

## Global Financial Crisis and Challenges for Georgia

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**Abstract:** *The paper is about global financial crisis nowadays, how it started, what did it cause, it is considered several factors causing the crisis, how does the US government try to eradicate it. Also it is about Georgian economy after post communistic transformation, modern condition of it, and the influence of global financial crisis on it.*

**Key words:** *Global Financial Crisis, Economic Development, Georgian Economy.*

### INTRODUCTION

Nowadays, all eyes are turned to world financial crisis and its negative aspects. Particular emphasis is placed on USA, as it is the originator of the world financial crisis. USA hypothec market crisis was one of the main reasons of the world crisis. On the modern scientific language this crisis is called World Bank and finance crisis, which took a start in the summer 2007 (July). However, the reasons that caused the crisis can be found in the earlier periods. In the summer 2007 the world's leading financial indexes (Dow Jones, NASDAQ, DAX, S&P500, and NIKKEI act.) started to slump<sup>1</sup>. USA and world financial system main index – Dow Jones slumped from 14200 points in July, 2007 to 7500 point in November 2008. [1] Fast-paced construction in USA up to 2007, with inadequate high prices, high volume of investments and use of improper methods of mortgage lending, caused gorging of USA real estate market and landslide of prices, followed by the solid losses for investors. The situation became complicated, because banks were lending out the mortgage credits at a low rate of interest and in most cases without participation. As a result, the mass non payment began that caused serious challenges for the banking sector. In addition to this, the unprecedented high prices on oil played its role that worked out 140 US dollars and more per barrel of oil in early July, 2008. Some of the experts believe that the second reason of crisis together with mortgage crisis was the artificially high prices on oil. This view is mostly presented by American experts, who do not wish to admit that the main reason is uncomprehending financial policy of US government's economic team. [2]

Scientists and researchers of the economy name the following factors causing the crisis:

- Common circulation of economic development;
- High prices on raw materials (inc. oil);
- Exhausting of the stock exchanges;
- Exhausting of credit market followed by US mortgage crisis;
- Application of new, unpractised financial methods and instruments alike credit default swaps and other.

Common financial and banking crisis in USA has been preceded by high risk mortgage lending crisis in 2007 (sub prime), in other words crediting persons with low income and negative credit history. After 20% landslide of the prices, American landholders grow poorer by 5 trillion dollars. In October 2008, American financier George Soros (George Soros, 1930) called the mortgage problem “mortgage soap bubble” and defined it as “stimulus mechanism for bursting the larger bubble”. He prognosticated weakening (slump) of the US economy and high growth of Chinese economy. From his words, “While we were accumulating debts, they (Chinese) were saving and growing richer. After some time Chinese will own most part of the world, as they turn their dollar reserves and shares into real assets. This may cause redistribution of forces. As a result of sins committed by America in the last 25 years the power will be redistributed to Asia”. [3]

Crisis in construction and real estate sector has been automatically reflected in other fields and by means of a chain reaction it has caused aggregate recession: the increase in

the number of unemployed people, declining demand on construction materials, banking crisis and etc. Despite quick response of USA to crisis and its crisis managing so called Paulson's plan (Henry Merritt Paulson, 1946, USA incumbent minister of finances), by that time it has already spread in other fields and countries. [4] In 2008, banks stopped lending the money for purchasing cars. Consequently, sales volume of auto giants like Opel, Daimler and Ford decreased and these companies cut the volume of car producing also.

### ***Slump in stock exchange and crash of investment banks***

In October, 2007 stock exchange market indexes reached its peak, followed by the slump: after 3 October, 2008 by the time when US Congress's House of Representatives on the second hearing approved Paulson's plan, S&P 500 Index dropped by 30%; Index MSCI World, which shows dynamics of developed country markets, slumped by 32,3%; MSCI Emerging Markets Index fell by 40,5%. In contrast to the drop of 2000-2002 (which was caused by the crash of technological companies on stock exchange and was limited only to US markets) 2007-2008 years drop concerned every country. [5] It was defined by the boom and next following crash in credit and domestic sectors and in raw materials' sector lately. Initially there was a dip in the share price of western banks. Mining industry companies' stocks of developing countries slumped after fast price reduction on oil. In 6-10 October of 2008 was the days of a maximum slump of the indexes in US in the history: Dow Jones Industrial Average (DJIA) dropped to 7882,51 and closed at 8451,195. In October 2008, the slump of stock exchange for USA was record braking for the last 20 years, and all-time in the history of Japanese Market. Bank Lehman Brothers declared bankruptcy. Together with it, four leading banks changed their current activities: Bear Stearns sold, Lehman Brothers bankrupted, Merrill Lynch sold, and Goldman Sachs and Morgan Stanley stopped their activity as investment banks, due to high risks and necessity of receiving support from Federal Reserve System. [6]

### ***Crisis impact on Georgian economy and existing challenges***

Coming out from the broadly developed international affairs, crisis initially started in USA rapidly spread all over the world, especially in the countries which have some economical relations with USA (incl. Georgia). As Georgian economy is a part of world economy; financial crisis had its negative affect on Georgian economy too. In terms of world financial crisis today Georgian has to face many challenges. Initial results of the crisis in 2009 are already visible and its aggravation throughout the year is inevitable.

Global financial crisis caused deceleration of the economy in every country. It especially decreased demand on luxuries, such as cars and other goods. This caused decrease in GDPs of world's leading countries. Assets of the wealthy have decreased considerably and some of them even became bankrupted. Population started to spend with care. In the previous years the main factors defining economical growth in Georgia were private capital flows from abroad (direct foreign investments and bank credits) and permanent growth of budgetary funds. Consequently decrease in foreign investments and bank credits impede the economical growth in 2009.

### ***Decrease in Investments***

Investments started to decrease in Georgia after August war events. At the current stage there is a trend of investment reduction caused by global financial crisis. This is also connected with exhausting of major units list offered for sale; nevertheless small units cannot lay a key role in this aspect. In 2008, Georgian economy received investments in amount of 2, 17 milliard US dollars, according to government's prognosis in 2009 Georgia will manage to attract 1,7 milliard \$ investments<sup>14</sup>. However, it's enough to provide few examples to understand that government is rather over-optimistic:

- After famous August war and against the background of financial crisis Kazakh Company "KazMunaiGaz" – refused to invest planned one milliard US dollars in Georgia. The company was planning to construct oil-refining factory in Batumi;
- American company "Clear Stream Holding" renounced declared investments in Georgia. Company purchased WiMAX frequency at 9 million 300 thousand dollars and was planning to build-up wireless internet service. According to company's Georgian partners project is deranged and "Clear Stream" won't pay the sum at the end of the November. [7]

The government plan of economical stimulation, that includes infrastructure investing, will arouse considerable percentage growth of total Gross Domestic Product (GDP) consumption and state purchasing. On the other hand investments start to decrease and this inequality leads us to even more challenges. Delays in the industry increase negative balance between export-import and accordingly the negative export rate rises.

### ***Banking system problems and the increase in the international financial resources's price***

The lack of financial resources of the banks became a worldwide challenge. In addition to this bankruptcy of the world's giant banks, which were granting financial resources for many banks took its effect. Consequently, interest rates increased on banking resources and their availability declined. Most of Georgian banks were receiving financial resources from foreign countries and then lending out money at a higher rate of interest to Georgian clients. Because of interest rate lessening policy failure in USA, followed by the mass non-payments, still stable financial banks couldn't apply such policy. This is the reason why we shouldn't expect financial market rate decrease in the nearest future.

Only in 2008 banks started to land out money at a high rate of interest, and this was defined by international credit rate increase and high rate of real inflation in Georgia. Credit boom of the past years and inadequacy of deposits and credits terms was arousing banking risk strengthening. If we take into consideration that Georgian banks mostly were lending out mortgage debts (to construction companies for real estate construction; and to corporate and physical bodies for purchasing of real estate), it became too risky to lend out money to construction sector. Due to trend of advance in prices, gradually populations buying ability is decreasing and fewer people apply to the banks to receive credit at high interest rate.

## **CONCLUSIONS AND FUTURE WORK**

### **Response to challenges**

Georgia is facing considerable challenges caused by international financial crisis. In order to minimize the problem it is necessary to ensure immediate and corresponding response to them. Government's anticrisis plan carries includes mostly declarative measures and it portrays always-changing presentation tabled on governmental sitting. Government should work out and elaborate actual anti crisis plan, discuss it with experts, donor organizations, and other interested parties. Afterwards it should be divided into active plans and monitored continually. Besides this, government's analytical team should conduct analysis of international economic environment, in order to face the new challenges that 2009 brings. Georgia should adapt to changes happening in international financial sector. Moreover, Georgian National Bank should play a key role in that process. It should be strengthened institutionally and help to strengthen financial sector in Georgia.

Government should consider the problems as a whole and instead of taking spontaneous measures; it should start taking consecutive measures. Priorities must be clear and oriented on economical growth of the country. From a pure economical point of view, in this year conduct of any kind of elections and spending budgetary or other financial resources on it would be fatal for Georgian economy. It is necessary to spend

money received from donor organizations systematically. Country's government should remember that planned 4, 5 are not only a help and big part from it should be returned in few years and with corresponding interest rates.

The world crisis started in August 2007 and was augmented by hostility in 2008 in Georgia. These events intensified negative impact of external factors of world crisis. Georgia has never been direct participant of financial market. Based on this, government representatives and some of our experts reckon that negative impact of world crisis will not reach. One might hear quite often that we managed to close borders and blocked the road to Georgia for crisis. However, it is hard to imagine this in the country with 85% of imported consumption. In other words world market is feeding our country and therefore influence of world crisis on our country is inflexible and hard.

Georgia is not integrated in the world market. It has quite low level of economic development (despite rating mania) and thus it tardily reacts on crisis. The wave of crisis blew up in USA approaches Georgia approximately in 6 months. Two months are needed for crisis to reach continental Europe and 3 to run up to Commonwealth countries. Taking comfort in the hope that we can be just spectators of negative tendencies that are developing at American stock exchanges is groundless. The same events with delay, but inevitably will develop in Georgia.

The first stage of world crisis, that started in January 2007 and blew up in August, has passed; the second stage finished with bankruptcy of Lehman Brothers and third stage was accompanied with nationalization of USA eighteen major banks. The process that took a start in USA is gradually approaching Georgia. There is one difference – people in USA are beating their brains out in order to find the way out of crisis on the contrary there is nothing done in Georgia.

All the abovementioned means that Gross Domestic Product (GDP) of Georgia will not even grow by 2% forecasted by Monetary Fund and it can even appear to be negative. We should anticipate serious crisis at the end of 2009. [7] How we should escape this enchanted chain of indebtedness? First of all it is necessary to define the depth of the problem. According to all existing theoretical calculations of economic science the cure is \$500 million. This sum is necessary to ensure that most part of employed people in Georgia not to lose jobs; to avoid bankruptcy of major part of construction companies and to help them to retain current front; to ensure liquidity of the banks and their active operating at the market; to save population from poverty and make them to spend money. Home consumption, savings and investments are issues that should be considered as a unity.

Up today it's been considered that it is very good when a country is an exporter. However, this opinion is under question right now: quite soon, supposedly in autumn of current year, fourth stage of crisis starts that will be named as Asian crisis. Whole business, financial field and industry of Asia were connected with export. Asian export was consumed by USA.

Georgia should elaborate optimal variant for its economy. It should find the way to increase consumption and savings that are minimal in our country. The share of domestic market is very small in GDP and thus Georgia has no resources. Therefore, special program should be elaborated that enables to have more mild forms of crisis than expected. Just like chicken and egg, there can be no savings without consumption and no consumption without savings. The main obstacle for both of them is crisis and both are connected with unemployment and slump of business dynamics. Therefore, Georgia needs to adopt such program that enables to escape from a stalemate of frozen consumption and savings and thus enables growth. In the nearest future we shouldn't expect any realistic foreign investment, except of portfolio investment. Every investor, when calculating profitability of a project first of all examines home consumption of a country. It would be better if we have recognized that Georgia is not country of regional economy any more. We are not allowed to enter Russian market; we cannot enter Turkish

market either and cannot strike roots in Armenia or Azerbaijan also. Therefore regional market is not an object for calculations. Rate of home consumption is more attractive for them.

Coming out from current critical situation, it would be justified to exempt small and average businesses from taxes. Small and average businesses are not bringing such benefits for the state budget. There are two matters in public finances: effectiveness and fairness. Fairness principle is of first-priority at this stage, effectiveness might be determinative as the state is lack of finances. However, in a strategic, future plan fairness will be of special importance. Hence, if 80% of people employed in small and medium business will be exempted from taxes temporarily for 5 years, more working places will be created, home consumption increases and Georgia becomes attractive for investments. This is the way out of crisis for Georgia.

Therefore the middle-term economic program of the country should be elaborated by contextual consideration of above-mentioned huge tendencies. Founding of private property, competitive environment and business freedom will become warranty for the construction of successful economy in Georgia. Otherwise, if Georgian government do not take serious approach toward crisis and do not study its symptoms and how to cure it, full collapse is awaiting us in the nearest future.

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**The report is reviewed.**