

## Georgia's Investment Strategy – Part I

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The growth acceleration and structural transformation have become major topics of interest as a result of economic shutdown due to Covid-19 pandemic. The expectations that the global supply chains would be immediately disrupted and the manufacturing would start relocating to other parts of the world (including in countries like Georgia) were not realized.

It is also true that relocating a production is a lengthy process, which is kept secret and may be finalized years after the negotiations have begun. Therefore, we may yet see the changes in the global supply chains as a result of Covid-19 to come to fruition.

Nevertheless, the factors, which [determine the relocation of the production](#) remain valid and important even during pandemic. Besides, despite the [advancement in world rankings](#), Georgia has a long way to go to increase the international competitiveness in order to attract FDI in manufacturing.

Within the context of growth acceleration and structural transformation, the importance of domestic sophisticated industries with strong export orientation has been discussed in detail in the [previous publication](#). The policies applied by some of the successful countries<sup>i</sup> to develop the sophisticated manufacturing (State-led top-down approach, subsidies, tariffs and limitation of competition) is not feasible in the current globalized world and is counterproductive most of the time. However, the strategy applied by these countries is valuable even today, that is, emphasis on the production of sophisticated products, maintaining competitive pressure, export orientation, long-term policy and prioritization.

Instead of the government's intervention in the market processes, the modern industrial policy is focused on the development of a long-term cooperation between the State and private sector where FDI can play a pivotal role.

In that respect, it is important to analyze new strategy adopted by Georgia for attracting FDI. This article aims to do this and provide additional approach, which entails the prioritization of a sophisticated industry, a focused

educational policy and a long-term strategy for developing the domestic capabilities. The second part of the article will discuss the policies aimed at developing the local capabilities and the role of FDI in this context.

### **FDI in Georgia**

The level of FDI and its ratio to GDP is frequently used as the measure of Georgia's competitiveness and investment climate. Since 1996, Georgia has attracted [USD 21 billion](#) in FDI.

By [definition](#), FDI includes purchasing by foreign investor of 10% or more of the voting powers in the domestic enterprise. The retained earnings of the domestic enterprise and the loans/credits issued by the investor to the enterprise are also included in FDI. This definition is contrasted with popular imagination that FDI necessarily entails creation of new production, hiring employees, transferring technology and other benefits. It is true that FDI is very important in terms of transfer of foreign currency in the country; however, purchasing of 10% of shares in a Georgian company or retaining the earnings does not necessarily result in the creation of new jobs or in launching a new enterprise. Therefore, identifying true benefits of FDI requires not only quantitative but also qualitative and detailed analysis<sup>ii</sup>

FDI has both [short and long-term benefits](#). In the short term, FDI brings in a foreign currency, increases tax revenues and helps improve the infrastructure. In the long run, FDI could facilitate the adoption of new technologies, creation of backward linkages and development of human capital. However, FDI's spillover effect is not automatically guaranteed and as the experience of other countries demonstrate, additional supporting mechanisms by the State may be required.

### **Spillover effect**

The long-term benefits of FDI depends on the spillover effects. This includes improving the capabilities of domestic firms by learning about new production techniques, management and business practices through demonstration and imitation<sup>iii</sup> as well as through linkages between the investor and domestic companies and by raising the skills and productive knowledge<sup>iv</sup> of employees.

The countries have used different policies to generate FDI spillover effect, which ranges from heavy form of intervention into the market processes by the State to more "softer" approaches. Interventionist policies include domestic content mandates, joint venture mandates and/or other technology-sharing pressures. In contrast, public sector "support" takes the form of creating industrial parks, reliable infrastructure, and vocational training<sup>v</sup>

In some countries, interventionist approach proved to be a success. In developing an oil and gas suppliers' cluster in the 1970s, Norway has understood that the existence of market failures and the lack of government failures would not be sufficient to develop domestic firms in the oil and gas industry. The state policies were quite interventionist. For example, the government intervened directly in the procurements of oil operators.

The Norwegian Petroleum Code imposed that operators communicate their lists of bidders to the government, which in turn had the authority to impose Norwegian firms and even to change which firm was awarded the bid. In addition, the licensing process required foreign operators to come up with plans to develop the competencies of local suppliers. Lastly, the government imposed a minimum of 50 percent of R&D needed to develop a field to take place in Norwegian entities. Although the restrictions were lifted in 1994 when Norway signed trade agreements with the EU, the government continued to support the suppliers. Eventually the suppliers' cluster became highly successful, including globally, spanning a large array of sophisticated industries such as subsea, geology, and seismic, developed the required skills, and employed directly about 114,000 workers in 2009, or more than five times the employment of the operators in the oil and gas sector<sup>vi</sup>

The policies adopted by Norwegian government may have been appropriate due to its position on the global market – the foreign companies were ready to accommodate the rules of operation in exchange for a potential big win (the right to extract oil). In absence of such market position, the acceptance of interventionist policies by the foreign investor is least likely.

Besides, in the modern globalized world it became much harder to carry out the interventionist policies. Cheap labour is more easily accessible than before and transnational corporations can largely pick and choose outsourcing locations. In addition, the interventionist trade measures [are largely prohibited](#) by WTO.

From this standpoint, for countries like Georgia more sensible approach is FDI attraction and development of domestic capabilities with less interventionist policies. The question is to what extent is the 'softer' approach actually effective in order to develop domestic capabilities? Experience of some of the countries, which have been in the similar position as Georgia, proves that this approach is feasible.

### **Sophisticated industries**

In 1996 Intel, the global producer of semiconductors and microchips, built a USD 300 million plant in Costa Rica employing more than 2000 people.

Three years after Intel entered Costa Rica it tripled its FDI to USD 1.3 billion. 72% of 61 multinational companies operating in Costa Rica reported that the Intel's decision to build a plant played an important signaling role for them to invest (36 in electronics, 13 in medical devices, 3 in business services, and 9 in other sectors). Within ten years of Intel's investment, Costa Rica's investment agency managed to attract new investments from 56 electronics firms, employing 11,000 workers. The country also targeted medical devices investors, attracting 23 firms, employing 6,000 workers. Western Union and chose Costa Rica to be its technical support center and Proctor and Gamble - for back-office services. As of 2014, there were some 250 multinational corporations operating in Costa Rica and the country competes with Chile as the most export-intensive economy per GDP in Latin America<sup>vii</sup>

In terms of population size, territory and resources Costa Rica is comparable to Georgia. In 1996 when Intel entered the country, the population of Costa Rica was 3.6 million. The area of the country is 51,100 square kilometers. It does not have natural resources nor populous, rich diaspora abroad. However, unlike Georgia Costa Rica has the experience of long-term peace and stability (since 1948 the country does not have a regular army). Costa Rica is an example how a small country<sup>viii</sup> can attract high technology firm.

Costa Rica's success, which resulted in the development of the electronics cluster, has become subject of much research and debate. Debora Spar, Senior Associate Dean of Harvard Business School Online prepared a great case study of how Costa Rica managed to attract Intel and develop an electronics sectors.<sup>ix</sup> In the following section we will draw on only a small part from this case study which concerns the priority sector and the education policy.

### **Priority sector and the education policy**

Once a developing country has liberalized its economy and begun to attract FDI a common mistake is to view the FDIs as isolated incidents. In such circumstances, the States can fail to appreciate the positive spillover effects the right kinds of investments can generate.

Costa Rica combated this by adopting a long-term view of the economic growth and evaluated an impact of each FDI to the countries overall economic development. In the 1980s, Costa Rica focused its investment promotion efforts on the apparel industry; however rising wages rendered this strategy uncompetitive. Instead Costa Rica targeted an electronics sector and specifically designed to attract investment from medium-and high technology foreign firms.

On the one hand, there is nothing new in Costa Rica's strategy of attracting high technology FDI. Many developing countries have tried this to increase the employment, capital flows and technological spillovers. Costa Rica differed from those countries in that it had not only a low-cost labor but a well-educated low wage labor pool. Costa Rica has always invested heavily in education and technological training. The country spent around 5% of its GDP on education and had an active bilingual ESL (English as a second language) curriculum.

After prioritizing the electronics sector, high schools and colleges were urged to develop higher technology curricula, with a focus on electronics. However, Costa Rica never tried to define precisely what the schools should teach. Instead, the government's strategy was to wait for firms from a particular sub-industry (for instance, semiconductors or disk drives) to come to the country, and only then to focus additional promotion and training efforts in those areas. This enabled the country to fully utilize and expand its educated labor potential, without risking all its resources on a single, narrow specialty.

### **Additional support**

Despite the high levels<sup>x</sup> of education in Costa Rica, Intel feared that the country's workforce did not meet Intel's requirements. The company required low-cost but highly trainable workforce and highly qualified engineers. In particular, it was necessary to train 800 technicians for assembly and testing plant. Besides, the competencies in English language, physics and chemistry were lower than expected.

Costa Rica knew that without addressing these challenges it would have been impossible to convince Intel to invest in the country. As a result, a team consisting of Intel Human Resources staff, Costa Rica's investment agency, the Minister of Education, the Minister of Science and Technology, and officials from national institutions of higher education was formed who spent considerable time identifying Intel's workforce requirements and matching those against the curricula of the country's technical high schools and advanced training programs

In addition, a group of four professors and two teachers made a six-week trip to Intel facilities in Arizona, New Mexico and Santa Clara. By speaking at great length to operators and technicians at the plants, they identified in specific terms the education and skills required to support an Intel workforce. After this, Costa Rica devised number of one-year certificate programs to raise the level of technical skills, physics, chemistry, and English language in the country.

### **Long-term strategy**

Costa Rica's electronics cluster was not created overnight, but developed gradually. After the country declared this sector a priority, small companies started to relocate to Costa Rica. Before Intel's arrival other multinationals, such as DSC Communications, Motorola, Conair, and Baxter Healthcare were already operating in Costa Rica. The recommendation from these companies played a decisive role for Intel to invest in the country.

Despite the success in the development of the domestic electronics cluster in Costa Rica, important challenges remain regarding the low capabilities of domestic firms and the limited spillover effect from foreign investments. However, Costa Rica's long-term strategy could be a good example for countries like Georgia.

Obviously, Georgia cannot repeat Costa Rica's path. There are important differences between the two countries, which renders any comparison limited at best. However, this does not prevent Georgia to adopt a long-term strategy to increase the level in STEM subjects in the country. Besides, it is not necessary to prioritize the electronics cluster or start attracting Intel itself. Nonetheless, a priority sector would help with better coordination, mobilization of resources and ensure a long-term cooperation between the State and the private sector.

### **Georgia's new investment strategy**

In December 2019, the Agency Enterprise Georgia presented an [updated strategy](#) to attract investments in Georgia. According to the strategy, the priority sectors include the hospitality and real estate, business process outsourcing (BPO), apparel and footwear, electronic equipment components, automotive and aerospace components.

The Agency aims to study 7000 companies, identify 700 from those and establish direct communication with them including by visiting these companies. The Agency hopes to attract up to 10 big and 20 medium size enterprises within the next three years. In addition, the Agency plans to establish a guarantee mechanism to help investors with employee training costs.

Selecting priority sectors and mobilizing resources to that end was a necessary step, which may indeed result in some of the enterprises relocating to Georgia. The compensation mechanism to train the employees would be an additional benefit for the investors. At the same time, these measures are for short-term and are not sufficient to develop the domestic cluster.

It is true that the compensation mechanism to train the employees is of great benefit for the investor; however, it shall be borne in mind that the investors primarily look at whether employees are trainable and what is the overall level of education in the country.

In light of the above, in addition to short-term policies aimed at attracting diverse set of enterprises, it is necessary to have a long-term strategy the key elements of which include a priority sector, education policy and FDI. In that respect, the State policy must be more active and synergetic.

### **Challenges**

One of the main challenges for developing the domestic sophisticated cluster is the adoption of new technologies and the diffusion of the productive knowledge. [Technology](#) is not only machines (equipment and devices) or codes (recipes, formulas, algorithms, etc.) but primarily a know-how, which is hard to acquire.

An advanced manufacturing in Georgia could seem a long shot; however, the seeds towards that end must be planted now. To that end, the fusion of the priority sector, education policy and FDI is pretty much realistic

Other benefits of the proposed strategy is that it may overcome the problem of continuity in public policy making. In particular, foreign direct investment and education is viewed as the most important drivers of growth in Georgia, which means that this strategy has the better chance to withstand the changes within the government.

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<sup>i</sup> These include the Asian Tigers - Taiwan (China), Hong-Kong (China), Singapore and South Korea

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- <sup>ii</sup> Manuel F. Montes & Jerik Cruz, “The political economy of foreign investment and industrial development: the Philippines, Malaysia and Thailand in comparative perspective”, *Journal of the Asia Pacific Economy* (2019)
- <sup>iii</sup> Jostein Hauge, “Should the African lion learn from the Asian tigers? A comparative-historical study of FDI-oriented industrial policy in Ethiopia, South Korea and Taiwan,” *Third World Quarterly* (2019)
- <sup>iv</sup> Ricardo Hausmann on Economic Complexity and Productive Knowledge, available at <https://www.youtube.com/watch?v=0JC24CBVsd0>
- <sup>v</sup> Jostein Hauge, supra note iii
- <sup>vi</sup> Reda Cherif and Fuad Hasanov, “The Return of the Policy That Shall Not Be Named: Principles of Industrial Policy”, IMF Working Paper, *Institute for Capacity Development* (2019)
- <sup>vii</sup> Theodore H. Moran, Industrial Policy as a Tool of Development Strategy: Using FDI to Upgrade and Diversify the Production and Export Base of Host Economies in the Developing World, *International Centre for Trade and Sustainable Development* (2015)
- <sup>viii</sup> In 2019 Costa Rica’s nominal GDP was USD 61 billion, three times more than Georgia’s GDP (USD 17.7 billion)
- <sup>ix</sup> Debora Spar, *Attracting High Technology Investment* (1998)
- <sup>x</sup> As of today, Costa Rica’s education levels are modest at best. According to PISA, Costa Rica’s average in math, reading, science is much lower than in OECD countries (<http://www.oecd.org/education/school/Education-in-Costa-Rica-Highlights.pdf>)