

## THE FINANCIAL SIDE OF CONFLICT: THE CASE OF THE GEORGIAN-OSSETIAN CONFLICT

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The Georgian-Abkhaz and Georgian-Ossetian conflicts represent key elements contributing to instability not only in Georgia but across the whole region. At first glance, all players within the region are interested in stability. However, this interest is not as unequivocal as it seems, at least due to the fact that Russia, the region's largest (per territory) and most powerful economy, has been one of the key contributors to the destabilization both directly and indirectly over the course of 25 years. Its actions risked not only Georgia (a country which is 20 times smaller than Russia) but also Russia's own reputation, international confidence and economic perspectives. Conflicts have claimed tens of thousands of lives and inflicted sufferings for hundreds of thousands more. Material losses worth billions of dollars have been sustained, invaluable time wasted and opportunities missed that could have been used for building an affluent future.

An increase in unemployment, a socially oriented budget overlooking the importance of economic growth, permanent political instability, a decreased level of national security and its constant exposure to persisting threats as a result of the deployment of the Russian military bases on the occupied territories – this is a humble list of the problems which Georgia has managed to pick up through several wars for the past 25 years. Potential solutions to these problems lie not so much in the political resolution of the conflict, but rather depend on financial-technical assistance provided by the international community.

There are more than enough examples suggesting that small and conflict ridden countries with lasting tensions (Israel, South Korea) have successfully managed to use their geopolitical location for greater benefits through building international relations in a thoughtful manner. Thanks to these tactics, countries who could not boast any distinction or achievement just a few decades ago have managed to re-emerge as powerful and advanced world economies. Georgia has this type of potential.

Georgia's economic retardation compared to the Baltic countries is indicative of how far the country could actually have gone. However, it should be noted that achievements of the country (reviewed in the next section) which, for the past 25 years, has lived through armed conflicts in Abkhazia and South Ossetia/Tskhinvali Region and war with Russia, the civil war, suffered from hyperinflation and heavy concentration of crime and corruption, several attempts of coup-d'état, the political revolution and a series of other problems (Jones S., 2013) are doubly impressive and deserve respect. Most importantly, they demonstrate that the country has the potential and the right to success.

Being a country with little territory and a small economy, and two parallel conflict areas, Georgia needs to pursue careful policies towards Abkhaz and Ossetians. It has become evident (especially after 2008) that any prospect of the integration of the two conflict territories without considerably positive relations with the population, seems, in fact, infeasible. Moreover, these are the minimum but not sufficient requirements for building a shared state.

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## **ACHIEVEMENTS OF GEORGIA AND SOUTH OSSETIA FOR THE PAST 25 YEARS**

The Georgian economy has been progressing for the past 25 years as corroborated by official statistics, World Bank data, as well as indicators of various international organizations. In a nutshell: according to the World Bank data, in 1995 per capita GDP was less than 600 USD but rose to 3.7 thousand USD in 2015 while assets of banking sector increased 90 times (from 276 million USD to 24.4 billion USD) within the same period of time (source: National Bank of Georgia). The World Bank estimates that Direct Foreign Investments increased from 10 million USD in 1996 to 1.35 billion USD in 2015. According to GEOSTAT the average wage increased 60 times from 13.5 GEL in 1995 to 818 GEL in 2014. The same period saw drastic growth of the volume of export (20 times) from 155 million USD to 2.9 billion USD.

Georgia's other achievements are of no less importance: 1. Combating pervasive corruption: According to Transparency International, in 2003 Georgia was 124<sup>th</sup>-129<sup>th</sup> among 133 countries in the rating of perceived corruption alongside Cameroon, Angola, Tajikistan and Azerbaijan. By 2014 it had moved up to 50<sup>th</sup> place out of 175 countries; 2. Unprecedented scale of fighting crime and 80 per cent of confidence and trust in police by population (Georgian authorities); 3. The World Bank's ranking of economies in their ease of doing business: 24<sup>th</sup> in 2015; 4. Georgia hit the list of countries with economic freedom compiled by the Heritage Foundation (11<sup>th</sup> ranking in 43 European countries and 22<sup>nd</sup> internationally). These and other achievements have contributed to Georgia's leap to a dimension drastically different from that of the 1990s.

At the same time, the South Ossetian economy with a minimum level of development within production and service sectors, has remained largely the same for the last 20 years. The level of salaries and public savings is insignificant while tourism and agriculture sectors remain underdeveloped. The investment volume (only from Russia) is minimal while finding extremely poorly paid jobs at Russian military bases is the only remedy to pervasive unemployment. Tax revenues to the budget of South Ossetia totaled just 500 million rubles (less than 10 million USD) in 2014 and GDP is below 1000 USD per capita which is one of the lowest indicators all over the world (together with Congo, Malawi and Nigeria).<sup>2</sup>

However, even though the economic capacity of South Ossetia is quite limited, we should be mindful of the fact that it is backed up by Russia, whose financial assistance to the South Ossetian budget through co-funding exceeds 10 or 11 times over the local revenues to the budget of 5.6 billion USD.<sup>3</sup>

In other words, without financial support from the Russian Federation, the South Ossetian economy is critically fragile. However, it is worth noting that because of deeply entrenched corruption both in Russia and South Ossetia only one tenth of official 'assistance' reaches the communities (an expert evaluation) and therefore, it has failed to positively influence the lives of ordinary citizens but rather benefits some clans or individuals close to these clans.

Although some indicators suggest that the problem also exists in Georgia to some extent, however, in general it is evident that if economic cooperation is to be established between South Ossetia and Georgia, the former is likely to experience a positive 'forging effect' and enjoy the opportunity to overcome a series of social-economic problems. However, due to the current state of affairs, no documents exist either in Georgia or South Ossetia which would allow for the improvement of economic cooperation of the parties. This circumstance hampers the development of both sides, and adds up to the immense losses sustained for the past 20 years.

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2 The World Bank Group <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>

3 REGNUM Info Agency. <http://regnum.ru/news/polit/1749839.html>

## 1. COST OF CONFLICT (GEORGIA)

### *A) Expenditure on Defense*

According to the Ministry of Finance of Georgia the incumbent Georgian governments for the past 10 years (2006-2015) spent up to 7 billion USD to uphold the high defense potential and continuous increase in its quality. The sum constitutes an average of 5.3 per cent of the country's GDP while annual shares are even higher: 2007 – 9.2 per cent, 2008 – 8.5 per cent, 2009 – 5.6 per cent.<sup>4</sup> For the sake of comparison, the average expenditure on defense in European countries totaled 1.5 per cent of GDP in 2014 (Austria – 0.7 per cent, Germany – 1.2 per cent, France – 2.2 per cent).

Taking into account Georgia's relatively moderate capacity in comparison with western European countries (expenditures on defense in 2007 were 40 per cent of the state budget)<sup>5</sup> the rate of spending is unjustified. Even more so when such spending does not help but rather contributes to the increase in the number of occupied territories. Consequently, if Georgia's expenditure on defense is to be gauged for the last 10 years, the cost of conflict amounts to at least 5 billion USD (if Georgia's defense expenditure would otherwise have been equal to European average – 1.5 per cent of GDP instead of 5.3 per cent).

### *B) Loss of Internally Displaced Persons, as a private sector*

By the end of 2013 the International Displacement Monitoring Center estimated that Europe homed 2.2 million displaced persons.<sup>6</sup> As a result of several waves of conflicts, mostly in 1992-1993 and 2008, the number of internally displaced persons in Georgia amount to 450,000, which would have been a huge challenge not only for small Georgia but also for any larger European state. As a result of the Russian-Georgian war, which (officially) even experts failed to see coming (Cornell S., Starr F., 2009; Asums R., 2010), a new wave of displaced persons hit up to 25,000 individuals. The UN data suggest that the number of IDPs from South Ossetia totals 20,000 (15,000 out of whom from 2008 war while 5 thousand from the conflict in the 1990s). If property of households is to be estimated (considering there are 4 members in an average household) at 20,000 USD, it appears that the loss sustained only by the private sector of Georgia's IDPs amounted to 100 million USD and even partial compensation of this sum costs the Georgian state much more. If putting together all the losses sustained by all IDP households in Georgia, the cost if these losses will be estimated at 2 billion USD.

### *C) Projects in Support of IDPs (Accommodation and Social Assistance)*

According to data available in March 2015, the country had 263,598 IDPs (7 per cent of total population) with 122,383 males and 141,215 women. Most of these IDPs reside in Tbilisi (39 per cent) and Samegrelo-Zemo Svaneti region (32 per cent).<sup>7</sup> There are 2000 compact settlements in Georgia, the largest being Tserovani with 6421 settlers, followed by Batumi (2231) and Poti (2145) new districts.<sup>8</sup>

It is worth noting that only 18,679 IDPs out of the total number of 263,598 (with the share (90 per cent) of those from Abkhazia) have received housing property (7 per cent of the total number). In monetary terms, this amounted to 20 million GEL (12 million USD). In addition, a fourth of IDPs were granted property rights in the accommodation where they were actually living at that time, or were given financial compensation (10,000 USD). Consequently, providing the rest of IDPs with accommodation will cost the Georgian

4 The World Bank Group <http://data.worldbank.org/indicator/MS.MIL.XPND.GD.ZS/countries/1W-GE-EE-LV-LT-AM-AZ?display=default>

5 The World Bank Group <http://data.worldbank.org/indicator/MS.MIL.XPND.ZS/countries?page=1>

6 International Displacement Monitoring Centre <http://www.internal-displacement.org/assets/library/Europe/Georgia/pdf/1-IDMC-HRC-Georgia-2013.pdf>

7 Ministry of Internally Displaced Persons from the Occupied Territories, Accommodation and Refugees of Georgia <http://www.mra.gov.ge/geo/static/55>

8 Institute for Development of Freedom of Information <https://idfi.ge/ge/number-of-provided-living-areas-for-idps>

government an additional 100-150 million USD. However, it is worth noting that this kind of compensation is a far cry when compared with losses sustained by the internally displaced persons.

Pursuant to the Law of Georgia on Persons Displaced from the Occupied Territories, every IDP is eligible for a monthly allowance of 45 GEL (provided that a person's monthly salary does not exceed 1250 GEL). Though increased to compare with monthly 28 GEL allocated in previous years, the allowance is far from being sufficient. Up to

600 million GEL has been paid to the IDPs as a monthly allowance. However, it is worth noting that the monthly amount is 4 times less than Georgia's living minimum totaling 160 GEL per capita. If taken separately, total amount of money spent on providing a monthly allowance for IDPs from South Ossetia has totaled 15 million USD.

*Perhaps my generation, the generation of the 1980's, suffered the hardest. We have witnessed many conflicts - April 9, 1989, the conflict of 1992, constant fear, the period from 2004, when there was constantly shooting, tensions, and 2008. Sometimes with my classmates we joke that we were born in war, grew up in war and got our education in war, and probably will create a family also in war. I went through many stages after the war, and in 2010 came to an informational meeting of the women's association. They offered free computer training courses. The population demanded that, since the computer entered our lives and everywhere computer literacy is required. The training was necessary. I was offered a training and payment if I trained others afterwards. Of course, I accepted the offer with great joy. In 2010, I started working. In this organization, I have learned so much, as if I graduated from second and third universities. I went through many trainings, seminars; learned how to help other people, how to use my own knowledge, how to indentify problems, how to conduct research, how to gather active people around myself. We set up an office, which is equipped with internet. There is a photocopier. And all of these services are free of charge for people. All this, and our work experience increased the confidence in the community as well. So now are some type of mediators between the government and local authorities. The path that I walked over the years, I think, helped me to become the person I am today. And what I say may sound very ambitious, but I believe that today I am a successful person."*

*Resident of the village Nikozi, Gori Municipality*

## 2. "BENEFITS" OF CONFLICT

### ***A) Grants and loans from international organizations;***

At a flash appeal conference held in 2008, 67 countries and members of the international community expressed their commitment to provide assistance to Georgia and pledged 4.5 billion USDs for the next 3 years (USA – 1 billion USD, International Monetary Fund - 750 million USD, EU Commission - 650 million USD, Japan - 200 million USD...). The assistance was expected to improve the socio-economic standards of IDPs as well as to address the needs of the banking sector, contribute to effectiveness of infrastructural projects and stabilize the state budget. It is worth noting that 60 per cent of the assistance (2.5 billion USD) is a loan given at concession which Georgia is responsible to return after a certain period of time. The remaining 40 per cent (2 billion USD) accounts for grants. Therefore, it can be assumed that 2 billion USD is a 'benefit' which Georgia received as a result of the conflict.

### ***B) International Organizations and Projects;***

From 1992 to 2008 before the closure of the international observers mission under the aegis of the UN (United Nations Observer Mission in Georgia – UNOMIG) by Russia, the mission had spent 397

million USD.<sup>9</sup> The biggest share of this sum was spent on accommodating the needs of the mission itself rather than on direct interventions aimed to improve the quality of lives of internally displaced persons. However, apart from financial assistance, the mission had rendered a very strong support to Georgia, in particular at the initial stage of statebuilding.

On October 1, 2008, after the closure of UNOMIG (Popescu N., 2011) EU monitors (EUMM counts approximately 200 monitors as of today) opened their office in Georgia under the legitimation of all EU member states.<sup>10</sup> Even though, it is widely perceived that EUMM failed to fully replace UNOMIG, according to data provided by the European Commission, the mission has already spent approximately 150 million EURO (approximately 200 million USD) on the needs of the project in Georgia which, in turn, has had a positive impact on the Georgian economy.

### SWOT Analysis – Cost of Conflict for Georgia

<p style="text-align: center;"><b>Strength</b></p> <ol style="list-style-type: none"> <li>1. Financial assistance of the international community,</li> <li>2. The presence of respective missions of the UN and EU taking into account Georgia’s interests.</li> </ol>	<p style="text-align: center;"><b>Weaknesses</b></p> <ol style="list-style-type: none"> <li>1. Costs of military actions and the mitigation of their effects</li> <li>2. Severe socio-economic conditions,</li> <li>3. Disempowered economy and limited opportunities for its development,</li> <li>4. Problems related to NATO and EU integration and damages inflicted upon the investment climate.</li> </ol>
<p style="text-align: center;"><b>Opportunities</b></p> <ol style="list-style-type: none"> <li>1. Visa free regime of movement with the EU member states,</li> <li>2. Free trade regime with the EU.</li> </ol>	<p style="text-align: center;"><b>Threats</b></p> <ul style="list-style-type: none"> <li>• Risk related to potential escalation of new conflicts as a consequence of the existing geopolitical reality,</li> <li>• Long term instability,</li> <li>• Deterioration of social-economic imbalance with the rest of the world,</li> <li>• National security weaknesses.</li> </ul>

## COST OF CONFLICT (SOUTH OSSETIA)

### 1. EXPENDITURES ON CONFLICT

#### A) Disempowered economy

At first glance, expenditures on the conflict in absolute terms are not high and total approximately several tens of million USD. However, when examined against South Ossetia’s economic capacity, it becomes evident that the above mentioned estimate is in fact an extremely heavy burden hampering the region’s socio-economic development. Interestingly, this kind of expenditure provides an excellent opportunity for certain individuals to accumulate wealth.

<sup>9</sup> United Nations <http://www.un.org/en/peacekeeping/missions/past/unomig/facts.html>

<sup>10</sup> EU Monitoring Mission in Georgia [http://eeas.europa.eu/csdp/missions-and-operations/eumm-georgia/pdf/facsheet\\_eumm\\_georgia\\_en.pdf](http://eeas.europa.eu/csdp/missions-and-operations/eumm-georgia/pdf/facsheet_eumm_georgia_en.pdf)

The average salary in South Ossetia in 2015 (according to data available to the author) was less than 10 000 rubles (less than \$ 130) (in Georgia approximately - \$ 350). Statistics on employment are virtually nonexistent, but according to experts it is not more than 2,000 people out of a population of about 30,000.

As of today, trade relationship exists only with the Russian Federation via the Roki Tunnel which is the only link connecting the region with Russia. The volume of export is very small and often does not go beyond small shipments of agricultural products. Therefore, the trade balance of South Ossetia is negative.

Issues related to the disempowered banking sector stand out as the most acute ones because of its significance as a catalyst for the development of any economy. The data provided by South Ossetia suggest that deposits amount to 3 million USD (compared to Georgia's 4.5 billion USD), while credits account for just one million USD (compared to Georgia's 6.3 billion USD). In other words, prospects for economic development at the local level are dim while financial support provided by Russia falls short to support stable and sustainable economic progress.

## **THE COST OF INDEPENDENCE**

It has been long recognized that the war of 2008 served as grounds for recognizing the independence of South Ossetia and Abkhazia by the Russian Federation which was later joined by a few countries such as Nauru (which shortly after revoked the recognition), Nicaragua and Venezuela. It is evident that prospects of the partnership with any of these countries except for Russia are almost infeasible. Subsequently, signing agreements on visa liberalization, opening representations and meetings among the heads of governments are futile efforts leading to wasted resources for regions that suffer from a lack of financial capacities.

Moreover, the Russia's recognition of independence has not entailed changing the status and the integration into international organizations including the financial and economic structures, which is one of the crucial indicators of an independent state.

Even control over the so called state borders of Abkhazia and South Ossetia is being exercised by the Russian Federation. This situation adds up to a volume of loans allocated to Abkhazia and South Ossetia, the return of which is not only hard to imagine but also not anticipated in the foreseeable future. This state of affairs is an omen of 'independence' turning into 'dependence' the extent of which is likely to be unprecedented for the past 20-25 years.

## **1. BENEFITS OF THE CONFLICT**

### ***A) Financial Assistance from the Russian Federation (Investments)***

According to Russian sources, from 2008 to 2015 Russia transferred around 100 million USD to South Ossetia on an annual basis. In 2016 financial transaction from Russia hit 8.7 billion rubles (approximately 130 million USD). In other words, for the past ten years South Ossetia has received financial support totaling almost 1 billion USD which, in light of the size of population not exceeding 30,000 residents, accounts for more than 30,000 USD per capita. However, surprisingly, the lives of ordinary residents of South Ossetia have remained largely unchanged for the past ten years.

### SWOT Analysis – Cost of Conflict for South Ossetia

<p style="text-align: center;"><b>Strengths</b></p> <ul style="list-style-type: none"> <li>• Financial support provided by the Russian Federation,</li> <li>• Employment opportunities on Russia’s labor market.</li> </ul>	<p style="text-align: center;"><b>Weaknesses</b></p> <ul style="list-style-type: none"> <li>• Deterioration of socio-economic conditions affecting the population</li> </ul>
<p style="text-align: center;"><b>Opportunities</b></p> <ol style="list-style-type: none"> <li>1. Visa free regime with the Russian Federation.</li> </ol>	<p style="text-align: center;"><b>Threats</b></p> <ol style="list-style-type: none"> <li>1. The recognition of ‘independence’,</li> <li>2. Constant exposure to a social-economic trap,</li> <li>3. Exposure of the local communities to a risk of becoming ethnic minority as a result of the replacement of those who has left the country with representatives of other ethnic groups;</li> <li>4. Transfer of mechanisms of local governance to the Russian Federation.</li> </ol>

## FUTURE PROSPECTS FOR BOTH SIDES

### *A) Transit Trade SGS (Société Générale de Surveillance)*

In the beginning of the 1990s, after losing its control over Tskhinvali and Sukhumi, Georgia had no valid mechanism to calculate the movement of cargo and goods to and from South Ossetia and Abkhazia.

In 2012, as an exchange for some compromises taken by the Russian Federation, Georgia agreed to give its consent to Russia’s accession to the World Trade Organization (WTO). The compromise enabled Georgia to acquire instruments, such as SGS, for monitoring the turnover of goods on the conflict territories. In turn, Russia ‘positioned’ this step as non-recognition of Georgia’s territorial integrity and as a support to Abkhaz and South Ossetian independence as monitors were to be deployed not on the most contested conflict territories, but on those which were effectively controlled by Russia and Georgia.

In the end, it turned out that Georgia, given the opportunity to place neutral (Swiss) monitors in the sections from Vladikavkaz to Gori (for South Ossetia) and Zugdidi-Adler (for Abkhazia), would still have incomplete control of the situation. Airfreights have never been considered (in spite of the fact that currently there are no airfreights, it is possible that this practice may be introduced in the future) while such important means as sea freights, which account for 20% of all freights (International Alert, 2014) have been taken off the table by Abkhazia. Moreover, Georgia has no control over the movement of freights (Vladikavkaz-Gori and Zugdidi-Adler sections) on either of so called borders, which, as some Georgian experts argue, is a strength rather than shortfall of the project, as Georgia should not recognize any border when it comes to its occupied territories.

It is evident that SGS per se is not likely to regulate the conflict, however, on the other hand, it certainly provides new opportunities for sustaining tight links and improving the socio-economic background of the region. At large, the project will enable Georgia to diversify transport and trade communications and simultaneously obtain three routes for land transportation connecting the country with Russia (under adherence to universal legal norms). South Ossetia (and Abkhazia) will enjoy additional revenues from transit and the development of the tourist sector.

### ***B) Visa Liberalization and Free Trade with the EU***

It is evident that under no circumstances do Georgia's territorial issues have a direct influence on its prospects for a visa free regime (from the second half of 2016) and free trade with the EU. However, for the EU this is an apparent chance to make its own positive contribution to the Georgian state. Visa free regime with the EU will not allow Georgian citizens to work in EU countries. However, this arrangement will certainly serve as an incentive for both businessmen and ordinary Georgian citizens.

Signing the Agreement on Deep and Comprehensive Free Trade with the EU gives Georgia an opportunity for improving socio-economic effects within the country, contributing to increased income and technological progress. In the long run Georgian GDP is anticipated to increase to 4.3 per cent, export is expected to reach 7.5 percent and salaries - 3.6 percent. On the other hand, the arrangement is expected to contribute to cutting back of consumers' costs to 0.6 per cent (ECORYS, 2012). Under constructive cooperation, these results will positively influence both Georgia and South Ossetia

Even though the Association Agreement has not been fully ratified (with Italy remaining the only EU state to ratify) its benefits are already felt in Georgia. According to the data provided by the Tbilisi State University's Centre for Analysis and Forecast for the first eight months of 2015 net export (export without re-export) of Georgian goods, compared to the same period of 2014 increased to 40.1 per cent (up to 342 million USD). The same period saw an increase in import of 2.3 per cent (up to 1569 million USD). The growth of net export for January-August 2015 affected the following goods: copper and concentrates – 24.2 percent, walnut – 18.5 percent, crude oil – 14.5 percent, nitrogen fertilizers - 8.9 percent, ferroalloys – 4.1 percent, vehicles – 2.5 percent. It is worth noting that the growth of net export to EU member states is an irreversibly positive occurrence while the growth of import from these very countries indicates to increased demand by Georgian customers for high quality goods (not limited to food commodities). Positive trends such as decreasing the rate of unemployment and consumers prices, increasing the number of jobs and wages, attracting investments in various sectors of the economy, etc. may also have positive effects on the South Ossetian economy, provided that it interacts with the Georgian economy.

## **CONCLUSIONS**

According to official data, Georgia's expenditures on the conflict are far higher than those of South Ossetia. However, if above mentioned sums are to be compared from the perspective of the economic capacity of the parties, it is evident that these expenditures have had detrimental effects on the general development.

On the other hand, 'benefits' brought by the war of 2008 for Georgia were also quite significant. However, in the long run, they could not obviously outnumber the massive losses inflicted by the conflict. As for South Ossetia, Russia's allocations since 2008 per capita could have been enough to turn the former into an 'economic heaven', but corruption schemes have completely destroyed such an opportunity. Financial benefits of Georgia from the regulation of South Ossetian issues in a short term perspective are practically non-existent. However, when considered from a long term perspective, these benefits will certainly prevail and bring powerful economic effects (provided that the conflict with Abkhazia will also be regulated).