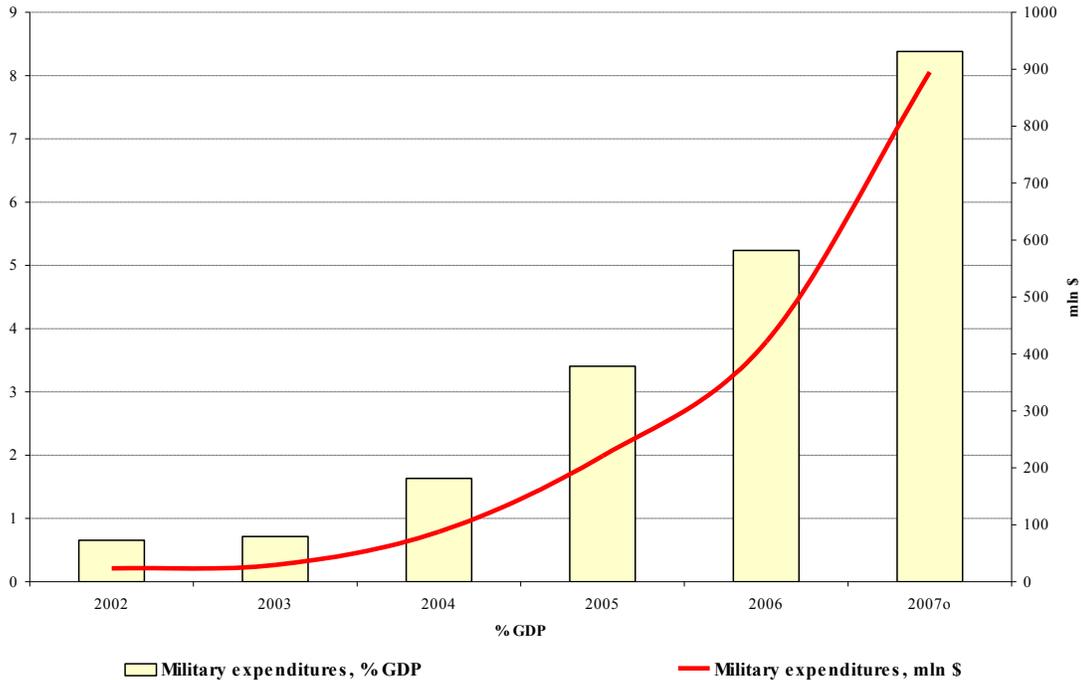
collapse of the Soviet Union, who – except for the tragic mistake of 2006 – should not have any specific problems there. A higher level of education among Georgian emigrants and adapting to the countries they are working in – Russia and Greece for example – suggests that their salaries and amounts sent back to Georgia are higher than usually thought (usually \$1,000-\$1,500 a year). Attempts by the Russian authorities to restrict money transfers in 2006 clearly did not work. We think that the growth in Georgia, considering the huge growth in imports without much of a growth in exports, could have mainly been based on the money of *Gastarbaiters*. So, the common people paid for the country and the collapse of the leadership in the 1990s.

Georgia had reached a level by 2006-2007 at which it was possible for it to raise foreign direct investment. It saw FDI of around \$2 billion, which covered half of the trade deficit in 2007. There is also Russian capital in Georgia. Russian electricity import and export operator Inter RAO UES is the biggest Russian investor in the Georgian economy. It bought the Tbilisi Electricity Distribution Company (Telasi) from U.S. company AES in 2003 along with several other small thermal power and hydroelectric plants. The biggest investors over the past few years have been Russia's VTB Bank (VTB-Georgia Bank); Russian mobile operator VimpelCom (the operator of mobile provider Mobitel); Industrial Investors (which runs Madneuli, Georgia's leading mining company), and several other companies.

The most incredible event was the dismissal of all corrupt highway patrol officers and the hiring of new police officers with an average official salary of \$1,500 a month. The question arises of what the level of income should be in a country so that the government sector receives a salary equivalent to \$18,000 a year. If one believes that consumption in a given country is half of its GDP and all of a family's income goes towards consumption, then GDP per capita in a country with such honest and well-to-do police officers should be approximately \$15,000 per capita – five times higher than GDP for the average citizen of the country! The corresponding income of the authorities should provide not only for highway patrol officers, but also for the army and part of the government apparatus. The country would have to find the financial resources for all of this. Russia's GDP per capital is approximately four times higher than Georgia's, thus a corresponding salary for a Russian road policeman would be \$6,000, which they do not even make now, bribes included.

At some point the rapid growth of economic resources played a negative role in their distribution. And it appeared that a military solution to the problem of the breakaway regions became possible. It is difficult to estimate how much money was used to create an army, equip it with weapons and pay, and set up a military infrastructure in regions neighboring on the conflicting territories. Part of the spending went by civilian budget items and grants, including roads, hospitals and other facilities. Some of the military weapons were acquired cheaply and even for free. Georgian officials have told the media that total military spending is estimated at up to \$5 billion, although the budget does not show that amount. In this case \$3 billion, including gifts and 2008 spending, looks like a more realistic estimate. Military spending was almost \$1 billion in 2007 and Georgia planned to increase it by one-fourth this year, but pre-war spending were to be huge and higher than planned.

Direct military spending of Georgia, 2002-2007



The Georgian budget is not balanced. Tax revenue, including custom duties, is only around 70% of government revenue. The remaining revenue is from grants and non-tax revenue, which, it seems, was used to finance military spendings. Spending on the army in recent years was the largest part of government spending and required 8% of GDP in 2007.

Even if we limit our estimate to \$3 billion in addition to an unknown amount of military weapons received as gifts, then this alone would make the level of militarization in the Georgian budget the second largest in the world after Israel. This only takes place when a country is getting ready for war, and the type of construction and defence points towards an offensive conflict. Obviously, training and equipping a 30,000-man army is expensive. We do not think it is possible to put all revenue and spending into a clear picture – blatant holes remain in the sources of funding for military spending. It is possible that this spending could be even higher in real terms. According to media reports, there were huge stockpiles of weapons in Gori and Senaki. It looks like the Georgian general staff wanted to repeat earlier Israeli victories by striking South Ossetia from Gori in two days; and then reroute the troops through Senaki to invade Abkhazia, go into Sukhumi and overthrow the breakaway region's government. Russia would immediately have seen a hundred thousands of refugees and would have had to plead its case for a long time – and unsuccessfully – to the UN Security Council that an attack of this kind leads to a humanitarian catastrophe.

The preparations for war took huge amounts of resources away from the development of the Georgian economy and one can only guess what could have been built with these resources. In any case, resorts in Adzharia were not rebuilt and tourists

did not start going to Georgia instead of Turkey. Exports are growing very slowly and nothing has been heard about economic services, like in Central and Eastern Europe.

Economic Losses and Consequences

It is hard to estimate even the direct consequences of the conflict in the first ten days. It is clear that enormous amounts of money have been lost as it was spent on military bases and the entire infrastructure in the conflict zone, equipping the army and stockpiles, which the Russian army is taking with it as it leaves Georgia. The bill will likely come to the hundreds of millions of dollars.

As the war is over, Georgia should see a noticeable slowdown in its growth and the country's sovereign rating is already lowered, although not by too much. Judging from Western media reports, civilian facilities in Georgia were not damaged much, although the unbelievable Georgian propaganda would turn a rail into a bridge. In general, there are no discussions about rebuilding public infrastructure or housing, which needs to be done in South Ossetia, especially in Tskhinvali.

The Georgian leadership is faced with an important decision of what to do with the army, which was trained for its participation in the Iraq war. Usually if an army is defeated, it is dangerous to reduce its funding to a lesser degree, however it is difficult to see how possible it would be to continue financing on such a scale of 8% of GDP. The army is without work and Georgia is standing at the start of real economic restructuring. A 30,000-strong army at a salary of a highway patrolman is half a billion dollars for one salary. Someone will have to pay the army for stability, but to talk them out of planning revenge.

The conflict did not affect the world economy. Oil prices fell to \$111 per barrel, and that proves better than political analysts can that Russia did not threaten any pipelines. Other conflicts - in Nigeria and Venezuela – had immediate adverse consequences. Russian stock indices dropped 10% in the first five days of the war. The Russian financial system pays more for the excessive role of foreign capital in trade and for the small amount of shares in free float.

We are not suggesting that the conflict will have a large impact on investment plans in Georgia, although some projects will clearly be delayed until hundreds of thousands of Russian tourists return to Adzharia beaches. We anticipate a larger wave of tourists to the beaches of Pitsunda and Gagra. Statements from Turkey and the U.S. are focusing more and more on plans to build pipelines. We do not see any great changes in technical and economic based projects. Safe underwater routes have become even better, risky ones are a bit worse, but nothing has been taken off of the agenda. It is worth repeating that diversifying energy supply routes to the EU and the world market are accompanied by extending routes by thousands of kilometers and bringing in several more countries with their domestic social and national problems. It is naïve to believe that increasing the number of pipelines will be a cure-all for EU energy security. This kind of diversification does not mean total reliability – explosions on pipelines in Kurdistan and Georgia were in no way related to Russian action. The political goal of

bypassing Russian territory with pipelines will, of course, survive. But any real advancement of the project to develop the corridor for energy producers from the Caspian to the EU will require a great deal of political dialogue by all the parties involved. The optimistic scenario envisions a great amount of regional cooperation in energy projects that would only advance them in the interests of key consumers in the EU and the U.S.

Post-conflict decisions could be made easier through international development aid - but in the hundreds of millions of dollars, not packages of macaroni - by helping refugees and by moving the focus from the conflict to new development projects. Russia is planning to finance the rebuilding of South Ossetia. No one knows the final amount of damages yet, however it is clear that the bill will be in the billions of dollars and is more than Georgian military spending. Russia will have to spend billions of dollars to rebuild everything – from water supplies to destroyed monuments. It is not the military infrastructure, but mostly the civilian economy that have been destroyed in South Ossetia.

Georgia still has its main financial sources and they were not affected by the conflict. Pipeline revenue will feed into the Georgian budget, but the country's educated population has the ability to do more and deserves better. The G7 has promised resources from international organizations for development - although not at the level spent on military weapons. Hundreds of thousands of Georgians working in Russia will still help their families. If the political leaders would agree to demilitarize the conscience of political elites in the region and would start providing for the needs of the general public (that is not part of the elite highway police), then this would be the start of prosperity in the Caucasus. World often helps to countries after a conflict , but it is worth it to try to improve the economy of a region instead of conflict. War will not resolve the problems of the 21st century; people have to live alongside each other, and have patience with old grievances. It is high time to move away from discussing the interests of the political elites and large players and to start thinking about the needs of the ordinary people.

Leonid Grigoriev is president of the Institute for Energy and Finance. Marcel Salikhov is head of economic research of the Institute for Energy and Finance.