FDI Declines in Georgia

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Abstract

Following an unprecedented surge in foreign direct investment in 2007, Georgia is suffering from a gradual decline in FDI inflows. Both local and international experts are unanimous in noting that the country is facing a tough challenge to either achieve a strong rebound of FDI or stimulate growth in high potential sectors of the economy in order to sustain the GDP growth rate and fully restore investor confidence.

Far Below Expectations

Despite extremely poor investment opportunities locally, the attraction of foreign direct investment has been one of the key priorities for the Mikheil Saakashvili government ever since it assumed power in 2003 and launched sweeping economic reforms. According to government estimates, Georgia's economy needs an annual injection of approximately $2 billion in foreign capital to stay afloat. It achieved this goal in 2007. Driven to a large extent by privatization, FDI inflow more than doubled that year, reaching $2.15 billion, which was 19.8% of GDP.

Credit for that skyrocketing foreign capital inflow should go to the government's efforts to streamline business regulations and reform the tax system, which left just six taxes instead of the initial 21, and only seven out of 15 customs procedures. Tax cuts have also played a role: VAT was reduced from 20% to 18%, profit tax from 20% to 15% and tax on dividends was lowered from 10% to 5%.

However, the global financial crisis coupled with the August war in 2008 and their aftermath have impeded growth. FDI nosedived to $1.56 billion in 2008 and fell further to $658 million in 2009. Despite such a dark picture, the government remained optimistic, with Prime Minister Nika Gilauri forecasting $1.2 billion in foreign capital inflows in 2010. But again, the target was missed. According to the preliminary figure released by Geostat, Georgia's state statistics office, FDI plummeted by 16% year-on-year in 2010 to $553 million. This is just 4.7% of GDP, not only well below the pre-crisis level but also at a record low level since 2004.

Georgia—A Model Reformer

Standing at a relatively low 5.9% in 2004, Georgia's GDP growth rate climbed to 12.3% in 2007. It is believed that without the government's success in creating a business-friendly climate and stamping out corruption this would have been impossible.

Investing Across Borders, the World Bank Group's initiative which measures the regulation of FDI, states that Georgia is one of the most open countries for foreign investors. The report argues that countries performing well on its indicators tend to attract more FDI relative to the size of their economies and population. According to the report, in Georgia business start-up procedures take "less than a week" (4 days), while in Haiti and Angola they can take half a year; In Georgia it takes 50 days to lease land from the government, while accomplishing the same task requires 351 days in Bulgaria.

Georgia became the top reformer in the CIS region in 2006, according to the World Bank and International Finance Corporation (IFC) annual survey which ranks countries on regulations that influence the overall business environment. *Doing Business 2011: Making a Difference for Entrepreneurs* declared Georgia to be one of the world's top 10 *Doing Business* reformers over the past five years, meaning that the country "made the largest strides" to make its regulatory environment more business-friendly.

In addition, according to Transparency International's Corruption Perception Index (CPI), one of the most credible yardsticks measuring corruption in the public sector worldwide, Georgia ranks 68th out of 178 countries. On CPI 2010 Georgia's overall score totals 3.8 against 2.2 in 2002, with 10 points being the most 'clean' and 0 being 'highly corrupt.' In comparison, Armenia ranks 123rd and Azerbaijan is 134th. Georgia ranks ahead of Montenegro, Serbia, Albania and Bosnia & Herzegovina—all EU-membership candidates.

Keeping the Economy Going

A major driver of the growth, FDI has been critical in financing Georgia's current account deficit during the last decade.

During the 2007 boom year, the current account deficit in Georgia was $2 billion, approximately 11.8% of GDP. In the wake of the crisis the lower demand in the external markets together with a dramatic drop in prices narrowed the current account deficit in 2009 to 11.7% of GDP and further to 10% of GDP in 2010.

The central bank of Georgia explained the improvement of the current account deficit by changes in the trade deficit. In 2009 the trade deficit narrowed by 32.5% to $3.24 billion from $4.56 billion in 2008, and increased only moderately—by 9%—in 2010 to $3.52 billion.

However, the current account deficit of 10% is still viewed as large in comparison to other emerging market economies in the region. Warning that for Georgia a shortfall in FDI in 2011 would thwart GDP growth and widen the fiscal deficit, international analysts such as the International Monetary Fund recommended reducing the current account deficit to approximately 5–6% of GDP over the medium term.

Unlocking Growth Potential

The Georgian government's vision is that in the post-crisis environment, relying solely on a resurgence of FDI may no longer be enough to power growth and that a more proactive approach is required. The local economists agree that in order to boost productivity and attract private investment the authorities should concentrate on sectors with high growth potential, such as agriculture and energy, among others.

Critics have repeatedly slammed the Saakashvili government for allowing the share of agriculture in GDP to plunge to 8.4% in 2010 from 14.8% in 2005. While over 50% of the vegetable and fruit consumed annually in Georgia are imports from foreign countries, FDI in this sector remains low—at less than 2% in 2010. Responding to this criticism in his annual address to the parliament, President Saakashvili vowed to double agricultural productivity by 2015, pledging that an additional 150 million lari ($90 million) would be channeled into the field.

The untapped potential of the energy sector looks equally impressive: while electricity exports in 2005 were approximately 122 thousand kW/h and were worth around $3 million, they exceeded 1 billion kW/h with a total cost of over $37 million in 2010. Last year Georgia exported 1,400 billion kW/h of electricity, which is 15% of total generation. The Ministry of Energy expects a dramatic increase, saying the country has the potential to export up to 5 billion kW/h electricity annually by 2016.

Foreign Capital: Key Players

In 2007 when Georgia's FDI inflow was at its height, the most attractive five sectors for foreign investors were transport and communications (20.7% of total FDI), industry (19.8%), energy (18%), hotels and restaurants (12%) and construction (8.5%). The Czech Republic, Netherlands, British Virgin Islands, Cyprus and Turkey were the top investors. That year Enego-Pro Georgia, the Czech company, became the biggest player on Georgia's power market after purchasing hydro power plants and distribution companies.

The preliminary statistics for 2010 show that foreign businessmen continue to invest heavily in transport and communications—35% of total FDI. The industry sector also remained appealing with 16.4% of total FDI, while the finance sector's share jumped to 16.2% from 6.8% in 2007 and real estate's share climbed to 15.3% from just 1.5% three years ago.

The top investor in 2010 was the Netherlands with $143.2 million of the total FDI. The United States came in second with $108.4 million. Russia took the third position with $51.3 million. International organizations were fourth with $50.2 million and Azerbaijan held the fifth place with $46.6 million. Over the past two years investors from the Netherlands were mostly engaged in the energy and financial sectors, while the United States was primarily interested in the transport and communications sector and industry. Russia was heavily investing in the transport and communications sector and the financial sector; the international organizations—mostly in the real estate and the financial sectors, Azerbaijan—in the real estate sector and transport and communications.

The United Arab Emirates, which was the biggest foreign investor in Georgia during the crisis—in 2008 and 2009—with $306.5 million and $169.8 million, respectively, fell to sixth place in 2010 with $39.9 million. UAE's state-owned Ras Al Khaimah Investment Authority (RAKIA) has invested mostly in large real estate projects.

Turkey was the second largest foreign investor in 2009 with $97.9 million. In 2010 its contribution to total FDI fell to $37.5 million—the 7th position. The key destination for Turkish capital has been transport and communications and construction. Turkey has also demonstrated high interest in Georgia's hydropower sector. Currently, the total number of ongoing projects in the hydropower sector is 30 with estimated investment over $3 billion. Out of these 30 projects, the Turkish investors are involved in the development of 16 and have expressed interest to engage in future projects as the Ministry of Energy keeps offering fresh proposals.

Stable Recovery Expected

In 2009 and 2010 the Georgian government focused on maintaining fiscal stability as well as attracting foreign investment inflows amid the drastically declining FDI globally.

After suffering a contraction of 3.8% in 2009, Georgia's economy grew by 6.4% in 2010, according to preliminary statistics. Fueled by a rebound of credit to the private sector and strong export demand, the growth in Georgia was one of the most impressive in the region (5% in oil and gas exporter Azerbaijan and 2.6% in oil and gas importer Armenia).

PM Gilauri has said that in 2011 the GDP growth "may range between 5% and 7%." This optimism, accord-

ing to him, derives from Georgia's ability to demonstrate that despite political and international shocks the economic fundamentals have proved strong enough to recover shortly.

With the private sector recovering, the government decided to withdraw fiscal stimulus and cut spending. As a result, the fiscal deficit narrowed from 9.2% of GDP in 2009 to 6.6% in 2010. Taking all these positive signs into account, international analysts' forecasts are positive. According to the April IMF report, the policy response of the Georgian government to the crisis was successful in stabilizing the economy and regaining confidence. "The economy is recovering at a solid pace," the report notes and predicts that as a sign of sizable fiscal improvement, the 2011 budget deficit will decline to 3.9%. GDP growth is projected at 5.5%.

Key Task: Higher FDI in 2011

At present attracting FDI tops the Georgian government's agenda with the forecast for FDI in 2011 at approximately $800 million. In the wake of the August war, the Georgian government's investment promotion campaigns—knowing that European investors tend to be wary of investing in conflict regions—mostly targeted the Asian countries, which are considered less cautious in this regard.

According to the Georgian National Investment Agency, which is responsible for developing the state policy for attracting FDI, Asian countries, in particular China and India, will remain the focus this year. Azerbaijan and Ukraine are also on the list, while priority sectors will be energy, tourism, infrastructure, agribusiness and textile.

Evaluating Georgia's opportunities to win back investors' confidence, the IMF considers that while the recovery of FDI has been slower in Georgia than initially anticipated, the overall position has continued to improve. By international standards, foreign investment inflows into Georgia are viewed as "quite respectable." In noting the progress, foreign analysts are cautiously optimistic. The IMF warns the Georgian government that the environment externally is likely to remain volatile. This means that the much expected rebound of FDI remains under a big question mark.

Conclusion

Prior to the twin crises, Georgia had witnessed a boom in foreign capital inflows. However, the shocks caused by the August war and global credit crunch dealt a big blow to investor confidence and entailed a continuing decline in FDI.

At present, the optimism of the Georgian authorities is centered on last year's stable fiscal position. This indicator, the government hopes, along with Georgia's internationally recognized business climate and the intensive investment promotion campaigns worldwide will help the country keep the trust of already established investors and attract fresh capital mostly from Asian countries.

In the medium term, as the risks linger, the key recommendation to the Georgian authorities from local and foreign experts is to provide better conditions for strong economic growth as well as to identify and promote the most promising business sectors.

About the Author

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