

**ECONOMICS AND
SECURITY**

170 ESCEW 07 E rev 2
Original: English



NATO Parliamentary Assembly

**SUB-COMMITTEE ON EAST-WEST ECONOMIC
CO-OPERATION AND CONVERGENCE**

**ECONOMIC AND POLITICAL TRANSITION IN
GEORGIA**

REPORT

KURT BODEWIG (GERMANY)
ACTING RAPPORTEUR AND SUB-COMMITTEE CHAIRMAN

TABLE OF CONTENTS

I.	INTRODUCTION	1
A.	GENERAL OVERVIEW	1
B.	HISTORIC OVERVIEW	1
C.	BUILDING A NEW DEMOCRACY IN GEORGIA.....	2
II.	MACROECONOMIC PROFILE	4
A.	THE CONTRIBUTION OF THE SECESSIONIST REGIONS TO THE GEORGIAN ECONOMY	5
B.	MACROECONOMIC CONDITIONS	5
C.	MONETARY AND FISCAL POLICY AND THE BALANCE OF PAYMENTS	6
D.	TRADE PATTERNS AND THE BALANCE OF PAYMENTS	7
E.	TAX AND MARKET REFORM AND THE SHADOW ECONOMY	7
F.	PRIVATISATION	8
III.	THE ECONOMIC STANDOFF WITH RUSSIA	9
IV.	ENERGY	10
V.	FOREIGN POLICY	11
A.	GEORGIA'S RELATIONS WITH ITS NEIGHBOURS	12
B.	RELATIONS WITH RUSSIA.....	12
C.	GEORGIA'S RELATIONS WITH THE UNITED STATES	14
VI.	DEFENCE POLICY AND RELATIONS WITH NATO	14
VII.	RELATIONS WITH THE EUROPEAN UNION.....	15
VIII.	CONCLUSION.....	17
	BIBLIOGRAPHY	1

I. INTRODUCTION

A. GENERAL OVERVIEW

1. Georgia's 2003 Rose Revolution – a popular uprising that ultimately brought down the regime of Eduard Shevardnadze after it attempted to rig the parliamentary elections – has had significant domestic, regional and international implications. Indeed, what has transpired in Georgia since the Rose Revolution has been nothing short of remarkable. From a point of administrative chaos, the virtual non-existence of an open national economy and the stranglehold of mafia like organizations, Georgia has moved rapidly to reconstitute the state's authority, abandon the structures and practices that made corruption endemic, launched a campaign to fight criminality, liberalized the national economy and opened it up to new disciplines and opportunities to play in global markets. In the space of four years, Georgia had not only constructed a real state but had also emerged as one of the world's fastest growing and most rapidly transforming economies.

2. By virtue of its strategic location, and in spite of its small size, Georgia is assuming an increasingly important geopolitical role. Situated between oil-rich countries of the Caspian region and the Black Sea, it is a natural artery for energy transport to European markets. Mounting concerns about energy security and diversity of supply have underscored Georgia's potentially crucial role in regional and European economic security. The South Caucasus, more generally, is assuming an important role in Europe's geopolitical calculations, in part, because it is emerging as an energy and transportation corridor between Europe and Asia (Cornell and Starr). The last wave of the EU enlargement has extended Union borders to the edge of the South Caucasus and has transformed the EU into a Black Sea actor. A systematic effort is underway in Georgia to develop closer ties with the European Union.

3. The 9/11 terrorist attacks have raised Georgia's strategic profile in US circles as well. It has become a key player in Washington's evolving "Greater Middle East" strategy (International Crisis Group - *Europe Report* No. 151). US officials initially saw Georgia as a vulnerable state that posed an array of security challenges due to internal instability. This outlook quickly evolved and Georgia has emerged an important regional partner in America's anti-terrorism efforts and now, for example, has deployed troops in Iraq. The growing Iranian security challenge has only further raised Georgia's security profile.

4. As suggested above, the Saakashvili government inherited a dysfunctional state, characterised by high levels of corruption and organised crime and embroiled in ethno-territorial conflicts (Lynch, *Challiot Paper* No. 86). Needless to say, Georgia's transformation process has been painful but dramatic. Although it has successfully undertaken a number of economic and structural reforms, which have bolstered the state's effectiveness, more progress is needed to reinforce nascent democratic institutions and build up a strong civil society (Mitchell, *ORBIS*, Vol. 50 ODIR). The lack of progress in settling disputes with the breakaway regions of South Ossetia and Abkhazia – two sources of instability in the South Caucasus – have also hampered the state-building process. Finally, Georgia's poisoned relationship with Russia, which is very much related to the frozen conflicts in Abkhazia, Georgia and South Ossetia, Georgia is also a source of regional tensions. Thus, while Georgia has made phenomenal progress in a very short space of time, there are still outstanding challenges that its leaders recognise need to be addressed.

B. HISTORIC OVERVIEW

5. A pro-independence rally in Tbilisi that the Soviet army violently suppressed in April 1989 constituted a critical turning point in Georgia's recent history. The discredited Communist regime

was never able to recover its legitimacy, and the first multiparty elections in October 1990 saw the victory of Zviad Gamsakhurdia's nationalist coalition. On 9 April 1991, Georgia formally declared independence. The country's first elected president, Gamsakhurdia, had initially gained strong popular support but his popularity plunged as a result of his authoritarian inclinations. Gamsakhurdia's ideology of ethnic nationalism directed principally against Abkhazians and South Ossetians – was a factor in fomenting tensions between Tbilisi and these two regions. When, in November 1989, Tskhinvali authorities declared a South Ossetian Republic, Tbilisi annulled the decision and ultimately sent several thousand troops to the region in January 1991. The ensuing war lasted until June 1992 and resulted in an estimated 1,000 killed with some 60,000 refugees fleeing to North Ossetia. Damage to the region's infrastructure was extensive. The conflict with Abkhazia was even more devastating. The war of 1992-1993, in which Russian troops played a role, ended in a defeat for the Georgian army, the displacement of 280,000 civilians and the death of several thousand people. The ceasefire in South Ossetia and Abkhazia, upheld by Georgian and Russian troops, has been interrupted by episodic violence, as occurred in May 1998 in Abkhazia and in July-August 2004 in South Ossetia. The uneasy peace has enabled the two secessionist regions to develop some of the institutional structures of statehood, although the international community recognizes neither as sovereign (Lynch).

6. Eduard Shevardnadze rose to head the Georgian state in 1993, after Gamsakhurdia was overthrown in a military revolt the previous year. Following unsuccessful attempts to establish sovereign control over secessionist regions, Tbilisi developed what has been called "a non-policy" towards the conflicts, ostensibly aimed to secure backing from a third party (Russia or the West). Shevardnadze, however, concentrated his efforts on strengthening his own position. He cracked down on the paramilitaries that had been instrumental to his rise to power and formed a political party – the Citizens' Union of Georgia (CUG) – which enjoyed enormous advantages over the opposition in financial and organisational terms (ICG). By late 1995, Shevardnadze's power was formidable; his party handily won the 1995 elections and the government proceeded to adopt a new Constitution which gave the president control of the interior, security and defence ministries (Country Review, *Georgia Review* 2007).

7. This government embarked on what, at the time, seemed a rather ambitious economic reform programme. Georgia's meagre financial resources, however, became a major impediment to the programme. By 1992-93, the country's GDP had already decreased by 80% from pre-independence levels. The lucrative black market constituted the core of national economic life, and this inevitably hindered the emergence of a strong and autonomous civil society. The dollar displaced the Lari as the currency of choice, and the state was simply unable to collect taxes. As a result, state finances were in tatters (Papava and Tokmazishvili).

8. Between 1994 and 1998, the government implemented a series of liberal economic reforms. These included an overhaul of the banking system, the introduction of a new national currency, trade liberalisation and privatisation. Bolstered by the construction of the Baku-Supsa oil pipeline, GDP grew by 11% in 1997. The positive impact of the reform agenda, however, proved short-lived. By 1998, economic and structural reforms ceased, and a period of stagnation ensued. The slow pace of economic growth between 1998 and 2003 (3-3.5%) served only to widen the gap between the impoverished majority and the wealthy few, and an estimated 52% of Georgians were living below the official poverty line. Income disparity stymied the emergence of a viable middle class, blocked the rise of medium and small businesses, and provided fertile soil for the growth of mafia-like structures (Papava and Tokmazishvili). Growing dissatisfaction with a regime unable to deliver on its promises sparked social unrest that ultimately triggered Shevardnadze's downfall in late 2003.

C. BUILDING A NEW DEMOCRACY IN GEORGIA

9. The Saakashvili government that followed embarked on a far more comprehensive range of reforms, many of which have aimed to restore rule of law and fundamental state authority. The arrests of public figures, officials and businessmen on charges of corruption and tax evasion quickly signalled that corruption would no longer be acceptable. Extraordinarily speedy trials and the release of criminals after they had pleaded guilty and paid hefty fines, however, generated criticism, particularly from the Council of Europe, as it seemed to accord arbitrary powers to the prosecution (Nodia and Pinto). The sudden dismissal of the entire and quite notorious traffic police force, and its replacement with a better-trained and equipped body, dealt an important symbolic blow to corruption (Tukvadze).

10. The Reform and Development Fund, set up in 2004 with the help of international donors and local businesses, has made possible higher pay for civil servants. The creation of a cadre of well-paid and professional state employees has clearly helped reconstitute state authority (Nodia and Scholtbach). The government's recruitment practices, however, which are at times based on party affiliation rather than merit, have generated some criticism (Tukvadze, Lynch, Papava and Tokmazishvili).

11. Although Georgia's progress across the board is impressive, its transition is far from complete. Freedom House continues to call Georgia an incomplete democracy, although it also notes the striking improvements that have been registered there. International experts have suggested that Georgia's electoral system also needs further improvement. Although electoral laws are generally conducive to the conduct of democratic elections, the OSCE/ODIHR and other international observers have argued that the 2006 municipal elections were not up to standard. The message from the Western democracies is clearly that Georgia must work on its democracy in parallel with its reforms of the state and the economy. Georgian officials readily acknowledge that Georgia's democracy is very young and some mistakes have been made, but they also note that the current government is very popular and hardly plebiscitary as some have charged. In any case, the government has signalled its attention to adhere to best democratic practices, not only to fulfil their ambitions for Euro-Atlantic integration, but also to ensure the sustainability of the political, administrative and economic reform process. (NATO PA Secretariat Report, 107 SEM 07 E)

12. The government has also developed a blue print for judicial reform and is using European systems as a model for court reform including the introduction of District Courts and Courts of Appeals. New magistrates are being selected and the President has asked the EU to send justices to hear both criminal and business cases.

13. Another source of concern is sectarian tensions, which NGO representatives attribute to some traditional elements within Georgian society that continue to link nationalism to orthodox traditions. It is generally agreed that more efforts are needed to reach out to religious and ethnic minority groups in order to give them a greater stake in Georgia's democratic transformation. (NATO PA Secretariat Report, 107 SEM 07 E)

14. Criticism of the post-revolutionary government has also focused on democratic governance matters. The constitutional amendments of February 2004, hastily enacted prior to Saakashvili's inauguration, have arguably weakened the parliament and reinforced presidential powers. The president appoints the Prime Minister as well as the Ministers of Interior and Defence. He also has the right to appoint a cabinet of ministers, if the latter fails to obtain parliamentary support three times, and can even dissolve parliament when it rejects the budget proposals three times (Mitchell). Critics suggest that, as a result, power is too concentrated in the hands of the executive.

15. Finally there is the problem of the frozen conflict with Abkhazia and Ossetia. Government officials insist that they do not want to resolve these problems with military force but through peaceful negotiation. Certainly old models have failed to solve outstanding differences and the

Georgians now say that they are intent on using conflict resolution techniques, reintegration, IDP (Internally Displaced Persons) return, and confidence building to remedy the tensions. The government, however, will not agree to any division on Georgian territory. It has been very concerned, for example, about a proposed EU-Russian visa facilitation arrangement that could result in the EU implicitly recognizing passports Russia has issued in breakaway regions of Georgia.

16. Despite these problems, there are signs that Georgian politics are rapidly maturing and the potential conflict resolving powers of the democratic processes are increasingly understood. Georgia is progressing from electoral to institutional democracy and there are signs that the process continues to advance. A government-opposition dialogue began when the latter returned to participate in the parliament after earlier boycotting the institution. The speaker of the Parliament, Nino Burjanadze, has worked hard to strike up a dialogue with the opposition. Georgian authorities readily acknowledge that their country's impressive efforts to build democratic authority on more solid foundations could be undermined if democratic rules of the game are not respected. They repeatedly express their determination to implement measures to reinforce Georgia's democratic structures. (NATO PA Secretariat Report, 107 SEM 07 E)

II. MACROECONOMIC PROFILE *

17. Of all the former Soviet Republics, Georgia has undergone the most dramatic economic evolution over the past decade. Once one of the richest republics of the USSR, it suffered an economic collapse after 1991 that resulted in one of the most consequential declines of any transition economy. Yet, it has rebounded almost miraculously since the Rose Revolution, and the World Bank praised it as the world's "top reformer" of 2006. However, there are some divergent views on Georgia's economic recovery. While the World Bank and the International Monetary Fund (IMF) have praised Georgia for its performance as recently as 2005, the Heritage Foundation and the Wall Street Journal rated the economy's country as "mostly unfree". (Doing Business 2006, Tchantouridze). But few would make that assessment today. Much has changed and at a very fast clip.

18. Georgia is a resource rich country but its poor post-independence economic performance was largely due to a deteriorating political environment, poor governance, civil war and strained relationships with its main trading partner, Russia. Conflicts in Abkhazia and South Ossetia and tension in the Pankisi Gorge created significant refugee problems, destroyed infrastructure, and disrupted important trade routes. They also undermined the investment and business environments and fostered corruption, rampant smuggling, extortion and kidnapping.

19. Since 2003, however, the government's effort to reconstitute the state's authority and open the economy to market forces has had a very positive economic impact. Georgian authorities have re-gained control over the region of Adjara, generated new budget revenues while reducing expenses, improving the investment climate and embarking on a poverty reduction programme. GDP grew by an astounding 9.4% in 2006, and at 11.4% in the fourth quarter, and is projected to reach 10% in 2007 in spite of the Russian trade ban (Rose-Roth). The poverty rate has dropped to 25% of the population, although 40% of the population is still economically vulnerable. The main economic challenge today could well be Georgia's energy dependence on Russia, the ongoing boycott and persistent internal and regional tensions (Georgia Country Brief, World Bank). Georgia's increasing appeal as a place to do business is reflected in rising foreign investment. Speaking at a recent NATO PA Rose-Roth Seminar, President Saakashvili told NATO parliamentarians that while Foreign Direct Investment (FDI) in 2003 stood at only \$50 million, the

* Economic data quoted in the report comes from "Georgia - Country Report", June 2007 *Economist Intelligence Unit (EIU)* unless otherwise specified

government is expecting foreign investments this year to reach \$2 billion. At first, these inflows were driven by privatisation, but they increasingly reflect investor willingness to establish their own commercial presence in Georgia.

20. Georgia has large deposits of high quality manganese, iron, gold, granite, limestone and marble. Coal is abundant in Tqvarcheli and Tqibuli, and there is oil near Batumi and Poti on the Black Sea. It also has numerous fast-flowing rivers with significant hydroelectric potential. These include the Rioni and its tributaries, the Inguri, the Kodori and the Bzyb in the west, and the Kura, the Aragvi and the Alazani in the rest of the country. Thick forests cover one-third of the country, and the coastal region is endowed with fertile land and a mild Mediterranean climate. The country has a long history of viticulture, and also grows tea, fruits and vegetables (particularly tangerines and nuts). Livestock and dairy products are also important commodities.

21. Industrial output generates roughly 30% of the Georgian GDP (Ministry of Finance). The country has a well established but ageing metallurgical industry and also produces construction materials, machine tools, chemicals and pharmaceuticals. Georgia's light industry includes food processing, oil processing, beverages and textiles. In spite of its reasonably developed industrial base, Georgia has not exploited yet its industrial potential partly due to political unrest and to its initial failure to foster a climate conducive to private business in the early years of its independence. In 1995, industrial output had fallen to one-fifth of the 1990 level and only began to recover in 2003. The absence of foreign investors further slowed industrial privatisation and only 15% of the industry was privately held in 2002. This has changed markedly.

A. THE CONTRIBUTION OF THE SECESSIONIST REGIONS TO THE GEORGIAN ECONOMY

(
22. When the Georgian government re-established controls over Adjara in 2004, the region was generating 9% of Georgia's income (Khutsidze). Adjara is a transportation hub and has a relatively diversified industrial base. It also has great potential as a tourist destination. Batumi, Adjara's regional capital, is a centre for shipbuilding and manufacturing and is the gateway for goods moving to Georgia, Armenia and Azerbaijan. It is also the transit point for Azeri oil piped to Supsa and then exported to the West. Kazakhstan or Turkmenistan could eventually avail themselves of Batumi's facilities.

23. Abkhazia's economy was long dependent upon tourism and agriculture and, for example, once accounted for 20% of the tea sold in the Soviet Union. After the region broke away from Georgia's sovereign control in 1994, its economy simply collapsed. Today half of the population is unemployed and a significant share of its physical capital is destroyed. By 1994, its GDP tragically stood at 14% of pre-war levels (Chirikba). Today, Abkhazian authorities circulate the Russian Rouble, and the region remains heavily dependent on Russian aid and Russian markets.

24. South Ossetia's situation is even worse. Its most important economic asset is the Roki Tunnel, linking Georgia and Russia. Customs duties on freight traffic generate one-third of its budget. Georgia has cut off electricity to the region, which, as a result, is now totally dependent on Russian supplies. Most South Ossetians live below the poverty line, and primitive farming is vital to their economic survival.

B. MACROECONOMIC CONDITIONS

25. Thanks to the radical liberal reforms of the current government, Georgia's economy has grown at a tremendous pace over the past four years, rising by 9.6% in 2005, and 9.4% in 2006,

as compared to a 4.9% average for the period 1998-2003. (IMF, the World Bank, EIU). Government spending on infrastructure has one driver of this expansion and has had important spill over effects on transport and communications. In 2003, government expenditure generated 9.2% of nominal GDP, rising to 15.7% in 2005 (Georgian Economic Trends) and 12.6% in 2006 (EIU). The construction sector that generated 8.8% of the GDP in 2005 has grown at 25% per annum since 2003. Although growth in this sector will invariably slow due to the completion of the Baku-Tbilisi-Ceyhan oil pipeline, there are still significant projects underway (including the South Caucasus gas pipeline and several main highways). The housing market also remains buoyant. Construction sector wages increased by 28% in 2005 in nominal terms and have helped trigger a consumption boom (EIU, Georgia-Country Report, November 2006).

26. Net FDI rose from US\$336.3 million in 2003 to US\$539.3 million in 2005 and almost doubled in 2006, reaching US\$1.044 billion. The rise in FDI inflows made it possible to cover 84% of the current-account deficit for the last year. The World Bank has applauded Georgia's efforts to improve its investment climate, and this is clearly reassuring the foreign investor community. Although exports have grown by 22% per year since 2003, imports have grown at a faster pace, as is often the case with economies in the midst of economic take-off. The trade deficit has accordingly widened. Improved trade turnover is partly due to growth, but is also related to a crackdown on smuggling. To date, export revenue and FDI inflows have covered import costs, but the economy is still vulnerable to terms of trade shocks.

C. MONETARY AND FISCAL POLICY AND THE BALANCE OF PAYMENTS

27. Georgia introduced its own currency, the Lari, in 1995. Since then, the National Bank of Georgia (NBG) has pursued the twin goals of low inflation and currency stability. As the Georgian government securities market is underdeveloped, the NBG has had problems in targeting inflation through open-market operations. The NBG relies on credit auctions and foreign exchange sterilization to keep prices in check. Simultaneously pursuing two competing monetary objectives, domestic price stability and external competitiveness, however, has generated tensions and exposed the NBG to some criticism (Tchantouridze).

28. Expansionary fiscal policies, burgeoning domestic demand and soaring energy prices have created inflationary pressure over the last two years. With IMF support in 2006, the NBG cut the money supply in order to reduce inflation. The NBG auctioned short-term certificates of deposit (CDs), which commercial banks purchased at a 12% interest rate. The NBG has worked to keep the prime interest rate between 16-24%. It is believed that higher interest rates will encourage savings and further attract foreign investors. Private saving has indeed increased in recent years, but there is little evidence that foreign investors are holding Georgian currency in Georgian banks. The policy has also had an adverse effect on loans to small and medium enterprises.

29. Higher interest rates have also strengthened the Lari, and contributed to a worsening trade balance. Since 2003, the Lari has appreciated against the US dollar (from 2.15 in 2003 to 1.78 in 2006 in nominal terms) and these trends will likely continue. Again, the strong Lari is an inevitable consequence of the NGB's anti-inflationary drive, but it is also linked to the high foreign currency inflows in the form of workers' remittances and external aid. Roughly 1.5 million Georgians are working abroad, and are remitting approximately US\$2 billion per year. This accounts for nearly 20% of Georgian GDP (including both recorded and non-recorded transactions) (Yasman). Despite the Lari's relative stability and strength, Georgians still prefer to save in dollar denominated deposits. According to the central bank, in 2005, 77% of deposits were denominated in foreign currency, and this trend continued in 2006.

30. Over the last four years, the Georgian government has lowered the state budget deficit through improved fiscal management, downsizing the civil service, a better business climate and privatisation. In 2005 the budget deficit was 2.4% of GDP, well below the 4.8% target. According

to the Georgian National Investment Agency, the budget deficit further decreased to 0.2% of the GDP in 2006 (<http://www.investinggeorgia.org/faq>). Indeed by September 2006 total state revenue had increased by over 47% compared with the same period in 2005. Revenue from privatisation is expected to decrease, as most of the state's valuable commercial assets have already been sold. Maintaining a low budget deficit will thus hinge on continued economic growth, rising tax revenues and additional cuts in government spending. The government has acknowledged some problems in managing public funds, particularly now that the budget is far less constrained due to rising state income.

D. TRADE PATTERNS AND THE BALANCE OF PAYMENTS

31. Just prior to the Russian trade embargo, 17.8% of Georgian exports were moving to Russia, 14.1% to Turkey, 9.6% to Azerbaijan, 8.7 % to Turkmenistan and 4.6% to Armenia. Georgia imported 15.4% of its goods and services from Russia, 11.4% from Turkey, 9.4% from Azerbaijan, 8.8% from Ukraine and 8.3% from Germany (EIU, Georgia-Country Report, November 2006). Following the Russian ban on Georgian wine and mineral water, Turkey briefly became Georgia's top trading partner, taking 12.6% of the Georgian exports in 2006, followed by Azerbaijan with 9.3% and Russia with 7.6%. In the first quarter of 2007, however, Russia re-emerged as Georgia's main destination of exports with 14.3%.

32. Georgia's principal exports are ferrous alloys and gold 14%, scrap metals 7%, and nuts 5.7%. Its main imports are crude oil and gas 17.8%, automobiles 8% and pharmaceuticals 3.1%. Georgia's trade deficit widened to US\$819 million in the first quarter of 2007, with export revenue covering only 22% of the import bill. Russian gas prices increases have obviously hurt, while the price for scrap metals has fallen sharply, worsening Georgia's terms of trade. In spite of these trends, however, analysts believe that Georgia exports will pick up in 2007, as a result of its effort to diversify export markets. According to conventional economic wisdom, trade deficits *per se* are not necessarily a bad thing, and such deficits are normal during economic take-off. As long as Georgian assets are attractive to foreign investors, one can argue that the gap can be funded.

33. The deteriorating trade deficit has had a negative impact on the current account. Although services have been in surpluses, as have income and transfers, largely due to the increase in migrant workers remittances, these failed to offset the negative trade balance. In 2006, the current account deficit reached US\$1.243 billion.

34. In 2006, FDI increased to US\$ 1.044 billion, from US\$539 million the previous year, covering 84% of the current account deficit. This influx demonstrates rising confidence in Georgia and its economic policies. However, this level of investment may not prove sustainable, since rising in FDI has also been linked to privatisation revenues. As most large state-owned properties have already been sold, FDI inflows will not increase unless the investor community begins to undertake more "Greenfield" investments.

E. TAX AND MARKET REFORM AND THE SHADOW ECONOMY

35. In 2004, Georgia introduced an important set of tax changes that slashed and simplified business taxes. In 2006 the government introduced a new customs code, which simplified customs procedures and introduced electronic tax returns. Tariff levels were reduced from 16 to 2-12% for food, agricultural produce and water and 5% for some agricultural products. The country now has only seven different tax rates whereas it once had many. Licensing new companies and permits have also been simplified, and if a company has not received a justified rejection for a permit within a short period after filing, it is automatically granted the permit. This is eradicating opportunities for corruption and has compelled the state to be responsive to the needs of the business community. Georgia has also eliminated minimum salaries and legal requirements on job

protection. This has bestowed the country with impressive labour market flexibility and has, in turn, sparked job creation.

36. Smuggling remains a problem in Georgia and is linked to separatism and frozen armed conflicts. Given existing tax differentials through the region, smuggling remains a highly lucrative enterprise. Petroleum products, tobacco and alcohol are all “moved” across the pseudo-borders of these separatist territories. Narcotics and weapons trafficking generate an estimated US\$1 billion per year for criminal groups, some of which are linked to the breakaway governments and criminal groups in Georgia itself (Curtis).

37. Legal enforcement poses a daunting set of challenges for several reasons, including poorly paid police forces, clan-like criminal organisations which have penetrated parts of the state, and persistent corruption.

F. PRIVATISATION

38. Georgia has privatised virtually the entire commercial patrimony of the state with the exception of the railroad. This has been largely beneficial, although it has precipitated budgetary management challenges with which Georgia must deal. The health care system, which was in utter collapse, is also being turned over to the private sector *en masse* with guarantees from investors for new hospital construction. There will be a massive shakeout in that industry, but this has occurred in other sectors as well. Restructuring along liberal lines has effectively required streamlining and this, in turn, has both eliminated jobs and created new ones. Such draconian strategies bear certain political risks, but as the government was elected with 96% of public support, it was decided that there was ample political capital to take tough measures, which, while not immediately popular, would ultimately bear fruit. The government, however, has undertaken measures to help those who have lost jobs retrain for new ones. The government is also working to restructure social spending so that state funding is available only to those most in need of public support. Means testing has been introduced, and this has allowed the government to concentrate its social policies on the most needy strata of Georgian society. (NATO PA Secretariat Report, 107 SEM 07 E)

39. To date, nearly 15,000 businesses have been sold. There are still over 2,000 enterprises to be placed on the auction block and about 230 are currently for sale (<http://www.privatization.ge/spp/eng/>). These are principally small and medium enterprises, and their privatisation will not generate a great deal of additional revenue. The sale of large concerns like Ocean Shipping Co., Chiatura manganese factory, the Vartshikhe hydro power plant and the Tbilisi Aerospace Manufacturing (TAM) has already generated the bulk of revenues that the state can anticipate from the sell-off.

40. In addition, there has been a heated Georgian debate over the sale of “strategic assets” to foreign buyers and particularly to Russian investors. This has somewhat slowed the pace of privatisation (Anjaparidze). In 2005, the Russian giant Evraz Holding purchased the Zestaponi ferrous alloy plant, Chiatura manganese mines and the Vartsikhe hydroelectric power plant. Alexander Abramov, president of Evraz Holding, also expressed interest in the Tkibuli coalmines and the Rustavi metallurgical plant and consulted President Putin about his Georgian ambitions (Anjaparidze). Eventually Evraz Holding withdrew from the deal, reportedly because of falling manganese prices. Georgian authorities ultimately sold the ferrous alloy plant to the British company Stemcor, which in 2007 also purchased the Chiatura mines and the Vartsikhe hydro power plant. Russian investors have purchased an electric locomotive plant, the United Georgian Bank, several gas distribution networks and the Tbilisi electricity grid.

41. For its part, Kazakhstan sees Georgia as a strategic link to European markets (<http://www.civil.ge/eng/article.php?id=10889>). In 2006 the state-owned company KazMunaiGas

formed a joint company with Batumi Oil Terminal that will allow more Kazakh oil to flow through Georgia. Currently, 12 million tons per year pass through Batumi. This generates more than 60% of Georgian railway revenue (<http://www.civil.ge/eng/article.php?id=13620>). A Kazakh state-owned company has purchased the Tbilisi gas distribution company, while the Kazakh bank TuranAlem (BTA) has taken control over Georgia's largest local and international telephone company, the United Telecommunications Company of Georgia and has implemented a US\$100 million project to rebuild part of Tbilisi's centre. BTA has also purchased 20 hotels in Adjara and is planning to develop tourist infrastructure along the Black Sea coast.

III. THE ECONOMIC STANDOFF WITH RUSSIA

42. Over the last year, the Russian government has taken a series of economic decisions that have cast an ominous shadow over Russian-Georgian relations (www.civil.ge):

- 27 March 2006, Russia banned imports of Georgian wine and several other food products, citing product contamination and high risks to consumer health;
- 5 May, it banned Borjomi mineral water, arguing that its mineral composition did not correspond to the specifications on the label;
- 6 May, Nabeghlavi mineral waters were banned on the same grounds as Borjomi;
- 28 September, Russia stopped issuing visas for Georgian nationals ostensibly to curb illegal migration;
- 3 October, Russia cut off air, sea, land and railway connections as well as postal communication with Georgia. Russian officials claimed the decision to suspend air traffic was related to the non-payment of US\$3.6 million by Georgian airlines to Russia. Russia blamed the severed railway link to a decrease in passengers. No explanations were given for severed sea and land links. The suspension of postal services was ostensibly a response to failure of the Georgian Post to deliver parcels;
- 6 October, 130 Georgians were deported from Russia. By February 2007, 3,000 Georgians had been deported.

43. Because Russia has been Georgia's main trading partner, the recent trade embargo had an immediate impact. Analysts anticipated a slowdown of the GDP growth, but IMF and Georgian officials have been very optimistic that Georgia has the capacity and the will to absorb the shock (Christiansen). Over the long term, Russian policy might well compel Georgia to diversify its export markets and lower its unhealthy over-reliance on the Russian market. Some industries, however, have taken a big hit. Wine producers, in particular, have suffered from the embargo. The economic blockade has also aggravated certain social problems as it has boosted unemployment and lowered the standard of living for those depending on remittances from Russia.

44. According to the Georgian Department of Statistics, exports fell from US\$18.7 million in March to US\$3.5 million in April as a result of the embargo on wine and mineral water. The estimated value of the wine to be exported to Russia in 2006 was US\$100 million or about 87% of the total wine export revenues (www.statistics.ge). Given the fact that wine comprises more than 9% of the Georgian exports, the government asked the IMF to estimate the impact of the ban on the Georgian economy. The IMF subsequently announced that the Georgian economy was sufficiently strong to absorb the shock and, other things being equal, it could expect to undergo a fall in GDP growth of only 1% as a result of Russian actions (<http://www.imf.org/external/np/sec/pr/2006/pr06276.htm>).

45. The decision to cut air, sea, land, railway and postal links to Georgia, as well as deporting ethnic Georgians from Russia, however, could eventually have a more serious effect of the macroeconomic stability. Roughly 20-30% of the Georgian labour force works abroad, and their

remittances account for nearly 7% of the GDP (Lauens). Of these, approximately 500,000 people (between one-third and one-half of the total migrants) work in Russia, generating two-thirds of the total flow of remittances, or roughly US\$556 million in 2006. If Russia cuts money transfers to Georgia and bans Georgians from working in Russia, the effect on the economy would be significant. It is unlikely that such a decision could be enforced. Russia has deported less than 1% of its Georgian migrant workers, and preventing financial transfer is almost “unenforceable” for several reasons: it violates IMF regulations, transfers can be made through non-Russian financial institutions, and money can be wired to Georgia through third countries like Ukraine or Armenia (<http://news.bbc.co.uk/2/hi/europe/5393106.stm>).

IV. ENERGY

46. Two factors shape Georgia's energy situation: Georgia's dependency on Russian energy imports, and Georgia's strategic position along the South Caucasian energy corridor.



Georgia: Gas pipes

Source: RFE/RL

Georgia is a net importer of energy; crude oil and natural gas comprised almost 18% of its total imports last year. The country remains vulnerable to supply disruptions and potential price hikes. This became apparent in the winter of 2006. On 22 January 2006, two explosions on the Mozdoc-Tbilisi pipeline in North Ossetia severed gas supplies to Georgia for a week, while a third brought down an electricity transmission

line from Russia to Georgia in the Karakayevo-Cherkessiya region. As a consequence, all gas supplies to Georgia were cut off for a week, as was 25% of its electricity. Georgian authorities accused elements in Russia of sabotage. The Russian side blamed Chechen rebels for the incidents and claimed to have strong evidence to support their case.

47. In a move that the Georgian government denounced as politically motivated and that Russians argued was market inspired, Gazprom doubled the price of its gas exports to Georgia once again in 2007, from US\$110 per 1,000 cubic meters to US\$235. The estimated impact of the price increase on growth ranges from 1.1% (Standard and Poor) to 3%, but there are several important factors that might soften the impact: some consumers have switched to substitutes like kerosene, coal and wood for heating; the government could decide to subsidise consumer prices; and the government could begin to purchase less expensive energy from other sources. It should also be noted that in 2005 Gazprom announced its intention to equalize the prices paid by other former soviet republics for its gas deliveries to those paid by the EU. Russian consumers paid US\$39.30 per 1000 cubic meters, former Soviet states US\$88.80, and EU consumers paid US\$242.50. In terms of export volume, former Soviet states received 28.8 billion cubic meters, and EU customers 45.6 billion cubic meters. Given the price differential, EU exports generated 70% of the revenues, in comparison to the former Soviet states which accounted for less than 25%. From a commercial perspective, price equalization across markets could indeed be justified, particularly as Gazprom faces decreases in supply from two of its main extraction fields, coupled with rising domestic and export demand. The real problem seems to be Russia's timing in communicating these decisions, as well as in the style in which the message was delivered.

48. Needless to say, these shocks have inspired Georgian authorities to reduce their reliance on Russian energy supplies. Currently, Georgia receives gas from three different sources: from Russia via the North-South gas pipeline, from Azerbaijan via and old rehabilitated Soviet pipeline and through the South-Caucasus gas pipeline, which transports gas from Shah-Deniz to Turkey.

However, Russian gas still accounts for 80% of the supply, and the average price from the three combined sources today stands at US\$191 per 1,000 cubic meters.

49. Because Georgia provides a critical land corridor for the transit of Caspian oil and gas to the West, its energy policies have an important international dimension as well. There are three new independent oil and gas pipelines from the Caspian basin to Western markets transiting Georgia: the Baku-Supsa and Baku-Tbilisi-Ceyhan oil pipelines, and Baku-Tbilisi-Erzurum (South Caucasus) gas pipeline. Batumi is a key terminal for gas exports from Russia to Armenia through rail transport links, and potentially to other partners like Turkey and South Eastern European countries. A New York based consortium is also investigating the feasibility of bringing Azeri gas from Shah-Deniz to the EU (either through Ukraine and Poland or through Romania) via Georgia.

50. Electricity transmission through Georgia is also at play. On 7 February 2007, Georgian President Mikheil Saakashvili, Azerbaijani President Ilham Aliyev, and Turkish Prime Minister Recep Tayyip Erdogan signed the "Tbilisi Declaration on a Common Vision for Regional Cooperation", by which they agreed "to support the construction of a new electricity transmission line from the Republic of Azerbaijan through the territory of Georgia to the Republic of Turkey, as well as other projects designed to enhance electricity exchange between the Parties in future". The stated aim of the declaration is that, through developing major regional energy projects and railway communications, the three states can establish "long term and predictable" relations (<http://www.civil.ge/eng/article.php?id=14589>).

V. FOREIGN POLICY

51. The South Caucasus has very quickly become part of the Euro-Atlantic community. A number of factors lie behind this, including Georgia's rapid transformation, the growing energy security concerns, Turkey's accession talks with the EU, as well as Bulgaria and Romania's integration into EU and NATO structures. (NATO PA Secretariat Report, 107 SEM 07 E, May 2007) There is a very strong public commitment to Euro-Atlantic integration in Georgia, and acceding to NATO remains the country's highest foreign policy priority. Polls now indicate that 80% of the public supports integration with NATO, as do all the opposition forces in the national parliament. This is indeed a very high percentage and helps explain why the Georgian government is so focused on the issue.

52. The *National Security Concept* that the Georgian Government adopted in the summer of 2005 outlined the main priorities of the country's foreign and security policy. It described Georgia as "an integral part of the European political, economic and cultural area," and asserted that the revival of the country's "European tradition" will be achieved through "full-fledged integration into the North Atlantic Treaty Organisation and the European Union" and by contributing "to the security of the Black Sea region as a constituent part of the Euro-Atlantic security system." The Concept maintains that the United States, Ukraine and Turkey are Georgia's "strategic partners," whereas Russia, Armenia and Azerbaijan are described as "partners" (Nodia and Scholtbach). Georgian leaders are very quick to point out that they do not feel that their country is simply a "consumer" of security. Georgia, they assert, has the assets, capabilities and the political will to project security, based on the shared values common to all NATO members. Georgian officials are very aware that their security is defined by events far away from Georgia's territory and, for that reason, have deployed troops to Iraq, Afghanistan and Kosovo.

53. Georgia's NATO aspirations have internal implications as well and they have helped consolidate the reform process and encouraged political elites to deal with internal disputes in ways designed to avoid the use of force. The government feels that Georgia has no positive and viable alternatives to Euro-Atlantic integration and Georgia's candidacy for NATO membership is

being watched closely by other countries in the region. It could be a factor, for example, in Ukraine's approach to NATO.

A. GEORGIA'S RELATIONS WITH ITS NEIGHBOURS

54. Georgia's close relations with Ukraine and Turkey are not only a function of proximity, but also reflect Georgia's position within the wider Black Sea region and common European aspirations. Georgia identified strongly with Ukraine's Orange Revolution and saw it as an affirmation of its own commitment to western values. Similar goals inspired it to form the Community of Democratic Choice (CDC) in November 2005. CDC is the product of a Saakashvili-Yuschenko declaration calling for an effort by the countries of the Baltic-Black-Caspian Sea area to advance democratic values, regional stability and economic prosperity; seven states have since joined the CDC.

55. Turkish-Georgian cooperation has been particularly intense. Ankara has consistently promoted development and stability in Georgia and worked closely with several successive Georgian governments with this end in mind. In 1997, the two countries signed a military cooperation agreement, which initiated several Turkish military assistance programmes. Ankara provided military equipment, trained Georgian troops, facilitated the reform of the National Defence Academy and helped bring Georgia's Vaziani airbase up to NATO standards. Moreover, 40 Georgian troops served in Turkey's KFOR battalion. In 1998-2005, Turkey's military assistance to Georgia totalled US\$37 million (Lynch). Georgia's strategic and economic partnership with Turkey has grown in importance since the completion of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline and the construction of the Baku-Tbilisi-Erzurum (BTE) natural gas pipeline. Turkey is the fourth largest investor in Georgia's economy and in 2006, its investments totalled \$127.08 million (11% of total volume and six times more than in 2005). Turkish investors have embarked on several major infrastructure investments including new airport facilities in Tbilisi and Batumi. (NATO PA Secretariat Report, 107 SEM 07 E) In August 2004, the two states established a Joint Intergovernmental Economic Commission to expand further these economic contacts (Lynch).

56. Georgian cooperation with Azerbaijan has steadily increased over the last years, particularly in the energy sector. Kazakhstan is now the third largest investor in Georgia's economy with \$152.3 million invested in 2006. Tbilisi also maintains a strong rapport with the new members of the EU: Romania and Bulgaria. It is a founding member of GUAM – an economic, political and security partnership bringing together Georgia, Ukraine, Azerbaijan and Moldova. In May 2006 the heads of GUAM member states renamed the organisation *GUAM: The Organisation for Democracy and Economic Development* and announced that the group would collectively seek deeper integration with the West. In December 2006, Ukraine's military officials reportedly announced that a GUAM peacekeeping force would be formed in early 2007 to serve in UN peacekeeping operations. GUAM foreign ministers also issued a joint declaration calling on Russia to refrain from unilateral actions against Georgia and supporting the introduction of international forces in the separatist regions (Nichol).

B. RELATIONS WITH RUSSIA

57. Georgia's most problematic relations are with its northern neighbour Russia. Since the Soviet Union's dissolution, tension and mistrust were the operative features of relations between Tbilisi and Moscow. In 1999, when Russia launched a second military campaign in Chechnya, it charged that Georgia's Pankisi Gorge was providing sanctuary for Chechen rebels and international terrorists (German). "We have killed so many foreigners in Chechnya carrying passports with a Georgian visa in their pocket... [Y]ou cannot deny they are penetrating our territory through...Georgia," declared Russia's Defence Minister Ivanov at the 2005 Munich Conference on Security Policy (Lynch). By labelling Chechen separatists as "Islamic terrorists," who used Georgia as a transit route through which Chechen fighters travelled to Afghanistan,

Moscow was clearly seeking to deflect international criticism of its own methods (German). But this rhetorical device did not obfuscate the brutality of its occupation. When Moscow threatened to enter Pankisi to track down Chechen rebels, Shevardnadze responded by deploying Georgian police and security troops into that Chechen ethnic enclave. Although Tbilisi reported that anti-terrorist operations had been concluded by late 2002, concerns about the renewal of terrorist activities prompted it to send additional forces to the Gorge in March 2003. In early 2007 Moscow again claimed that some Chechen “militants” remained in the area, but added that they were now being denied access to Russian territory due to the construction of dozens of Russian border guard posts (Nichol).

58. Russian support for the secessionist republics of Abkhazia and South Ossetia is however, remains the primary irritant in Russian-Georgian relations, even more so because Georgians understand that regaining control over the breakaway regions effectively requires Russian consent. A brief positive interlude after Saakashvili first became President was shattered by a series of bilateral crises. In August 2004, a small shooting war between South Ossetian and Georgian soldiers erupted. In September 2005, during an “independence day” celebration held by South Ossetian authorities, several mortar rounds struck the capital city, wounding ten people. The Russians quickly suggested that the Georgian military was responsible, and President Saakashvili’s response was harsh. In July 2006, Tbilisi denounced Moscow’s negative reply to the Georgian Parliament’s call for the withdrawal of Russian peacekeepers from the disputed regions. Russia’s Foreign Minister Lavrov announced that Russia was ready to defend the population of the two republics, most of whom had been given Russian passports. Defence Minister Ivanov went further by saying that Russian forces staging manoeuvres in the North Caucasus were prepared to assist the peacekeeping forces should the situation in South Ossetia and Abkhazia deteriorate (Georgia Review). This seems to suggest the view that Russia feels it can exercise a degree of suasion from bases outside of Georgia.

59. Relations between the two countries further deteriorated recently when five Russian military officers were arrested in Tbilisi for spying. Russia responded by withdrawing diplomatic officials and threatening to halt the withdrawal of its troops from Georgian bases. Saakashvili described this as an “hysterical” reaction, while President Putin characterised the arrest of Russian officers as “an act of state terrorism” (Georgia Review). These events led directly to the Russian trade boycotts, described above.

60. Russia’s use of energy and market leverage to apply political pressure on Georgia, the forced repatriation of Georgian citizens working in Russia, harassment of Georgians remaining in Russia and continued Russian intransigence with regard to the breakaway regions have simply reinforced Georgia’s commitment to the course of Euro-Atlantic integration and have rendered any “Russian option” unpalatable to its people. Russian actions are effectively consolidating a Western consensus on Georgia. Although Moscow officials soon realised that tactics aiming to intimidate Georgia into compliance have produced the opposite effect, they are reluctant to come to terms with what they apparently see as a “loss” in a zero sum game. They miss no opportunity to condemn Georgia’s foreign policy orientation and reiterate that its accession to NATO would have “serious” consequences. The Georgian response is that they want to have a close and mutually beneficial relationship with Russia and they do not believe that NATO membership would have any negative long-term effects on that relationship or on Russian security (NATO PA Secretariat Report, 107 SEM 07 E). Indeed they argue that a stable western oriented Georgia will help build regional stability which is also in Russia’s interest.

61. Thus beyond gas and its important internal market, Russia seems to be offering very little to Georgia in terms of prospects for a fruitful relationship. From the Georgian perspective, Russia’s mistake has been to assume that pressure would intimidate the state into compliance. In fact, it has had the opposite effect. According to the foreign minister, Georgia feels that the

Commonwealth of Independent States (CIS), of which it has been a member, has lost its meaning and purpose and hardly represents a community of values to which it would want to adhere.

C. GEORGIA'S RELATIONS WITH THE UNITED STATES

62. Georgia considers the United States as its most important ally and, by implication, something of a counterweight to Russia. Among South Caucasian states, Georgia has been the largest recipient of US security assistance. In 1992-2005, the country received US\$379 million from US security and law enforcement assistance programmes. Since 1997, it has also been eligible for US International Military Education and Training (IMET) and Foreign Military Financing (FMF) programmes. In 2007, Georgia is scheduled to receive US\$1.235 million for IMET and US\$10 million for FMF, as compared to US\$790,000 and US\$3.5 million allocated for corresponding programmes in Armenia and Azerbaijan. The US sponsored *Georgia Train and Equip Program* (GTEP) – a US\$64 million project to train the Georgian military in counter-insurgency tactics – was launched in 2002, after former President Shevardnadze asked for assistance in his country's anti-terrorism efforts in the Pankisi Gorge. In the course of the Program, four battalions of over 2,000 troops, a 270-member mechanised armour company and some 200 officers, including a small number from police force and border guards, received training from the US military's European Command (USEUCOM). The deployment of a 550-member infantry battalion in Iraq in March 2005, which increased the number of Georgia's troops in that country to 850, partly demonstrated the success of that programme. A *Sustainment and Stability Operations Program* (SSOP) represents a follow up to the GTEP. Initiated in January 2005, the US\$60 million project seeks to facilitate military reform, train four battalions of 2,000 troops for eventual deployment to Iraq, and develop critical military support infrastructure (Nichol).

63. The 2006 *Georgian National Security Concept* underlines the significance attached to US assistance programmes and maintains that troops trained under GTEP and SSOP "constitute the core of the Georgian Army." However, some domestic observers point to problems associated with these programmes, noting that a certain number of GTEP trainees did not re-enlist when their service contracts ended. There are also concerns that Georgia's very significant deployments in Iraq divert Georgia's attention from more vital national security challenges closer to home (Nichol). Nonetheless, in July 2006 an additional US\$30 million was allocated for the programme, and SSOP was extended for another 12 months.

64. Georgia has also met stringent standards for US assistance under the Millennium Challenge project. The US\$295 million project seeks to galvanize economic development by underwriting regional infrastructure, enterprise development and anti-poverty initiatives. The program supports Georgia's democratic transition and facilitates the implementation of economic and social reforms (Lynch).

VI. DEFENCE POLICY AND RELATIONS WITH NATO

65. In the three years following the Rose Revolution, Georgia's military and security sector has undergone extensive reform, although there is still more to achieve. In 2004, the Army Development Fund set the reform process in motion. More efficient tax collection procedures sparked a sharp rise in state revenues and ultimately made it possible to allocate more funds for national defence.

66. In February 2005, NATO appointed a Liaison Officer to foster deeper NATO-Georgia cooperation and to monitor implementation of the Individual Partnership Action Plan (IPAP), endorsed by the North Atlantic Council in October 2004. The areas identified in IPAP were outlined in Georgia's 2005 *National Security Concept* and confirmed the country's commitment to carry out reforms needed to facilitate its integration in transatlantic structures. An Intensified Dialogue with

NATO began in 2006 and has dealt directly with Georgian aspirations for membership and ways in which its reform process might be shaped to help it accede to the Alliance. This dialogue has dealt with a range of political, military, human rights and legal issues. The Allies have been impressed by the economic resilience of Georgia's economy in the face of the Russian embargo. Georgia has also moderated its policies toward the breakaway regions in a way that appears to be creating new opportunity for dialogue and resolution. This is very welcome in NATO circles. (NATO PA Secretariat Report, 107 SEM 07 E, May 2007)

67. According to the *Military Strategy of Georgia*, the goals of the military reform programme are: (1) to enhance the armed forces' combat capabilities in order to ensure their capacity to address national threats and challenges; (2) to build a professional army fully compatible with NATO standards; (3) to continue contributing to the Euro-Atlantic security system, and (4) to institutionalise a multi-force integrated command-and-control system that enhances the armed forces' ability to conduct joint operations. Thus, the focus has been on making Georgian forces smaller and more professional while introducing modern planning, budgeting and acquisition techniques.

68. Despite its limited capabilities, the Georgian military has contributed to international peacekeeping operations and confirmed its important geostrategic position. Beyond its aforementioned presence in Iraq, Georgia also has a 150-member contingent in Kosovo. In March 2005, the country signed an agreement with NATO allowing transit for NATO personnel and troops.

69. The government has undertaken a number of measures to encourage civilian control and legislative oversight of the armed forces. The government has appointed a civilian defence minister and articulated a clearer division of responsibilities between the military and the Joint Staff. Civilians are now responsible for policy issues, financial management and international relations. Since 2005, Georgia has also participated in the Partnership Action Plan for Defence Institution Building (PAP-DIB), the main aim of which is to improve the operational capability of the military while, again, ensuring military subordination to civilian authorities. Georgia has participated in the Planning and Review Process (PARP) since 1999, and the PARP has become a comprehensive tool for measuring Georgia's success in the process of defence reformation.

70. NATO member states have strongly supported the reorganisation and modernisation of Georgia's armed forces. The United States, the United Kingdom, Germany, Turkey, France and the Netherlands have been particularly active in this regard and have helped reorganise the planning, programming, and budgeting systems of Georgian armed forces. The aim is to increase democratic methods and transparency within the military sector and to introduce rational planning and procurement policies that ensure funds are spent in a more optimal fashion. Both are key priorities of Georgia's security reform agenda. The United Kingdom has been instrumental in the country's efforts to modernise and improve the armed forces' personnel management system (Georgia's Democratic Transition). NATO support has also made Georgian forces more compatible with those of NATO.

VII. RELATIONS WITH THE EUROPEAN UNION

71. The EU's interest in the south Caucasus has increased substantially as a result of the EU's enlargement, but also because of the EU's special relationship with both Russia and Turkey and its energy interests. There are several countries in the region with European ambitions and this puts the EU in a difficult position. It wants to encourage reform and integration but it does not want to disappoint expectations. The EU is thus compelled to acknowledge the aspirations of these countries without endorsing them. The EU is also paying close attention to the myriad security

challenges in the region. It has seen the Rose Revolution as a positive development and views the consolidation of democracy in Georgia as critical to the region.

72. Thus in contrast to Georgia's goal of rapid accession to NATO, the prospect of Georgia becoming a member of the European Union is not a subject of discussion in Brussels at this point in time and this is certainly recognised in Tbilisi. Still, the Georgian government is anxious to exploit existing instruments to associate the country as closely as possible with the EU and move it towards eventual membership. The State Minister for EU and NATO Integration, Giorgi Baramidze told members of this Committee that Tbilisi understands that enlargement fatigue is a problem in Brussels and Georgian authorities do not want to become "anyone's problem" (Presentation, 2007 Spring Session, Madeira).

73. Relations with the EU have been developed within the framework of a Partnership and Cooperation Agreement (PCA), signed in 1999. The PCA provided for the establishment of three joint institutions, the Cooperation Council, the Parliamentary Cooperation Committee and the Cooperation Committee, all of which meet regularly. Although the PCA identified priority areas for encouraging political dialogue, trade, investment, and economic cooperation, prior to the Rose Revolution, cooperation was largely restricted to economic and technical issues. The presence of political issues on the cooperation agenda is a more recent phenomenon (Leonard and Grant). Georgia hopes to gain greater access to the EU's internal market and is intent on establishing free trade arrangements with the EU, particularly in light of the recent Russian embargo. It is worth noting that the parliament is working to introduce European legal standards into the corpus of Georgian law where this is possible. (65th Rose-Roth Seminar, Tbilisi).

74. The EU has a long record of assistance to Georgia. Between 1992 and 2004, it provided €420 million, which included €160 in humanitarian aid, €110 million in TACIS (Technical Assistance to the Commonwealth of Independent States) related projects, and €70 million for the Food Security Programme. Georgia has been among 29 states that have received assistance through the European Initiative for Democracy and Human Rights (EIDHR), which seeks to promote the development of civil society. It has also been part of the EU Transport Corridor Europe-Caucasus-Asia Programme (TRACECA) and the Project on Support in Oil and Gas Infrastructure Cooperation (Interstate and Gas Transportation to Europe-INOATE) (Lynch).

75. It has long been recognised that the effectiveness of EU assistance will be limited unless a solution is found to Georgia's territorial conflicts. The EU, however, has yet to develop a strategic approach towards the conflicts, and its policy has been rather piecemeal. It was only during the Swedish presidency in 2001 that the South Caucasus was identified as an EU priority region. The establishment of the EU Special Representative for the South Caucasus in July 2003 signalled the Union's growing interest in the region and its intention to play a more active role in conflict resolution there (Lynch).

76. In June 2004, the EU General Affairs Council extended its European Neighbourhood Policy (ENP) to the South Caucasian states. The decision of the EU General Affairs Council was at least partly influenced by the outcome of Georgia's Revolution and its leaders' active diplomatic overtures (Nodia and Scholbach). A series of objectives set out in the Action Plan, did not enter the negotiations phase until late 2005. It included the promotion of democracy, the rule of law, good governance, respect for human rights, market principles, as well as conflict resolution. On 2 October 2006, the EU and Georgia signed the Action Plan, which was formally approved at the November 2006 bilateral Cooperation Council session.

77. Since 2004, EU assistance to Georgia has dramatically increased. Together with humanitarian aid through the European Commission Humanitarian Aid Office (ECHO) as well as a rehabilitation programme for conflict zones, total aid amounted to €137 million for the period 2004-2006. In June 2004, a Brussels Donors Conference, co-chaired by the European

Commission and the World Bank, secured pledges worth €850 million from individual member states (Jones). When Moscow vetoed the extension of the OSCE border monitoring mission's mandate, the Council of Ministers jumped in to assist the reform of Georgian Border Guard service (Lobjakas). In July 2004, the Council also dispatched a civilian ESDP mission to assist Georgian authorities in the development and implementation of judicial reform and anti-corruption policies. Reforming the judiciary – arguably, the weakest point of Georgia's nascent democracy - remains an outstanding challenge. The EU has also assumed a more prominent role in Abkhazia and South Ossetia, becoming the largest single donor to those regions. It supports economic development and infrastructure rehabilitation, including water supply and electricity networks, educational support and capacity building projects with local NGOs (Lynch).

VIII. CONCLUSION

78. Georgia has made tremendous strides over the past 3 years in initiating a transition process that dramatically reinforces Georgia's political and economic transition. Despite its great success, Georgia, still confronts myriad problems, both internal and external. It is thus essential that the international community continues to reach out to the Georgian people and to its government. Both the EU and NATO have important roles to play in providing road maps for transition. Each has played a vital role in East European transitions over the past 15 years and now Georgia is clearly demonstrating a strong desire to adhere to the Euro-Atlantic Community and the values that undergird it. In a region as critical as the Caucasus, this should be welcome. At the same time, Russia should hardly see Georgia's successful transition as its loss. To the contrary, a democratic, transparent, and prosperous Georgia will provide a model for the rest of the region and contribute to stability in the neighbourhood. That should be welcome by all regional and external players.

79. Allied countries should not accord any country in the region a veto on Georgia's NATO membership aspirations, nor should they be prepared to allow intransigence on the part of the leaders of breakaway regions, or their sponsors, to become an excuse to thwart Georgian goals, particularly if Georgia is acting in good faith to resolve the conflicts. The decision to invite countries to join the Alliance is collective and depends both on whether members are convinced that the candidate is ready and if it can make a contribution to the general security order. Georgia will have to be firm, patient, and continue its reform process.

80. Greater efforts are needed in confidence building to demonstrate that Georgia can be attractive to Abkhazia and Ossetia. Georgia's dynamic growth could help in this regard but is hardly sufficient to overcome the ethno-political dimension of the conflict. Trade restrictions on Abkhazia will invariably prove counterproductive. There remains a great deal of work to do with civil society and NGO's, both of which are needed to create constituencies for peace and reconciliation.

81. Georgia's government must continue to strive to adhere to best democratic practices, not only to fulfil their ambitions for Euro-Atlantic integration, but also to ensure the sustainability of the political, administrative and economic reform process. Concrete actions are needed to ensure that national elections in two years are fully fair and transparent and that judicial reforms, in particular, are implemented to ensure both the independence and incorruptibility of Georgia's judges. More efforts are also needed to reach out to various minority groups in order to give them a greater stake in Georgia's democratic transformation. Greater decentralization of political authority could help on this front. As for the frozen conflicts on Georgian territory, more can be done on both sides of the divide to foster a climate of trust that might advance reconciliation.

BIBLIOGRAPHY

“Baky, Tbilisi and Ankara to Construct Electricity Transmission Line”, *Civil Georgia*, 8 February 2007, <http://www.civil.ge/eng/article.php?id=14589>.

“Batumi Oil Terminal To Handle More Kazakh Oil”, *Civil Georgia*, 3 October 2005, <http://www.civil.ge/eng/article.php?id=13620>.

“Doing Business,2006”, the World Bank and the International Financial Corporation.

“External Trade in Georgia (January-June 2006)”, Department of Statistics, www.statistics.ge

“Georgia - Country Report”, Economist Intelligence Unit, June 2007.

“Georgia - Country Report”, Economist Intelligence Unit, November 2006.

“Georgia Review 2007”, Country Review, Country Review Inc., 2007.

“Georgia - Country Brief”, the World Bank, <http://web.worldbank.org/WEBSITE/EXTERNAL/COUNTRIES/ECAEXT/GEORGIAEXTN/>

“Georgian Economic Trends”, Georgian-European Policy and Legal Advice Center, October 2006, http://geplac.org/files/english_october_2006.pdf.

“Kazakhstan Eyes Georgia’s Transit Routes”, *Civil Georgia*, 3 October 2005, <http://www.civil.ge/eng/article.php?id=10889>.

“Q&A: Russian Georgian Ties”, *BBC News*, 2 October 2006, <http://news.bbc.co.uk/2/hi/europe/5393106.stm>.

Anjaparidze, Zaal, “Russia Claims Strategic Victory in Georgian Privatisation Round”, *Eurasia Daily Monitor*, Vol.2 (22), 1 February 2005.

Chauffour, Celia, “Irakli Chagovadze: Why Do Foreign Companies Have Troubles Competing With Russians, Kazakhs and Ukrainians in Georgia?”, *Caucas: Europeanews*, 13 December 2005. http://www.caucas.com/home_eng/breve_contenu.php?id=215.

Chirikba, Viacheslav, “Abkhazia: Economic and Political Situation and Perspectives”, <http://www.abkhazia.org/chirikba19990411.html>.

Cornell, Svante E. and S. Frederick Starr, “The Caucasus: A Challenge for Europe,” *Silk Road Paper* (Central Asia-Caucasus Institute Silk Road Studies Program), June 2006.

Corso, Molly, “Privatisation in Georgia: Solving the Sensitive Issues”, 19 July 2005, http://www.eurasianet.org/departments/business/articles/eav071905_pr.shtml.

Curtis, Glen, “Involvement of Russian Organized Crime Syndicates, Criminal Elements in the Russian Military, and Regional Terrorist Groups in Narcotics Trafficking in Central Asia, Caucasus and Chechnya”, Report Prepared by the Federal Research Office, Library of Congress, October 2002, <http://www.loc.gov/rr/frd/pdf-files/RussianOrgCrime.pdf>.

German, Tracey C., “The Pankisi Gorge: Georgia’s Achilles’ Heel in Its Relations with Russia?” in *Central Asian Survey*, Vol. 23 (1), March 2004, 27-39.

International Crisis Group, "Georgia: What Now?", *ICG Europe Report No. 151*, 3 December 2003.

International Monetary Fund, "Statement by IMF Staff Mission in Georgia", Press Release No. 6/276, 15 December 2006, <http://www.imf.org/external/np/sec/pr/2006/pr06276.htm>.

Jones, Stephen F., "The Rose Revolution: A Revolution without Revolutionaries?" in *Insight Turkey*, Vol. 7 (4), October-December 2005, 50-66.

Kamushadze, Anna, "Georgia to More than Double Iraq Contingent," *The Messenger*, No. 046 (1313), 12 March 2007.

Khutsidze, Nino "Adjara Boosts Government's Financial Hopes", *Civil Georgia*, 8 May 2004, <http://www.civil.ge/eng/article.php?id=6902>.

Khutsidze, Nino, "MP Speaks Out Against Free Economic Zone", *Civil Georgia*, 18 May 2007, <http://www.civil.ge/eng/article.php?id=15143>.

Laurens, Peter, "Current Spat with Russia Has Georgia Under a Clout", *AmCham News*, No. 6, 2006, http://www.magazine.amcham.ge/issues/2006_6/06_2006_1.htm.

Leonard, Mark and Charles Grant, "Georgia and the EU: Can Europe's Neighbourhood Policy Deliver?" *Centre for European Reform: Policy Brief*, September 2005.

Lobjakas, Ahto, "Georgia: Tbilisi Lobbies EU for Border Monitors, Harder Stance on Russia", *Radio Free Europe/Radio Liberty*, 12 April 2005.

Lynch, Dov, "Why Georgia Matters" *Challiot Paper No. 86*, February 2006.

Ministry of Finance of Georgia, www.statistics.ge

Ministry of Economic Development of Georgia, <http://www.privatization.ge/spp/eng>.

Mitchell, Lincoln A., "Democracy in Georgia Since the Rose Revolution", in *ORBIS*, Vol. 50, 4 (Autumn 2006), 669-76.

Nichol, Jim, "Armenia, Azerbaijan, and Georgia: Security Issues and Implications for US Interests", *CRS Report for Congress*, 1 February 2007.

Nodia, Ghia and Alvaro Pinto Scholtbach (ed.), *The Political landscape of Georgia. Political Parties: Achievements, Challenges, Prospects* (Eburon Delft, 2006).

OSCE/ODIHR, "Georgia; Municipal Elections, 5 October 2006", (OSCE/ODIHR Limited Election Observation Mission Final Report), 20 December 2006.

Papava, Vladimir and Michael Tokmazishvili, "Becoming European: Georgia's Strategy for Joining the EU," in *Problems of Post-Communism*, Vol. 53 (1), January-February 2006, 26-32.

"Georgia: Towards Euro-Atlantic Integration," NATO PA Secretariat Report, 107 SEM 07 E, May 2007, <http://www.nato-pa.int/Default.asp?SHORTCUT=1209>.

Shepashvili, George, "Wine Row - Estimating Potential Economic, Political Losses", (Interview with Robert Christiansen, IMF representative in Georgia), *Civil Georgia*, 19 April 2006, www.civil.ge/eng/article.php?id=12384.

Tchantouridze, Lasha, "The IMF in Georgia: Evaluating the Fund's Unique Vision of Economic Success" in *Central Asia and the Caucasus*, No 6 (36), 2005, 121-29.

The Government of Georgia, *Georgia's Democratic Transformation: An Update Since the Rose Revolution* (Tbilisi, January 2007).

Tukvadze, Avtandil; Joashvili, Georgi and Rati Tukvadze, "Transformation of the Political System in Georgia Today", in *Central Asia and the Caucasus*, No. 2 (38), 2006, 90-98.

Yasmann, Victor, "Georgia: Moscow's Next Step in Spy Row", *Radio Free Europe/Radio Liberty*, 2 October 2006, <http://www.rferl.org/featuresarticle/2006/10/8df7034f-6cc5-42a6-a42b-92850ee39c63.html>.