Research

Foreign Direct Investment Trends in Georgia

Economic Outlook and Indicators

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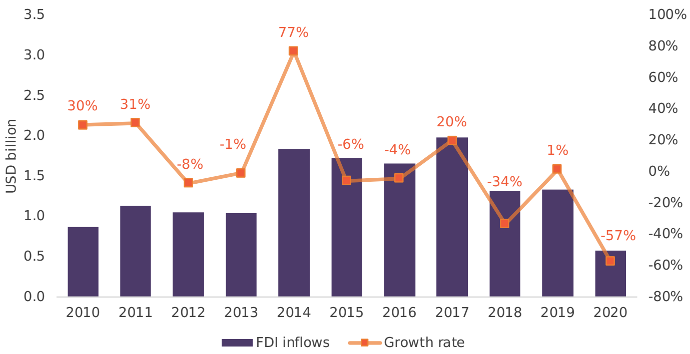
For developing countries, attracting foreign direct investment (FDI) has great potential to serve as a tool to achieve higher economic growth through reducing unemployment, increasing exports, boosting productivity, and improving capital inflows. During the last two decades, Georgia has adopted many reforms to eliminate obstacles in the way of doing business and to attract foreign investors. As a result, Georgia became one of the best performers in the world according to international indices on doing business and openness to investments, and recorded substantial growth in FDI, especially in the period of 2014-2017.

However, in recent years it has become clear that despite important progress being made, those reforms have not been sufficient to ensure a prolonged steady inflow of FDI (which has started to decline since 2017) nor have they maximized the potential gains from foreign investment (productivity and exports have remained low, while unemployment and poverty is still high). Apparently, behind Georgia's reputation as a great place to do business, there are important weaknesses in its economy that must be addressed by further reforms. The need for further changes has become even more urgent since the recent cancellation of the World Bank's "Doing Business" rankings[1].

The dynamics of FDI in Georgia and its growth rate, (2010-2020 FDI)



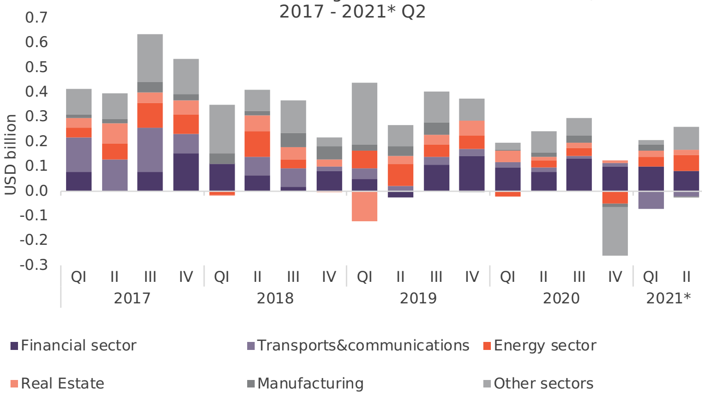
Source: National Statistics Office of Georgia

Against this background, we take a closer look at the trends regarding FDI in Georgia over the last decade and discuss weaknesses and gaps in this regard, as well as opportunities for future improvement and policy targeting.

In the second quarter of 2021, the volume of FDI entering into Georgia amounted to USD 234.2 million, which was 2.6% lower compared to the same quarter of 2020 but 77.1% higher compared to the first quarter of 2021. The total volume of FDI entering the country during the first six months of 2021 was USD 366.4 million, which represents the lowest volume of FDI for the first half of a year for the last 11 years. Geostat cited the reduction of the amount of equity and the transferring of ownership from non-resident to resident units in several companies as the main reasons for this marked decline in FDI. Meanwhile, even though the Georgian economy has started to recover from the crisis caused by COVID-19, the pandemic continues to be an important reason behind the decline of Georgia's FDI inflows in 2021.

In general, the pandemic has hit FDI inflows to Georgia harder than the economies of most other countries. In 2020, Georgia received its lowest volume of investments since 2005: USD 572 million, which was 57% lower compared to 2019. This fall (-57%) was significantly greater than the average FDI decline across the world (-34%) or for developing economies (-8%)[2]. The more moderate FDI decrease for developing economies on average has been mainly due to the resilience of flows into Asia (indeed, inflows into China have actually increased). Before this heavy hit of the pandemic, a declining trend in FDI was already evident. Specifically, while in 2014 FDI in Georgia amounted to USD 1.8 billion, by 2019 it was only about USD 1.3 billion, marking a 27% drop. Therefore, overall, the COVID-19 pandemic has merely exacerbated the problems and economic vulnerabilities that were already causing a decline in FDI inflows into Georgia. It should also be noted that the reduction to specifically occur in 2019 was related to the prior completion of the South Caucasus Pipeline Expansion upgrade, which subsequently led to a decline in BP investment, indicating that Georgia is highly dependent on individual projects.

Net FDI inflows into Georgia and the shares of sectors, 2017 - 2021* Q2



Source: National Statistics Office of Georgia, Calculations of PMC research

A particular problem can be seen by looking at the shares of different sectors in the net FDI inflows into Georgia. Most of the FDI since 2017 has gone to non-tradable sectors such as the finance, transport and communications, energy, and real estate. In Q2 2021, those sectors have received 62% of total FDI. Meanwhile, investments in tradable sectors, particularly in agriculture and manufacturing (including manufacturing of agricultural products), were extremely low in this period. Looking at stock FDI since 2017, only 0.3% of investments were made into agriculture and 8.9% to manufacturing. It should be noted that low investments in agriculture could be connected to the tightening of regulations on the foreign ownership of land in Georgia. Even though investments in this sector were low even before this restriction, these stricter regulations might have flashed a discouraging signal to foreign investors in a way that could produce long-term negative consequences on the investments in Georgia's agriculture.

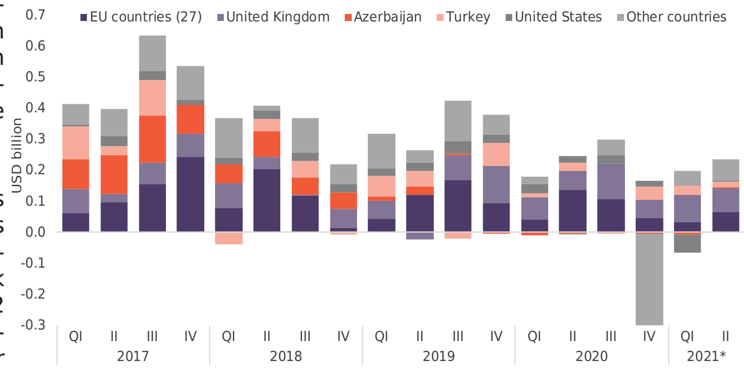
The problem here is that even though non-tradables are important contributors to economic growth, they are not characterized by significant job creation or productivity[3]. Accordingly, without development of tradable sectors, it might be impossible to facilitate broader and more stable economic growth and to fully grasp the positive benefits of foreign investment. This will require efforts on the part of the Georgian government to strongly encourage investments in the tradable sector[4].

The figures for the countries of origin of FDI inflows into Georgia during the first two quarters of 2021 show that 91.9% of investments were received from only five countries: United Kingdom (45.2%), Turkey (26.2%), Czech Republic (12.3%), Russia (10.5%), and Netherlands (10.1%). This means that FDI into Georgia is highly concentrated. Investments from the UK most likely mainly come in form of reinvestments from the one of the major banks operating in Georgia, Bank of Georgia, which is registered in the UK and whose investments are counted as FDI inflows. Moreover, analyses of country origins of FDI inflows helps to explain the large drop (USD -429 million compared to the previous quarter) down to the USD -134 million that occurred during the Q4 2020.

It can be seen that this decline has been driven by a fall in the FDI inflows from ‘other countries’, particularly from Panama, which in just one year dropped by USD 287 million. The reason behind is that Bidzina Ivanishvili, the country’s richest man and former prime minister, transferred a significant proportion of his businesses and real estate in Georgia, which he previously owned through a company registered in Panama, to the Cartu Foundation[5].

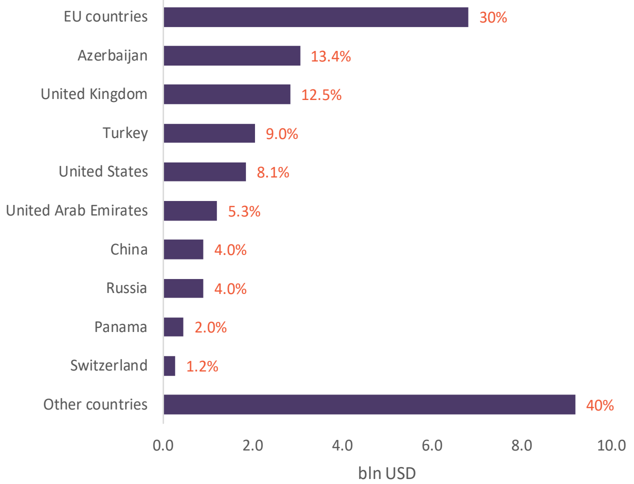
It should be noted here that, in recent years, large FDI inflows have been recorded from so-called offshore zones, such as Panama, the Virgin Islands, and the Marshall Islands. The investments from Panama were so large that looking at stock FDI in the Georgian economy by countries by the end of Q2 2021, Panama, which accumulated USD 460 million of FDI, remained among the biggest FDI partners of Georgia even after the aforementioned drop that occurred in 2020.

Net FDI inflows into Georgia and the share total FDI inflows by country, 2017 - 2021* Q2



Source: National Statistics Office of Georgia, Calculations of PMC research

FDI position (stock) by country and shares of countries in stock FDI by the end of Q2 2021*



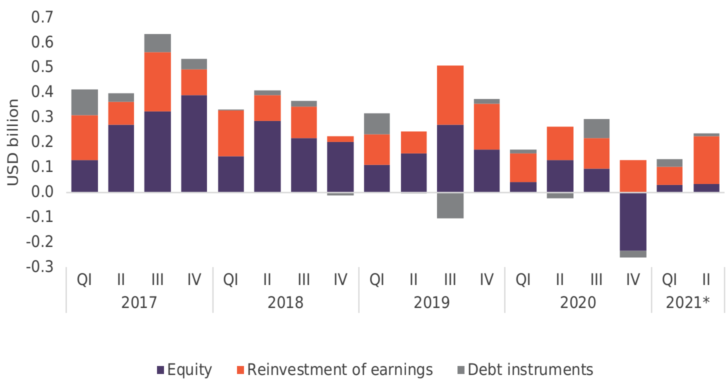
Source: National Statistics Office of Georgia, Calculations of PMC research

In general, it is common practice for businesses around the world to operate through offshore registered businesses, which poses a number of benefits for them, such as tax avoidance. However, data about the origin of FDI tracks only the country of registration of the company but not the ultimate beneficial owner. Therefore, it might be possible that Georgian citizens/residents are responsible for large amounts of FDI that officially comes from offshore countries, meaning that the figures on FDI into Georgia might be quite misleading[3].

In Q2 2021, the share of reinvestment in total FDI inflows into Georgia reached 81.4%, while equity accounted for only 13.9% (32 out of USD 234 million). Taking a general look at the components of FDI, it can be seen that equity investments in Georgia have been declining since 2019 and, in general, FDI has been maintained mainly on the expense of reinvestment of earnings . Interestingly, flows of the reinvestment of earnings have doubled from 2016 (USD3.1 billion) to 2017 (USD 6.2 billion), which can be partially attributed to the introduction of the Estonian taxation model into the Georgian tax system[6]. That reform represents a great example of how such successful economic policies can attract and retain foreign investors.

Meanwhile, recent data showed that there is an urgent need to introduce further effective policies. A wider understanding of where such policies should be targeted can be gleaned from looking at the opinions of the investors and businessmen themselves (for example, looking at the BAG Index which is based on the responses of member companies of Business Association of Georgia , and research by the OECD, GeoWel, PwC, and others[7]). In short, the main problems repeatedly highlighted in those reports were: investors’ lack of confidence in the judicial sector’s ability to adjudicate commercial cases independently or in a timely and competent manner; volatility of the national currency exchange rate; lack of competent labor force and especially a lack of technical and language skills; shortcomings in connectivity and quality infrastructure and particularly transport and digital infrastructure; and inefficient decision-making processes at the municipal level.

Net FDI inflows in Georgia and the shares of components, 2017 - 2021* Q2



Source: National Statistics Office of Georgia, Calculations of PMC research

To sum up, despite the introduction of some successful reforms and some notable achievements being recorded, there remain essential problems in Georgia that must be addressed by further reforms in order to attract and retain FDIs and to also effectively use those investments to achieve greater economic growth. FDI figures in Georgia during the last decade show a reduction in the share of equity investments and the high share of reinvestments in the FDI structure, which means that the inflow of new investments to the country has decelerated markedly. The above-reviewed data also imply a need to target tradable sectors and to diversify FDI markets, as Georgian FDI inflows are concentrated in certain countries and highly dependent on individual projects. Meanwhile, research and surveys of investors and businessmen have highlighted problems in the judicial sector, education system, and infrastructure, all of which will need to be swiftly and comprehensively resolved.

1. Source: https://www.worldbank.org/en/news/statement/2021/09/16/world-bank-group-to-discontinue-doing-business-report
2. Source: UNCTAD’s World Investment Report 2021: “Investing in Sustainable Recovery”
3. Source: Geowell’s “Why Doesn’t Georgia Export More to Europe: An Assessment of the Challenges of Enhancing Georgian Trade with the EU 2021”
4.It should be noted here that the process has partially started with the recent introduction of export oriented FDI grants that will be implemented by Enterprise Georgia. A range of products and services for attracting and supporting investments have not particularly targeted the tradable sector before and new grants can be viewed as a step in the right direction.
5. Source: https://bm.ge/en/article/ivanishvili-transferred-quotparagraphquot-quotpanoramaquot-quotelita-burjiquot-and-other-assets-to-quotcartu-fundquot/73103
6. At the beginning of 2017 Georgia alligned its tax system with the Corporate Income Tax (CIT) – the Estonian Taxation Model under which all businesses, except profit-sharing businesses, should be exempt from income tax.
7. Bag Index Q3 2021; PwC “Impact of COVID19 on the Georgian Economy Medium term Strategy for Recovery”; Geowell’s “Why Doesn’t Georgia Export More to Europe:”; US Department of State “2021 Investment Climate Statements: Georgia”

Basic Economic Indicators	2018	2019	2020	2021 Q1	2021 Q2
Nominal GDP (mln USD)	17 596.6	17 470.7	15 888.1*	3 402.3*	4 782.7*
GDP per Capita (USD)	4 722.0	4 696.2	4 274.6*	912.5*	1 282.7*
GDP Real Growth (%)	4.8%	5.0%	-6.2%*	-4.5%*	29.9%*
Inflation	2.6%	4.9%	5.2%	4.5%	8.3%
FDI (mln USD)	1 317.1	1 335.8	572.0	132.2*	234.2*
Unemployment Rate (%)	19.2%	17.6%	18.5%	21.9%	22.1%
External Debt (mln USD)	5 434	5 741	7 535	7 721	8 017
Poverty Rate (relative)	20.5%	20.1%	19.7%	-	-

*preliminary data