Financialization of Monetary Policy in a Dollarized Economy: the case of Georgia

Abstract

The paper examines financialization of monetary policy in Georgia in the context of high unofficial dollarization, by analysing monetary policy of the Georgian central bank in 2004-2009 and after the adoption of inflation targeting, from 2009 to 2012. The paper contributes to the literature on the role of foreign capital in emerging and developing economies, that examine the abuse of interest rate differentials and volatilities of these economies in terms of overvalued exchange rates, capital flight, and rise of public debt. It provides empirical insights from a peripheral dollarized economy and contributes to the conceptualisation of financialization in developing countries through embedding the analysis within a political economic state theory. The paper concludes that financialization has encouraged the process of dollarization in Georgia. The power of the central bank declined due to local and global pressures and ineffectiveness of inflation targeting regime for a dollarized economy.

Keywords: monetary policy, dollarization, inflation targeting, peripheral financialization

Introduction

Georgia is a highly dollarized country (dollarization rate is around 53% as of 2020 (National Bank of Georgia, 2020a, p. 16)) which has also been undergoing the process of financializaton over recent decades. Even though financialization is by now a widely discussed topic in the academia and a rich scholarship has been emerging on financialization in the Global South, this concept is a 'foreign word' in Georgia. The issue of dollarization also remained beyond political, expert and societal debates for a long time.

Financial dollarization is a widespread phenomenon in the post-socialist space. It refers to the replacement of the functions of a national currency by another currency, where Dollar is used as a general term for all foreign currencies (Levy-Yeyati, 2006, pp. 63–64). Dollarization limits sovereignty of monetary policy and the role of the central bank as a lender of last resort (Priewe & Herr, 2005, p. 160); it leads to the loss of exchange rate as a policy tool (Priewe & Herr, 2005, pp. 175–176), financial fragility, barriers to economic growth (Levy-Yeyati, 2006, pp. 108–109), and vulnerability of foreign currency creditors - households, firms and government - to exchange rate fluctuations (De Nicoló et al., 2003; Versal & Stavytskyy, 2015). Despite negative implications of dollarization for households, firms, local economy, and monetary sovereignty of the state, the central bank of Georgia did not have a de-dollarization strategy until 2010 (National Bank of Georgia, 2011, pp. 9–10). The shift to inflation targeting in 2009 clearly indicated prioritisation of the interests of local and foreign capital over currency stability.

Georgia is a small and open economy, which is oriented on the service sector and its industrial base has not recovered since the devastating results of the break-down of the Soviet Union. While Georgia remains a role model for transition policies and one of the key sites of neoliberal experiments in the post-socialist space (see (Gugushvili, 2013), its economy still suffers from the current account deficit, weak industrial base, soft currency, dollarization, high unemployment, and poverty rates, as well as household over indebtedness (see (Eradze, 2021). Dollarization has preceded and paved a way towards financialization in Georgia, while financialization also encouraged the persistence of foreign currency domination. Therefore, this paper studies financialization of monetary policy in a dollarized peripheral state. It contributes to the literature on the role of foreign capital flows in emerging and developing economies, that examine the abuse of interest rate differentials and volatilities of these economies in terms of overvalued exchange rates, capital flight, and rise of public debt (see (Kaltenbrunner & Painceira, 2015, 2017; Painceira, 2009; Powell, 2013).

Firstly, the paper identifies the patterns, drivers and key actors in financializing the monetary policy and draws implications for post-socialist transition countries, that went through a similar political economic development path as Georgia did. ***Secondly,*** the study offers empirical insights into the interconnectedness of dollarization and financialization in a peripheral economy. ***Thirdly,*** it contributes to the theoretical conceptualisation of financialization in developing countries through applying a peripheral state theory (Ataç et al., 2008; Becker, 2008; Becker et al., 2010) and reflecting on the international dimension of financialization (Kaltenbrunner & Painceira, 2017; Karwowski & Stockhammer, 2017; Powell, 2013). Thereby the study also aims to fill the gap on debating the state in the process of financialization (Karwowski, 2019; Karwowski & Centurion-vicencio, 2018).

The paper is structured as follows: the analytical and methodological framework – financialization in the peripheral state - is proceeded by the main dilemmas of central banking in Georgia from 2004 to 2009, which is embedded in the post-Rose Revolution (2003) foreign direct investment (FDI)-led accumulation regime. The main body of the paper deals with the financialization of monetary policy after the shift to inflation targeting in 2009. Here the main patterns and dimensions of financialization are explained along three themes: inappropriateness of inflation targeting, ineffectiveness of interest rate, and negative implications of reserve accumulation for dollarization and the overall economic development.

Financialization in a Peripheral State

Financialization is "a pattern of accumulation in which profit making occurs increasingly through financial channels rather than through trade and commodity production" (Krippner, 2005, p. 174). It has been progressing since the 1970s in the Global North and most of the research has also been conducted on Europe and the USA. Financialization is articulated in the countries of the Global South (see for the overview of literature (Bonizzi, 2013) as a variegated process - demonstrating different forms in different economic areas and states (Karwowski & Stockhammer, 2017). It is embedded in the imperial power relations of the world market. Powell emphasises the subordination of local capital markets to the global ones, as well as currency hierarchy, indebtedness of households and financialization of non-financial corporations (Powell, 2013, pp. 143–145) (see also (Bonizzi et al., 2019; Kaltenbrunner & Painceira, 2015). While this conceptualisation attributes strong agency to the global actors and profit-making interests of foreign capital, it runs the danger of downplaying the importance of local forces. The concept of peripheral financialization offers more analytical space for exploring the role of local agencies. Financialization in the Global South has been traced in the accumulation regime, shareholder value, everyday life (as identified by (Karwowski & Centurion-vicencio, 2018, p. 4), exchange rate regimes, currency hierarchy, central bank policies (Epstein, 2001; Kaltenbrunner & Painceira, 2015, 2017; Painceira, 2009), as well as in inflation targeting (Epstein, 2001; Epstein & Yeldan, 2008; Karwowski & Centurion-vicencio, 2018).

Epstein points at the connection between the inflation targeting regime and financialization. Debtor countries face a challenge of attracting foreign money and central banks are being pursuaded by international actors that inflation targeting will help them access international capital (Epstein, 2001, pp. 4–5). Yet, inflation targeting regime is directly linked with the interests of financial investors in price stability (Karwowski & Centurion-vicencio, 2018, p. 16). Gabor argues that inflation targeting with its focus on interest rate encourages and enables speculations. Furthermore, dropping exchange rate from policy tools discourages export competitiveness and increases vulnerability to short-term capital flows (Gabor, 2010, p. 821). Moreover, Epstein raises a plausible question on the central bank accountability and independence and argues that central banks become accountable to financial markets (Epstein, 2001, pp. 7–8). Thus, inflation targeting can be perceived as financialization of monetary policy, as it serves the interests of financial capital in the first place. The analysis of inflation targeting in a dollarized economy like Georgia demonstrates further dimensions of financialization – primacy of price stability aims over currency stability, weakening the role of the central bank at the currency market, while attributing more power to the banks, and reducing the function of the central bank to chasing inflation when it cannot not even have much influence on the inflation rate.

Post-socialist transition states have not been in the focus of financialization debate, so far, beside a few exceptions (Gabor, 2012, 2013; Sokol, 2017b, 2017a). Georgia is an exemplary case for studying financialization of monetary policy in dollarized peripheral economies, where the central bank has turned into a terrain of local and global power struggles and the monetary policy faces policy dilemmas between price and exchange rate stability. Therefore, this study aims to embed the recent developments in currency relations and monetary policy of Georgia in the global debate and offer insights into the relations between dollarization and financialization through a peripheral state approach.

State has often been forgotten in financialization studies. However, as Karwowski and Centurion-vicencio (2018) correctly point out, shifts in the accumulation regime cannot be analysed without studying financialisation of the state (Karwowski & Centurion-vicencio, 2018, pp. 4–5). A recent study of Karwowski (2019) focuses on the role of the state through examining fiscal and monetary policies, but this conceptualisation builds on separate analytical categories of *state* and *financial markets*, where state is understood as sovereign power. Accordingly, financialization of state is defined as "increasing influence of financial logics, instruments, markets and accumulation strategies in state activities" (Karwowski, 2019, p. 1002). However, financialization is not a separate process outside the state realm, but it is an integral part of the state and is embedded in the process of accumulation, governance, political and civil societies.

State is a social power relation, which is embedded in production, and other social relations. Therefore, it is not a neutral actor. The state and the accumulation regime influence one another, as accumulation strategies need the support of the state, and the state also depends materially on the accumulation process (Becker, 2008, p. 10). Thus, the state apparatus is embedded in the financialized accumulation regime, where the financial sector also needs the state. In an FDI-led accumulation regime of peripheral economies financialization is articulated in the victory of foreign capital interests, as countries in the periphery are usually dependent on the accumulation regime of the core and experience passive extraversion (Becker et al., 2013, pp. 35–36). Peripheral countries try to attract foreign capital through overvalued exchange rate and high interest rates. However, high interest rates impact the development of local production negatively and these countries become import dependent, while their external debt increases. As soon as high debt and imbalances becomes obvious for investors, capital flight occurs and the crisis breaks out. Often the crisis appears to be a foreign exchange crisis, but it actually has other core drivers (Becker et al., 2010, pp. 229–230). Becker refers to the negative role of dollarization in this process, which makes countries even more dependent on foreign capital. Thus, dollarized financialization might cause devastating results in case of decreasing capital inflows (Becker et al., 2010, pp. 229–230). Yet, financialization can encourage dollarization through prioritising price stability over currency stability.

State is not an 'external' actor that time to time interacts with financial markets, but it is the structure and the context, that enables financialization. Moreover, state has agency in state-financial market relations, where non-state actors on the local and global levels are also involved. A relational understanding of state enables to analyse the agency of the state apparatus not only in governing the accumulation regime, but also in shaping the legal and institutional structure that paves a way towards financialization. The agency of a neoliberal state can be rather ambivalent – while it might be directly encouraging financialization through the deregulation of financial markets or liberalisation of currency account, at the same time it might be trying to maintain control mechanisms over the market or central banks.

Civil society represents an important terrain for these relations, where hegemonic struggles take place over social and legal norms for the mode of regulation (Becker et al., 2010, pp. 226–227). Here the fate and trajectory of financialization is being decided. Currency related power relations and central bank policies are also embedded within these struggles. Central banks are influenced by the government, local capital, foreign investors, and international organisations. The International Monetary Fund (IMF) is a well-known advocator of independent inflation targeting (Gabor, 2010) and the foreign capital profits from the deregulated markets, where currency and capital accounts are liberalized. Tensions may arise in government-IMF relations, especially regarding the central bank independence, and a power coalition of IMF-central bank might oppose the government. Thus, such institutions as the IMF can also be viewed as one of the key actors in financialization.

Political Economy of Central Banking and Inflation Targeting in Georgia

The financial sector started to flourish in Georgia after the Rose Revolution (2003). Yet, tensions between the government and the central bank increased. The post-revolution political elite started radical libertarian economic reforms and shaped a neoliberal authoritarian state, which was embedded in the FDI driven accumulation regime. A wave of radical deregulation, in the name of a minimal state, led to the empowerment of the financial market (mostly commercial banks), and attracted foreign investments at the cost of the flexible labour market and favourable business conditions, but the Georgian economy remained trapped in its peripherality. While Saakashvili's government dreamt of creating a financial hub in Georgia and deregulated the market to its radical ends, it also wanted to keep the control over the central bank policies. International organisations interfered number of times to protect the independence of the central bank (thesis).

The Dollar has been a dominant currency in Georgia since the independence of 1991, due to the economic collapse, political chaos, the hyperinflation of 1993, and early liberalisation of exchange rate and capital account (1996) (Gurgenidze et al., 1994; National Bank of Georgia, 1997). The level of deposit dollarization reached 80% in 1999 (Kakulia & Aslamazishvili, 2000, p. 23). The libertarian discourse of the post-revolution government did not perceive dollarization as an issue. Dollarization persisted at high levels (National Bank of Georgia, 2006a, p. 58) and the dependency of the economy on foreign capital and goods increased. After the revolution (2003) finance became the fastest growing and most profitable sector of the economy and foreign owned commercial banks turned into the main agents of financialization. Moreover, the libertarian state-building agenda of the post-revolution government questioned the need of the central bank (Timm, 2013, p. 9) in line with libertarian view on central banking and national currencies (see (Hayek, 1990). The National Bank of Georgia (NBG) turned into a terrain of local and global struggles, in between price and currency stability aims, interests of the capital and the broader society. Furthermore, the adoption of a currency board (see (Papava, 2007, p. 7) and multicurrency zone (Khaduri, 2009) was considered by government officials. Despite government attempts to reduce the power of the central bank, the NBG managed to become independent from the government influence. In 2006, the Georgian government was forbidden to borrow from the central bank (National Bank of Georgia, 2006b, p. 50). Several attempts of the government to remove banking oversight function form the central bank also failed (Papava, 2010, p. 51) (see (Lashkhi et al., 2008, pp. 27–28). In 2009, the central bank regained its supervisory role (Gelaschwili & Nastansky, 2009, p. 5) and with the shift to inflation targeting in 2009, it was declared institutionally independent by the Organic Law (National Bank of Georgia, 2009, p. 8).

A closer look at the developments in the Georgian economy enables to identify two important periods for analysing the monetary policy: from 2004 (aftermath of the Rose Revolution) until the double crisis of 2008-2009, and from 2009 to the presidential elections of 2012. If before the crisis, due to the economic growth, legalization of the economy and foreign capital inflow, the Georgian Lari was appreciating and dollarization level was declining, the 2008-2009 crisis reversed the situation and among other factors, a sharp decline in foreign capital negatively influenced the stability of the Lari and dollarization.

Monetary policy in 2004-2009: ‘strong’ currency dilemma and the double crisis

The National Bank of Georgia followed monetarism until 2009; its main functions were defined by the Organic Law (Article 2). The bank was responsible for maintaining the value of the national currency, price stability, functional money-credit system, and liquid financial sector (National Bank of Georgia, 2006b, p. 39). Thus, currency stability was among the main aims of the central bank. Under monetarism, the National Bank of Georgia used exchange rate as an instrument and intervened in the foreign currency market in case of volatilities (National Bank of Georgia, n.d.). However, the Georgian central bank was still limited in its policy decisions to favour currency stability and de-dollarization or watch price stability.

Legalisation of the economy after the Rose Revolution raised demand for the Georgian Lari, the volume of money in circulation increased and the NBG was able to encourage monetization of the economy (National Bank of Georgia, 2004, p. 32). The demand for Lari was especially triggered by increased budget transactions, which positively effected the trust to the national currency (National Bank of Georgia, 2004, pp. 39–40). Consequently, the level of deposit dollarization decreased from 86% to 74% within a year (2004) (National Bank of Georgia, 2006a, p. 58). The appreciation of Lari against US Dollar was mainly caused by foreign capital inflows. Georgia was facing a danger of 'Dutch Disease', which caused decline in exports and rise in inflation in 2004-2008 (Anguridze et al., 2015, p. 14). Thus, the inflow of foreign capital (due to privatization), as well as increase in tax payments and remittances, strengthened the value of the national currency but negatively influenced the current account (Papava, 2007, p. 8).

The IMF considered the Georgian Lari to be underappreciated before the revolution, and suggested the central bank to let the exchange rate float freely so the value of Lari could get close to the equilibrium. However the NBG had to watch price stability, as well (International Monetary Fund, 2006, pp. 51–52) It was sterilising foreign capital inflow effects through purchasing US Dollar, in 2004-2007 (National Bank of Georgia, 2006a, p. 37, 2007, p. 32). As a result, international reserves doubled in 2004 (National Bank of Georgia, 2004, p. 36). The NBG also faced a dilemma of boosting export competitiveness through currency depreciation or encouraging de-dollarization through currency appreciation (see Figure 1).

The trend of Lari appreciation and de-dollarization changed after the August war of 2008 with Russia, as the inflow of foreign currency decreased significantly and the overall economic development regressed. The Gross Domestic Product (GDP) decreased by 3,9% in 2009 (National Bank of Georgia, 2009, p. 10). The Georgian central bank could hardly satisfy the demand for foreign currency (National Bank of Georgia, 2008b, pp. 23–24). In 2008-2010, Lari nominal exchange rate was depreciated by 11,2% to USD (real effective depreciation to USD was 8,7%). Loan dollarization increased in 2008-2009; this trend was reversed towards the end of 2009, yet dollarization remained at a higher level than before the crisis (National Bank of Georgia, 2010b, pp. 55–56)

Monetary Policy in 2009-2012: inflation targeting

The Georgian central bank fighting against windmills?

In 2009, inflation targeting regime was introduced in Georgia and the inflation target was set at 9%. Inflation targeting usually means sacrificing such aims as full employment or high investments, for the sake of price stability (Epstein, 2001, pp. 3–4) (see also (Kaltenbrunner & Painceira, 2017, p. 453)). Article 3 of the Organic Law announced price stability as the highest priority of the central bank. Other functions from the previous mandate, such as guaranteeing stable financial system, as well as encouraging sustainable economic development turned into secondary aims. The main instrument of the central bank became interest rate (National Bank of Georgia, 2009, p. 8).

The shift to inflation targeting shall be understood in the context of the double crisis and the subsequent capital flight, that put the FDI-led accumulation regime under serious threats. The Georgian government was in desperate need of attracting foreign investments and it initiated the Liberty Act in 2009, which announced Georgia as "a flagship of worldwide economic liberalism" (Saakashvili, 2009 cited in (Jobelius, 2011, p. 85)). This Act made a referendum mandatory for tax raise and the creation of regulatory institutions. It also attributed freedom to currency exchange and conversion in the constitution (Jobelius, 2011, p. 85). The shift to inflation targeting promises price stability to foreign investors (Epstein, 2001, pp. 3–4) and it thus meant turning the green light on for foreign capital[1].

Thus, even though the government was trying to weaken the central bank and keep its control over its policies before 2009, the urgent quest for foreign capital made it accept the new mandate of inflation targeting and central bank independence, as inflation targeting signalises a shift towards 'scientific expertise' and depoliticization of finance (Gabor, 2010, pp. 810–811).

Interest rate became the main policy tool of the NBG. However, underdevelopment of the Lari market limited the effectiveness of this instrument (National Bank of Georgia, 2009, p. 34). The NBG used the following monetary policy instruments: refinancing loans, overnight loans and deposits, treasury

[1] As argued in author's paper *Dollarization Persistence in Georgia in the Prism of State Building*, which is currently under review.

notes, and minimum reserve requirements (National Bank of Georgia, 2009, p. 44). The main mandate of the central bank was also tackling inflation under monetarism, but from now on monetary policy was operated "by adjusting the *price* of money, not by controlling the *quantity* of money" (International Monetary Fund, 2017, p. 14) (italics original). Thus, the functions of the NBG was reduced to setting monetary policy rate.

A high level of dollarization, under development of financial and inter-bank markets, as well as their excess liquidity create challenges for the effectiveness of the interest rate channel. As for the exchange rate channel, monetary policy can affect the level of savings in national currency and the exchange rate, that influences the level of exports and prices. In an import dependent country, like Georgia the linkage between the exchange rate and prices on imported goods are direct, as the appreciation of the national currency leads to decreasing prices of imported goods (Bluashvili, 2013, p. 62). Yet, the impossible trinity of price and exchange rate stability with free capital flows, makes countries prioritise either exchange rate or price stability (National Bank of Georgia, 2008a, p. 18) (See Figure 2). Major developments on the Georgian foreign exchange market after 2009 resemble general drawbacks of inflation targeting. Studies, conducted in 2007-2008, confirm the weakness of the interest rate channel (as well as for developing and transition countries in general). The 2009 annual report of the National Bank of Georgia already revealed the first limitations of interest rate channel due to dollarization (National Bank of Georgia, 2009, p. 37). Except dollarization, high level of foreign ownership of Georgian commercial banks also limit the effectiveness of the interest rate channel. As banks could easily access money on international markets, they were not interested in refinancing loans of the Georgian central bank in national currency. The banking sector had excess liquidity in 2009-2010 (National Bank of Georgia, 2010c, p. 65). The Georgian banks mostly borrowed from international financial institutions and non-resident banks in 2007-2010 (National Bank of Georgia, 2010c, p. 72). In 2010, the Georgian central bank started to create new instruments to encourage banks participate in the refinancing market. A permanent refinancing loan was introduced with the rate of 1 percent plus the refinancing rate of the central bank Furthermore, in 2010, the NBG set 5% reserve requirement for money borrowed abroad (which did not exist until then), to make it more expensive for the banks (National Bank of Georgia, 2010c, pp. 78–79). It also raised the minimum reserve requirement for foreign currency money from 5 to 15% (National Bank of Georgia, 2011, pp. 45–46).

When price stability becomes the key priority for a central bank, the question is to what extend the central bank can influence inflation. The Georgian National Bank identifies following drivers for inflation: prices on key products like sugar or petrol on international markets, oversupply of money, external shock that might hinder the production and increase the prices, indirect costs like increased value added tax (VAT), nominal exchange rate and level of competition in certain sectors of economy (as oligopolies and monopolies might lead to increase in prices) (National Bank of Georgia, 2008a, pp. 18–20). Georgia has a high non-core inflation, as it relies on oil and food imports (Economic Policy Research Center, 2012, p. 21). Food inflation is often more volatile, persistent and higher compared to other goods' inflation. Therefore, developing countries accommodate food prices with a relatively large share in the consumption basket (for the Georgian case it was 30% in 2012) (Economic Policy Research Center, 2012, pp. 31–32). See (National Bank of Georgia, 2010a, p. 20). Remittances also influence inflation. This money is mostly spent on imported goods in Georgia, as "largest share of remittances are believed to be used for consumption and little for saving and investments" (Economic Policy Research Center, 2012, p. 24). Furthermore, as remittance recipient families often exchange Dollar to Lari, they influence the increase of demand on Lari. Further sources of inflation can be fiscal deficit and external state debt. Fiscal deficit is directly linked with increased foreign debt as it is mostly financed through borrowing (Economic Policy Research Center, 2012, p. 26). 25-26

Thus, if the main aim of the central bank is to control inflation, which of these factors can it really influence? The National Bank of Georgia has no influence on the rise of prices on international markets, exogenous shocks or taxes. Its influence on competition on the market is limited. The NBG cannot affect remittances and FDI. Thus, the key factor, it could influence is the nominal exchange rate. Yet, currency stability is neither the primary aim of the Georgian central bank, nor is the exchange rate its main policy tool. Charaia and Papava identify further limitations for fighting inflation in Georgia. As 80% of products in the consumer basket are imported, the NBG can address price changes or imported inflation to a limited extend only (Charaia & Papava, 2017, p. 98). Inflation targeting regime faces more challenges in developing countries compared to developed countries, as it is meant to tackle demand driven inflation (Economic Policy Research Center, 2012, p. 30).

Thus, the shift to inflation targeting and the limitation of policy tools to interest rate made it visible for the Georgian central bank that its power was declining. It was probably no coincidence, that it initiated a de-dollarization program in 2010, to improve the effectiveness of monetary policy (National Bank of Georgia, 2011, pp. 9–10). In 2010, the NBG enforced strict monetary policy through increasing interest rate and reserves for loans issued to non-residents, also in foreign currency (National Bank of Georgia, 2010d, pp. 9–10).

Price stability vis a vis currency stability in a dollarized economy

Under inflation targeting the exchange rate should be floating and a central bank is supposed to influence exchange rate only if its fluctuation creates issues for price stability (Epstein & Yeldan, 2008, p. 138). While monetarism allows management of flexible exchange rates, inflation targeting does not consider such interventions necessary, and the exchange rate is left to the market to be defined (Acosta-Ormaechea & Coble, 2011, p. 3; Gabor, 2010, p. 815). Thus, inflation targeting regime is in general not useful for dollarized economies, because the exchange rate becomes subordinated to inflation control as a policy instrument (Kaltenbrunner & Painceira, 2017, p. 453). The effectiveness of interest rate as the only policy tool for central banks is especially questionable in the context of dollarization, where the volatility of the exchange rate has a direct impact on firms and households indebted in a foreign currency. According to Kaltenbrunner and Painceira, in the presence of inflation targeting, exchange rate management and free capital account does not function. Empirical research shows that developing and emerging economies influence exchange rates during fluctuations under inflation targeting. Nevertheless, a combination of inflation targeting, exchange rate management and liberalized capital account is not successful (Kaltenbrunner & Painceira, 2017, p. 454), as price and currency stability under free capital inflows make an impossible trinity. By now, the

IMF also recommends interventions into the foreign exchange market, but inflation shall remain the prior aim for central banks (Kaltenbrunner & Painceira, 2017, p. 458).

Inflation targeting weakened the Georgian central bank through replacing its role on the currency market by commercial banks. The Georgian central bank was also restricted from intervening into the foreign exchange market, other than if temporary inflow of foreign capital would cause short term volatility of the exchange rate, or for increasing international reserves (Baiashvili, 2015, p. 55). Before 2009, the National Bank of Georgia was the main actor on the local currency market; its interventions accounted for 86,6% of the total turnover of FX market in 2007 (National Bank of Georgia, 2008b, pp. 23–24). If in the first half of 2009 the share of the NBG intervention on the market was between 75% and 85%, in the second half of the year it declined to 5 to 20% (National Bank of Georgia, 2009, p. 47). The share of the NBG in buying and selling foreign currency declined four times in 2010-2011 in comparison with 2008 (National Bank of Georgia, 2011, p. 11). After the shift towards exchange auctions, the volatility of Lari exchange rate increased (National Bank of Georgia, 2010d, p. 80).

The 2015 Lari crisis was a nice demonstration of incompatibility of inflation targeting priorities with dollarization Political implications of Lari depreciation in 2015-2016 crystallised power tensions between the government and the central bank, government, opposition parties and the role of the IMF. In 2015 Lari lost almost 50% of its value (World Bank, 2018, p. 6), that severely impacted firms and households indebted in foreign currency. Yet, the president of the NBG was avoiding the responsibility of managing the exchange rate, as the currency depreciation had not affected price stability (Kharadze, 2015) As the foreign currency debt burden surged and the opposition parties started to criticise the governing party for its inability to solve the issue, the government started to put pressure on the central bank to intervene in the foreign exchange market. This turned into a major conflict between the government and the central bank, and the parliament tried to remove the banking supervisory function from the NBG (Civil.ge, 2015a). Yet, international organisations, local NGOs, business associations called on the government not to limit the central bank power and independence (Civil.ge, 2015b; Transparency International Georgia et al., 2015) After the president of the central bank was eventually changed in 2016, the NBG follows inflation targeting in a more flexible manner as its interventions into the currency market have increased to counteract Lari depreciation (International Monetary Fund, 2017, p. 3).

Accumulation of reserves and original sin

After adopting inflation targeting, the Georgian central bank started accumulation of international reserves through foreign debt, which is a common issue for developing countries. Empirical data shows that countries increase their foreign exchange reserves after adopting inflation targeting, which in fact, they shall not be doing, as central banks should not intervene in exchange rate markets (Epstein & Yeldan, 2008, pp. 137–138). Reserve accumulation (usually in US Dollar) occurs through rising domestic debt for most countries in the periphery, as they usually suffer from current account deficits (Painceira, 2009, pp. 13–16). Kaltenbrunner and Painceira refer to this kind of relations in reserve accumulation in US Dollar as ‘subordinated’, where the reserves are supposed to balance out negative influences of capital inflows on domestic liquidity, asset prices and exchange rate, as well as ensure the readiness of the economy for capital flight into other currencies with higher liquidity (Kaltenbrunner & Painceira, 2017, p. 8).

Georgia also finances international reserves through loans from international institutions. However, most of this debt is in foreign currency (95% of Georgian foreign debt was denominated in foreign currency in 2015 (Mkhatvrishvili, 2016), that leads to the issue of original sin and dollarization persistence (see (Eichengreen & Hausmann, 1999). According to Eichengreen, Hausmann, and Panizza, original sin is “the inability of a country to borrow abroad in its own currency” (Eichengreen et al., 2007, p. 122). Thus, the accumulation of international reserves not only leads to debt surge in peripheral economies, but it also encourages dollarization.

Reserve accumulation through borrowing leads to the rise of domestic debt, as central banks sterilise to tackle the impacts of foreign capital inflow on inflation. When central banks increase foreign exchange reserves for the sake of stabilisation, the monetary base increases. As the foreign capital inflow can cause the appreciation of the exchange rate, central banks try to sterilize to avoid this affect. However, central banks usually pay more on their domestic liabilities than receiving profit from FX reserves (Helleiner, 1997, p. 7).

International reserves can also be denominated in Special Drawing Rights, which is an asset created by the IMF in 1969. However, the value of these assets is also based on the basket of 'key' currencies: US Dollar, Euro, Chinese Renminbi, JapaneseYen and British Pound sterling (International Monetary Fund, n.d.). Thus, reserves are accumulated in the currencies of developed countries, which resembles the core-periphery relations in the international monetary system. This kind of power relations explain how the United States could afford strong currency along with constant current account deficit (Eichengreen, 2004, p. 4). Developing countries usually invest reserves abroad, so that this capital is not used productively. Foreign exchange reserves are mostly invested in low-risk assets of developed countries (Often these assets are US treasury securities). Therefore, despite capital flows to developing countries, net capital inflows are often negative (Painceira, 2009, p. 13). Georgia also invests reserves in developed government and international organisation bonds or keeps them at the banks with best ratings. For example, in 2006, most of the reserves were invested in government bonds of Germany, Belgium, France, as well as in the assets issued by international banks (National Bank of Georgia, 2006b, pp. 44–46).

Besides currency hierarchy and dollarization, borrowing money from international organisations also creates a debtor-lender relation with disbalanced power base. For example, in 2008, the Georgian central bank mainly filled the reserves through purchases on the interbank market, money earned through privatization and by managing international reserves (National Bank of Georgia, 2008a, p. 32). In 2009 reserves were filled through the IMF tranche, WB and Asian Development Bank's loans, as well as privatization (National Bank of Georgia, 2009, p. 11). In 2011 main sources of reserves were: currency interventions, WB loan, EU grants, other loans and grants of international institutions and donor states to the ministry of finance (National Bank of Georgia, 2011, p. 11). Such dependence on foreign donors paves a way towards the power of international organisations in central bank policies in Georgia.Thus, accumulation of reserves for Georgia has two major negative implications: it leads to the debt surge and asthis debt is denominated in foreign currency, that encourages dollarization persistence.

Conclusion

Financialization of the monetary policy is interlinked with inflation targeting. In a peripheral dollarized economy its implications are articulated in the tensions between price and exchange rate stability. Monetary policy becomes ineffective under inflation targeting, as the interest rate is a futile tool when the dollarization rate is high, and most banks are in foreign ownership. Moreover, inflation targeting weakens the central bank as an institution, as its role at the currency market is replaced by commercial banks. Here, the value of the national currency turns into an object of potential speculations and actors like commercial banks acquire more power. Financialization of monetary policy hinders de-dollarization as currency stability becomes subordinated to price stability aims. It also directly encourages dollarization through demanding increase in international reserves, which leads to the rise of debt in foreign currency in peripheral economies and original sin.

Dollarization persistence was encouraged by financialization of the monetary policy in Georgia. Financialization weakened the central bank and limited its policy space. After the shift to inflation targeting in 2009, the National Bank of Georgia was constantly facing dilemmas of dollarization and price stability aims. Exchange rate stability was not the top priority of the NBG. The central bank could influence the Lari market only due to dollarization and commercial banks were not interested in refinancing loans of the central bank due to excess liquidity in foreign currency. Even though a de-dollarization strategy was adopted in 2010, monetary policy remained under multiple constraints and dilemmas of exchange rate stability, inflation targets and current account deficit. Monetary policy in Georgia was a terrain of struggles among contesting interests of international capital, commercial banks, the Georgian government, and international organisations (see Table 1).

Monetary policy is not shaped by the central bank only. It tries to counteract the influences of foreign and local capital, government and international organisations. The state represents the key vessel of these relations, but it also keeps its agency. While local government exercises power over the central bank, especially in transition countries with socialist experience, it also accepts inflation targeting and de-politicization of the central bank to keep the FDI-led accumulation regime going. Thus, the analysis of monetary policy in a neoliberal dollarized state demonstrates how the power relations are outplayed among the political society and capital on the local and global levels. Here the issue of dollarization becomes secondary and the process of financialization further encourages dollarization persistence due to the financialization of monetary policy and increased foreign currency lending.

The shaping of central bank policies in peripheral countries requires further research, to unfold the power relations and define the character and patterns of financialization in these countries. The embeddedness of this analysis within the state theory can open further analytical areas than governments and financial markets, and provide novel insights for the conceptualisation of financialization, as well as counter strategies for de-financialization.

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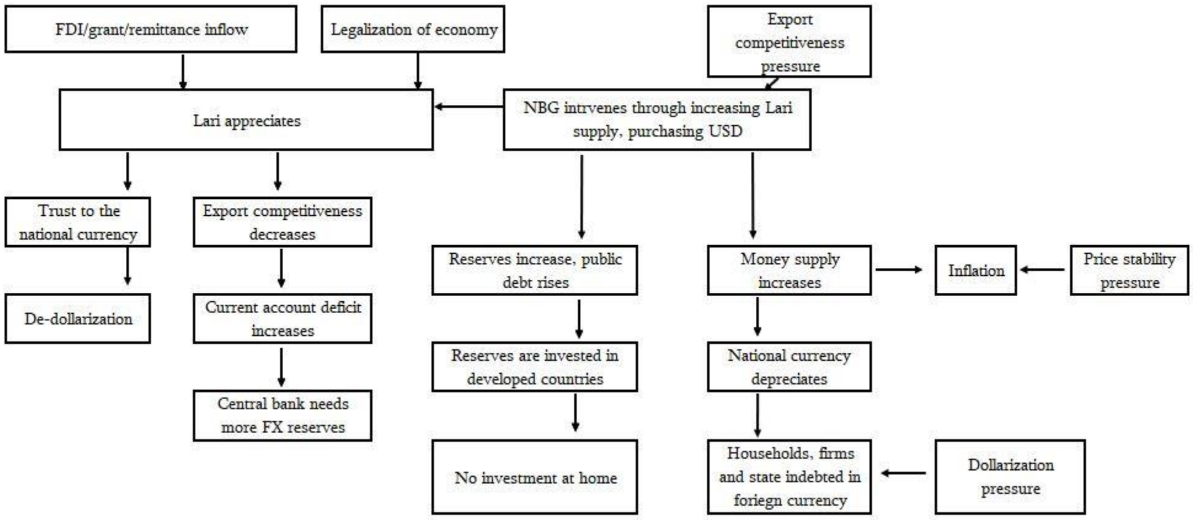
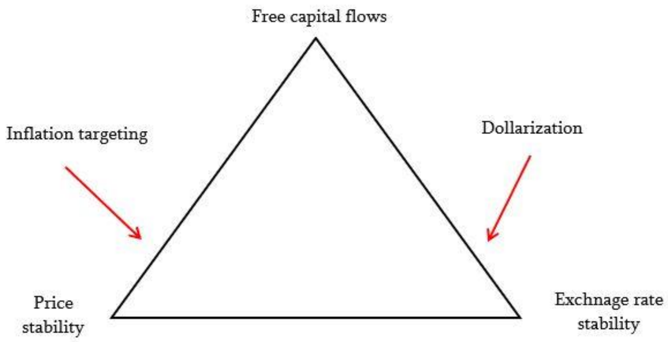
Figure 1 Central bank dilemmas in Georgia, 2004-2007 (Page 9)



Source: author's illustration, based on the literature discussed in this section

Figure 2 Impossible trinity under dollarization and inflation targeting pressures (page 11)



Source: Author's version of Mundell and Flaming's trilemma, based on (National Bank of Georgia, 2008a, p. 18).

Table 1 Dimensions and patterns of financialised monetary policy in Georgia (Page 17)

Financialization of Monetary Policy: Inflation Targeting

Central Bank independence	**Interest rate as the main tool**	**Price stability as the main aim**	**Accumulation of international reserves**
Depoliticization of monetary policy	Subordinating exchange rate to interest rate; more power to commercial banks on foreign exchange market	Subordinating growth and employment to price stability aim	Reserve accumulation in foreign currency, usually through debt
Monetary policy and dollarization out of scope of political debate	Weakness of interest rate tool due to dollarization and foreign ownership of banks; avoiding interventions in the foreign exchange market	Economic growth and development of export sector essential for a strong currency	Increase of foreign debt in foreign currency