Available online at www.sciencedirect.com

SciVerse ScienceDirect

Procedia - Social and Behavioral Sciences 62 (2012) 1303 – 1307

Procedia
Social and Behavioral Sciences

WC-BEM 2012

Changing of the investment climate of georgia after the war

Faruk Gursoy*

Department of Economics, International Black Sea University, Tbilisi, 0131, Georgia.

Abstract

This study aims to investigate factors determining flow of FDI in Georgia, especially after the war with Russia. The key point of the analysis is the impact of stability of economic and legal environment on the pattern of FDI. I also tried to examine in this paper the changes of investors' opinion concerning the investment climate of Georgia after the war and global finance crisis in 2008. This work, I believe, will also fill the knowledge gap in the area of foreign direct investment (FDI) research on Georgia. The analysis focuses on major obstacles faced by investors. I first identify and then quantify the major obstacles for both foreign and domestic investors using the case studies of investors in Georgia and the statistics obtained from these data. The study results indicate that the most serious problem for investors is the political instability. I also found that the issues such as government regulations (regulatory burden), infrastructure, safety or corruption do not act as major deterrents of FDI inflows, especially after the successful reforms of the Saakashvili government. It was also found that most investors have been satisfied with their operation.

Key words: investments climate, foreign direct investment, Georgian economy

1. Introduction

Despite facing a lot of difficulties Georgia has impressed the whole world with the improvements made in the present century, and it has become a good example for others to follow. A lot of countries are willing to learn from Georgia, and to uncover the secrets of rapid economic growth. However, economic statistics of the Soviet and the post-Soviet periods in Georgia are difficult to evaluate due to the country's underground economy.

In order to analyze and evaluate the reasons Georgia grew from the Soviet country into the economically fast-growing nation, we should carefully look at the specific time frame: the years of 1990 to 2003, prior to the revolution and year of 2004 to 2011, post revolution. In my research, the analysis of this segment of time will be provided, dividing it into two distinctive phases: the years of disregarding economics (1991-2003), and years of economic growth (2004-2011). In the last part of the study, results of the survey, that analysis the investment climate of Georgia after the war, will be presented

* Department of Economics, International Black Sea University, Tbilisi, 0131, Georgia.
Email: fgursoy@ibsu.edu.ge

 doi:10.1016/j.sbspro.2012.09.223

2. Phase One: Disregarding economics (1991-2003)

Like many other post-Soviet countries, Georgia as well had to go through a period of sharp economic decline during 1990s. During the Soviet period, Georgia was an important supplier of food products and minerals and it was the main touristic attraction. Moreover, the country was also dependent on imports to provide products vital to industrial support. When the instability was ruling the Soviet Union, Georgia no longer had reliable sources of those products; there was political instability in the country, followed by the dramatic decrease of investments. All the above-mentioned factors led to the fall of Net Material Product (NMP) by 12 % in 1990.

Political turmoil following Georgia's independence had a catastrophic effect on the country's economy. The cumulative decline in real GDP is estimated to have been more than 70% between 1990 and 1994, and by the end of 1996, Georgia's economy had shrunk to around one-third of its size in 1989.

In the first half of 1994 the government didn't have a determined pattern of reforms, carefully and well-constructed plan. Despite the several attempts the main aims were not reached and severe economic conditions remained unchanged. Obviously, the failure was caused by serious reasons such as: political instability after the restoration of independence, the conflict of interests, the lack of experience, corruption and so forth.

In September of 1995 the most important reform was taken-the establishment of new national currency, the Lari (GEL). The attempt of liberalizing prices was also taken in 1993 but it turned out to be aimless because of the establishment of interim currency or coupon which led to the hyperinflation. Since the main problem, inflation, was solved and the currency became stable, the ball started rolling which is obvious from the statistics. In 1998 the foreign investment reached 27%, unemployment rate was 12%, during the second phase the average GDP growth rate reached 29% (from GEL 4.442 Billion in 1994 year to GEL 5.729 Billion in 1998).

Other significant reforms except liberalizing prices and the establishment of national currency were enterprise privatization, improvement of foreign trade, development of bank and payment system, deepening international economic relations, etc. The reforms were implemented with the help of International Monetary Fund (IMF) and the World Bank (WB).

Despite all the problems, Georgia managed to achieve high rate of GDP growth (11.1%) in 2003. This was mainly because of the construction of the Baku-Tbilisi-Ceyhan oil pipeline. The state budget deficit continued and reached $90 million in 2003, which later grew to $120 million. Monthly pension amounted to only $7.[†]Such bad conditions spread dissatisfaction among the population and the ground for the revolution was prepared.

If we sum up this period of post-Soviet Georgian economy, according to statistics from 1999 to 2003, GDP growth rate was approximately 26% (1999 – 2.96%; 2000 – 1.937%; 2001 – 4.7%; 2002 – 5.5%; 2003 – 11.1%), investments have increased from 26.471% (1999) to 32.511% (2003) but we can't say the same thing about unemployment. Unemployment in 1999 was 12.697% and it had only slightly decreased to 11.562% in 2003.[‡]

3. Phase two: Promising Economic Growth (2004-2011)

Georgia opened a new white page with new government. After the Rose Revolution, Georgian economy started to increase thanks to introduction of political and economic stabilization programs, which involved the strengthening of central authority, decline of crime rates, fighting effectively against corruption, competitive trade regime, low taxes and acceleration of privatization.

[†] Vladimer Papava, "The Political Economy of Georgia's Rose Revolution", *East European Democratization*, Fall 2006
[‡] Statistics were taken from: http://www.economywatch.com/economic-statistics/country/Georgia/

In order to build a competitive trade regime, there was a need to have deep reforms in the system of taxation. Number of taxes decreased to six from twenty-one. Custom procedures also decreased from fifteen to only seven. There had been some tax cuts, like the VAT was reduced from 20% to18%, profit tax was lowered from 20% to 15% and tax on dividends was also decreased from 10% to 5%. Georgia was selected as the 4th least tax-burdened country by Forbes Magazine in 2008. Number of import tariffs decreased from 16 types to only three types, 0%, 5% and 12%. Total number of licenses has decreased by 84% recently. Georgia has preferential trade regimes with major partners, including the EU, the U.S. and free trade with CIS countries and Turkey.

Georgia is doing its best in order to promote the establishment of new enterprises, such as developing the infrastructure by building nationwide networks of roads, railways and airports. In addition, it is worth mentioning that setting up a business in Georgia needs only one day.

The reforms that Georgia launched has shown the successful results and recognized by international organizations. According to International Finance Corporation (IFC) and World Bank survey results in 2006, Georgia became the top reformer in the CIS region. Georgia is ranked in the 11th place for the "ease of doing business" in 2010 by World Bank. When we compare that Georgia was only in the 112th place in 2005, we can say that reforms were successful.

Additionally, according to Transparency International`s Corruption Perception Index (CPI), Georgia ranks 127th place in 2003. The same organizations 2010 results rank Georgia in the 66th place out of 183 countries. In comparison, Armenia ranks 123th and Azerbaijan is 134th place. According to the Heritage Foundation's Index of Economic Freedom for 2010 , Georgia improved its rating in 26 place, for the first time changing its status from " mostly un-free" to "mostly free". According to the data, most EU countries have the same degree of economic freedom. Georgia is ranked 14th out of 43 countries in the Europe region, and its overall score is higher than the world average.

With the implementation of sweeping economic reforms, investment climate became attractive for the foreign investors. As result of these effective reforms, you can see from the table 1, FDI and GDP increased each year. GDP reached its high record level, $12.8 billion in 2008 since independence. GDP growth rate, 5.9% in 2004 jumped up to 12.3% in 2007. In spite of the fact that Georgia had twin crises in 2008, the economy grew up more than the expectations, 6.4% in 2010.

Table , Macroeconomic Indicator of Georgia from 2004 till 2010

	2004	2005	2006	2007	2008	2009	2010
GDP Growth(Bil.USD)	% 5.9 (5.1)	% 9.6 (6.4)	% 9.4 (7.7)	% 12.3 (10.1)	%2.3 (12.8)	% - 3.9 (10.7)	% 6.4 (11.7)
Inflation Rates	7.5	6.2	8.8	11	5.5	3	11.2
Unemployment Rate	12.6	13.8	13.6	13.3	16.5	16.9	16.3
FDI (Mil.)	499.1	449.8	1190.4	2014.8	1564	658.4	553

As mentioned by Gursoy and Kursun (2008) in their survey study that the issues such as government regulations (regulatory burden), infrastructure, or safety do not act as major deterrents of FDI inflows in Georgia, especially after the successful reforms of the Saakashvili government.

The inflow of FDI almost doubled in 2007, reaching 2.01 billion, which was 19.8% of GDP. However, the global financial crisis coupled with the August war in 2008 and their aftermath had impeded growth. FDI decreased to $1.56 billion in 2008 and fell further to $658 million in 2009 and $553million in 2010. This is just 4.4 % of GDP, not only well below the pre-crisis level but also at a record low level since 2005.

4. The Questionnaire

The study was conducted among 60 companies, from Tbilisi in September, October, November and December of 2010. Out of 60 companies, 46 are foreign and 14 are domestic ones. Sectoral breakdown of the companies is as follows: Trade and Retails (24), Manufacturing (17), services (6), transport (4), energy (5), and banking (4). Most of them were large companies (30), medium size (20) and small ones (10).

Table 2 shows summary statistics of the responses on the obstacles. Responses (and thus, mean scores) are based on a five-point scale ranging from 0=No Obstacle to 4=Very Severe Obstacle.

Table 2, Basic Summary Statistics for Investment Climate in Georgia

Obstacle	Mean Score	Number of Responses (out of 64)
Economic and Regulatory Policy Uncertainty	2.37	59
Macroeconomic instability (inflation, exchange rate)	2.33	60
Cost of Finance (interest rate)	2.00	57
Skills and Education of available workers	1.63	60
Tax administrations	1.34	59
Access to Finance	1.33	54
Tax rates	1.27	60
Customs and Trade regulations	1.10	58
Crime, theft, and disorder	0.95	59
Transportation	0.92	59
Anti-competitive or informal practices	0.84	57
Business Licensing and Operating Permits	0.80	50
Corruption	0.76	59
Electricity	0.73	60
Access to Land	0.68	57
Labour Regulations	0.63	59
Telecommunication	0.59	59

The highest mean score (2.37) was for the statement that the biggest obstacle for investing in Georgia is economic and political uncertainty. Second biggest obstacle for investors is the macroeconomic instability (2.33). We must consider the fact that survey year was just after the political causes, demonstrations in Tbilisi.

My survey also proves that corruption is not a severe obstacle for investors in Georgia, as it was mentioned by the Transparency International`s Corruption Perception Index.

Some suggestions on what measures can be taken to encourage investment in Georgia is given in the figure1.

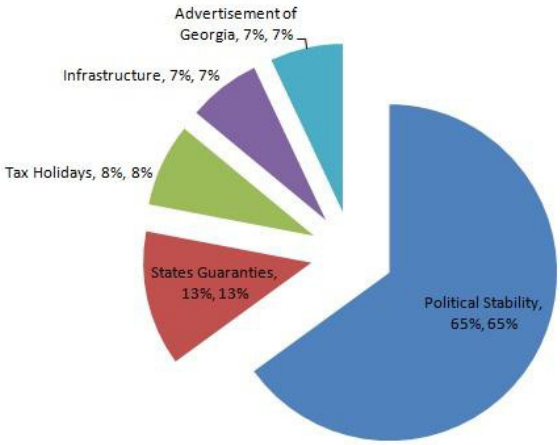

Figure 1 , Some suggestions to encourage investment in Georgia

5. Conclusion

The pre-revolution (1991-2003) economy of Georgia was ambiguous and very instable. During the 12 years, Georgia met the economic fall which was caused by disregarding economy, then 4 years of improvement and reforms which were again replaced by the depression and corruption. The reasons and causes of failures are considered to be political condition, complicated relations with Russia, corruption, racket and so forth. Implementation of effective reforms brought economic and political stability in the country after the rose revolution, changing the investment climate in Georgia. In order to have better growing economy, Georgian and the foreign experts are suggesting that Georgia should provide better conditions as well as identifying and promoting the most promising business sectors.

References

Economist. 1993. “Just Awful.” 326, Issue 7798, (February 13, 1993): 56.

Farrell, Diana; Jaana K. Remes, and Heiner Schulz. 2004 “The Truth About Foreign Direct Investment in Emerging Markets,” The McKinsey Quarterly, (1): 25-35.

Foreign Business in Georgia, “Investment”, Winter / 2007, Tbilisi, 2007.

Georgian Business Week, “Liberalization of Customs Tariffs Increases Investment Attraction of Georgia”, Weekly Bulletin of News and Analysis, September 4-10, Tbilisi, 2006.

Invest in Georgia, Georgian National Investment and Export Promotion Agency, Tbilisi, 2006.

Investor’s Guide to Georgia, Ministry of Economic Development of Georgia, Tbilisi, 2006.

Ramaz Abesadze, “Economic Development and Its Characteristics in Post-Soviet Georgia”, Tbilisi, “Metsniereba” 2003

USAID, Business Climate Reform, “Attracting Foreign Direct Investment”, Tbilisi, May 2006.

Vladimer Papava, “The Political Economy of Georgia’s Rose Revolution”, *East European Democratization*, Fall 2006

http://www.economywatch.com/economic-statistics/country/Georgia/