

Georgia's challenge now is to protect its faltering economic revival



Mikheil Saakashvili's Rose Revolution promised both the return of Georgia's lost territories and economic vitality. **Gerald Knaus** and **Besa Shahini** warn that the failure of his first promise and August's ill-fated conflict with Russia now poses a serious threat to the success of his economic pledge

Georgian ships sunk off its Black Sea port of Poti. Russian soldiers cutting off the country's main East-West road linking Poti to the capital Tbilisi. Railway connections destroyed or blocked by Russian soldiers. Air traffic suspended because of bombs dropped close to airports. And waves of displaced persons seeking shelter, uncertain whether they will ever be able to return to their destroyed villages.

These were some of August's dramatic images from the Southern Caucasus, when Russia's military actions constituted a turning-point in its relations with the West – a "return to the 19th century" as Sofia-based analyst Ivan Krastev has put it. But this short war is also a turning point for Georgia itself. Much will depend on the lessons policymakers and Georgian society as a whole draw from this crisis once the dust settles.

This is not, after all, Georgia's first military defeat; Georgian forces lost the wars in South Ossetia and Abkhazia in the early 1990s, and its President Mikheil Saakashvili lost his first gamble to forcibly take South Ossetia by surprise in 2004. And now, with even more disastrous consequences, it turned out that Georgia's "new" US-trained armed forces were again incapable of pulling off a surprise military foray in the valleys of South Ossetia. Georgian military strategy, noted expert Richard Giragosian in *Jane's Defence Weekly* was based on a simultaneous overestimation of Georgian capabilities – with a military divided between four light infantry brigades made up of professional servicemen and a poorly trained conscript force – and a serious underestimation of the possible Russian response. Every European government, aside from Russia, continues to affirm Georgia's territorial integrity, but at the same time there is an almost universal

consensus outside of Georgia that using the Georgian military to put the issue on the international political agenda has been a costly blunder.

What has been receiving less attention has been the implication of these events for other parts of Georgia's own policy agenda

that have been implemented since Mikheil Saakashvili came to power in early 2004. The Rose Revolution was both about the promise to recapture "lost territories" and the promise to bring to an end a period of widespread corruption and profound economic mismanagement which had left Georgians desperately poor. There was always

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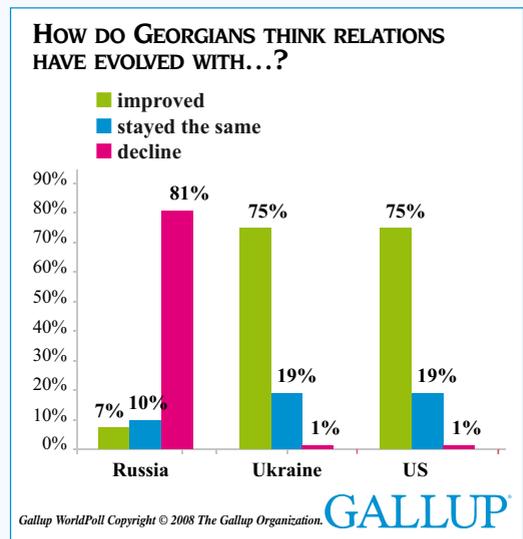
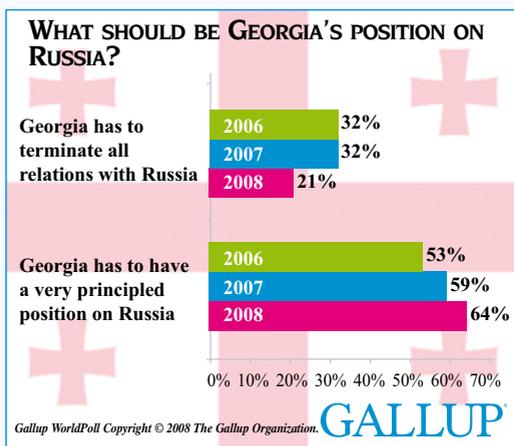
No love lost of late in Russia-Georgia relations

Relations have been souring between the populations of Georgia and Russia since at least 2007, according to Gallup surveys.

In spring 2007, over 80% of Georgians reported that relations between their country and Russia had declined. Asked about their country's relations with various foreign partners, only one in 10 people said that relations with Russia had stayed the same, and even fewer said they had improved. In contrast, three-quarters reported that Georgia-Ukraine relations and Georgia-US relations had gotten better.

The same feeling was expressed on the Russian side. In summer 2007, over two-thirds of Russians – 68% – said that relations with Georgia had become worse.

Despite this sense of deteriorating relations, two months before Georgia launched the ground attack in South Ossetia, in June 2008, a significant majority of Georgians (64%) said that it was important to have good relations with their larger neighbour "by all possible means". There was more support for this position than in the two previous years' surveys. In comparison, only one in five (21%) thought that Georgia should take a very principled position with Russia, down from 32% in both 2006 and 2007. Only 1% of respondents in 2008 wanted to terminate relations with Russia. (For security reasons the question of the 2008 survey were not asked in Abkhazia and South Ossetia.)



a tension between these two promises, and the events of August brought this tension into the open in dramatic fashion.

Looking back at developments since early 2004, four domestic policy achievements stand out. First, there was a significant growth in per capita incomes. In the past four years Georgia experienced strong economic growth, reading 9.4% in 2006. The result is that real GDP per capita has increased from €472 in 2001 to €700 in 2006. Second, Georgia saw an impressive increase in public revenues and therefore state spending, a measurable indicator for overcoming the state's extreme weakness of the recent past. Third, there was a successful effort to use its liberalising reforms to market Georgia to foreign investors. The result has been rapidly growing FDI. Finally, there has been a sharp improvement in the provision of essential public services ranging from electricity and garbage collection to basic policing: Georgia in 2008 is certainly no longer a failing state. The common thread connecting these different achievements is the restoration of a sense of predictability, both for Georgian citizens and for outside investors: a major achievement of Georgian leaders since 2004.

Attracting substantial amounts of FDI is more than one among many policy goals: it is an absolutely crucial part of any plausible development strategy in Georgia. Very limited domestic industrial production, few small and medium-sized enterprises, very

high (even though falling) interest rates have all made significant growth based on investments by local companies difficult to achieve. There are few Georgian products that are internationally (or even domestically) competitive. Too few Georgians have jobs that yield them a cash income. More than half of Georgia's population lives in the countryside, most of them subsistence farmers struggling to survive without any help from the state. From devastated tea-growing areas, that have lost a large part of their population, to citrus producers unable to compete with imports, the country's rural structural problems are immense.

Maintaining stability, democratic governance and rapid growth remains an enormous challenge for Tbilisi

One result is that the emigration of Georgians continues. At the same time, the demographic trends have been among the most alarming in Europe. And even high economic growth does not automatically translate into rising living standards for the substantial proportion of the population that is not part of the formal labour market. Maintaining stability, democratic governance and rapid growth thus remains an enormous challenge for the government in Tbilisi.

Recent economic policy has been to promote Georgia as a centre of trade, to invest in the tourism infrastructure and to pursue specialisation opportunities in banking and finance. Georgia's young prime minister, Lado Gurgenidze, came to politics from the banking sector less than a year ago and has been articulate about this strategy. Warning that in order to address the huge

trade deficit Georgia urgently needed to increase its exports – which amount to less than a third of the country's GDP – he listed those sectors that have the potential to do so: financial institutions, transport, tourism, hydro-electricity and food processing. All of these sectors require FDI and Gurgenzidze said he hoped to attract \$10-20bn in the coming five years, adding that he expected to achieve this "if we maintain stability".

Here then is the Georgian dilemma following Russia's recent aggression: Can this strategy still work? Until spring 2008, the strategy of promoting an open Georgian economy was working remarkably well. A recent study of Georgian economic trends notes that the high growth rate achieved in 2006 "was, in fact, totally caused by that of external revenues", including \$1.1bn in FDI and \$800m in remittances, and further supplemented by international grants and pipeline revenues. Until recently, important outside investors did not appear to be overly concerned about the destabilising impact of Georgia's unresolved territorial conflicts or Tbilisi's tense relations with Moscow. FDI this year appeared headed for a new annual record, having reached, in the first two months alone a substantial \$450m. Deals were signed with the United Arab Emirates and Turkish and Kazakh companies. Plans to invest in the port town of Poti for the creation of the free trade and industrial zones, in the upgrading of the Batumi oil terminal and in new hydro-power were supposed to create tens of thousands of new jobs.

To "turn Georgia into the Dubai or Singapore of this region" as President Saakashvili has put it requires stable relations with his country's main neighbours

Recent months had also seen a shift in the focus of Georgia's social and economic policy. It seemed that the government had taken to heart the dissatisfaction expressed by the street protests in Tbilisi late last year which had led to the heavily criticised State of Emergency imposed by President Saakashvili. Following early elections, the new prime minister, Lado Gurgenzidze, promised a greater focus on social programmes and on job creation. The government also announced what it termed a "significant cut" in defence spending. Despite the fact that state spending had risen from 18% of a much smaller GDP in 2003 to 32.4% of GDP in 2006, the bulk of new spending was being focused on defence, public order and security. Expenditure in this category had gone from 1.9% of Georgia's GDP in 2003 to 12.9% in the third quarter of last year. The government's focus on NATO as its overwhelming foreign policy priority had come at a real cost.

To focus on banking and trade, to promote an image as a gateway to the Caucasus region and to promote social spending over defence all suggest a 21st century development strategy. This is hard to reconcile with Georgia's preoccupation to recover lost territory through a military build-up, however legitimate this aspiration has seemed to successive Georgian governments.

To "turn Georgia into the Dubai or Singapore of this region" as President Saakashvili has put it requires stable relations with his country's main neighbours. As the recent war has shown,

Russia is capable and more than willing to use its military force to prevent any future Georgian attempts to impose its authority in Abkhazia and South Ossetia. Russia is also able to strike at the confidence that has been essential to Georgia's development strategy. Bombs on the port of Poti, bombs on a large German cement factory and the sabotage of transport links all send the signal that Georgia's stability is now at the mercy of its powerful northern neighbour. It is therefore all the more crucial for Georgia that Russia maintains no troop presence near its main transport infrastructure.

One of President Saakashvili's promises has been the restoration of Abkhazia and South Ossetia to Georgian control. But there was a second promise inherent in the Rose Revolution: to bring the basic stability and economic change that for the vast majority of the Georgian people had for two decades proven so elusive. There is now an urgent need to restore confidence and to attract the levels of FDI needed to keep alive the achievements of recent years. This might require a trade-off between the policy of confronting not only Russia but the separatist leaderships in Abkhazia and South Ossetia and the policy of attracting foreign money into development and banking.

So the immediate question for Georgia and its friends and partners is how to return to the status quo before the recent conflict in terms of troops and basic hard security. A second question is how to re-establish a credible sense of security for economic development.

What should a Georgian foreign policy that is in tune with its development priorities

look like? Perhaps the historical lessons most relevant for Georgia, are those of the small nation states that had to tread carefully with Russia yet pulled-off the feat of capitalist development and democratisation during the Cold War: Finland and Austria. As long as such a foreign policy is not the result of a Russian diktat but a choice made by elected Georgian leaders, it is certainly worth asking how the creation of a 21st century economy and liberal democracy can best advance under the baleful gaze of a hostile neighbour.

Georgia must retain the right to choose freely which international organisations it wants to join. But upon reflection it may well decide that the time has come for foreign policy trade-offs to preserve its vulnerable economic and political model. This also raises the question about how the EU can better support a very promising experiment in democratisation in what in a European Security perspective is a sensitive strategic region. A recent paper by ECFR argues that following the Georgian war the EU "should recognise Ukraine's right to join the EU." Why should the EU not do the same for Georgia, thus supporting a reassessment of Georgian foreign policy priorities? □

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