

# Investment Climate Analysis for Georgia

**Strengthening Institutional Capacity to Compile and Analyze Financial  
Soundness Indicators for Investment Climate Assessment**

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# Georgia: Insights into the Investment Climate

## Introduction

The stability of a banking system is a function of multiple factors, not the least of which is a resilient, well-diversified industrial base of the country. Sound investment climate is therefore a crucial component of financial and economic development. Problems in the regulatory framework, property rights protection, tax administration, etc. can create investment bottlenecks, which in turn impact the development of the banking system.

Poor investment climate leads to increased cost of funding, increased risk of investment in domestic projects, reduced profitability of banking sector and greater systemic risk. For this reason, policy-makers pay particular attention to investment climate and investment constraint assessments for both large enterprises and SMEs.

Typically such assessments are done via investment climate surveys, where the standard practice is to ask the existing firms to rank the constraints to investment and growth they encounter according to severity of impact. An alternative approach is a comprehensive Growth Diagnostics analysis, which attempts to uncover the binding constraints to investment by analyzing the evidence on whether and how firms attempt to overcome such constraints.

Below we discuss the pros and cons associated with the standard approaches, and present the results of a survey conducted in conjunction with the in-depth interviews of several largest firms and banks in Georgia. The purpose of the survey was to gain the new insight into the investment climate in the country. Our main findings confirm the existence of property rights uncertainty, regulatory framework deficiencies, and insufficient human capital as the principle constraints to investment.

## Investment Climate and Investment Constraints: review of existing studies

The main business climate surveys in Georgia to date are the BEEPS surveys done by EBRD and the World Bank Group (the most recent ones were performed April-August 2008 and July 2012 - December 2013), and the GeoStat Small and Medium Business in Georgia survey (2009), which covers two quarters in 2007 and 2008 respectively.

In these surveys the firms' managers/ business owners are asked to report the obstacles to doing business on the 5-point scale, ranging from "no obstacle" to "very severe obstacle". According to BEEPS 2008 [2] survey results, the top-ranking problem was electricity (with 65% of the firms citing electricity as a problem), while access to finance was second on the list (55% of the firms). Other problems (ranking 3<sup>rd</sup> to 6<sup>th</sup>) were tax rates; crime theft and disorder; access to land; and skills and education of the workforce (in the order of decreasing magnitude of severity)

The scores have been calculated based on the percentage of firms who reported the problem as either moderate, major or very severe. The drawback of this type of ranking, however, is that it does not give a clear indication of whether the constraint in question is truly binding. In other words, whether removing the constraint would have maximum impact on the firm's growth. To this effect, the Enterprise survey (administered by World Bank) also reports the ranking of problems by the percentage of firms who reported them as being the main, or the biggest obstacle for their business.

In the latter case, the **access to finance, political instability and electricity** came out on top of the rankings in **2008** (having 18%, 17.4% and 16.4% of the firms respectively reporting them as the main obstacles). In addition, these problems in Georgia appeared to be more pronounced than in other countries of Europe and Central Asia (ECA) in the same time period.

In **2012-2013**, however, the situation changed, with firms overwhelmingly reporting **political instability** (42.1% of the firms) as the main obstacle [3]. This result is definitely not surprising, and is likely temporary in nature, given that the country went through its first democratic transition of power via parliamentary and presidential elections in this period.

**Access to finance** was number 2 on the list of main obstacles to doing business in Georgia in 2012-2013 (20.9% of the firms). In contrast, in the ECA countries access to finance was a problem for 15.3% of the firms.

**Tax rates** came in 3<sup>rd</sup> in the ranking for Georgia (15.2% of the firms), although the problem was less severe than in the ECA countries on average (17.6% of the firms). Electricity concerns dropped to 7<sup>th</sup> place in the ranking for Georgia (2.1% of the firms).

Interestingly, the inadequate education of workforce does not appear to be the main obstacle for doing business to many firms (only 4.1% of firms reporting education as the biggest obstacle in 2008, and only 2% in 2012-2013). This may signal, however, that a potential constraint associated with human capital may be for a time obscured by other, more binding constraints, such as political stability or access to finance.

As far the **SMEs**, the three leading constraints emerging from the 2007-2008 (GeoStat) survey [5] were **high inflation rate, high interest rates and high tax rates**, followed by credit availability, even though it was cited as an obstacle by only 1 in 10 firms.

The advantage of the surveys is the ability to utilize a large sample size for statistical analysis and estimate fairly precisely the (perceived) constraints facing the existing firms. However, one of the main disadvantages is the obvious sample selection bias of such surveys.

The questions about the constraints are asked of the existing firms in operation, which by definition consists only of those firms that have overcome the most severe obstacles to starting and staying in business.

**The sample selection bias** results in certain inconsistencies in the reported data. For example, even though access to finance was cited by 18.3% of the firms in Georgia as the main constraint, as much as 60% of existing firms did not apply for a loan in 2012-2013 because it was not needed (this number is the second highest in the ECA after Kosovo)

BEEPS 2008 survey reveals that 38% of Georgian firms indicated that financing was NOT a problem for them (as compared to 34% and 30% respectively in ECA and FSU-S (Former Soviet Union - South) countries, such as Armenia, Azerbaijan, Moldova, Kyrgyz Republic, Tajikistan, Uzbekistan.). [2]

In addition, 15.9% of the firms in Georgia cited unfavorable interest rates as the reason they did not apply for a loan in 2008 (as compared to 18.8% of the firms in the FSU-S countries). In the same year, only 3.7% of the Georgian firms cited collateral requirement as the reason they did not apply for a loan (once again, this percentage was slightly higher in both ECA and FSU-S countries), although the value of collateral as a percentage of the loan value has been very high in Georgia (185.1% vs. 133.4% in the ECA countries in 2008 [4]; and 222.8% vs. 136.9% in the ECA in 2012-2013 [3]). Given the evidence of high cost of financing in Georgia, one can conclude that a large percentage of firms had to adapt to the unfavorable credit conditions in order to stay in business. The survey, however, would only capture the firms that have adapted successfully.

It is also worth noting, that the survey-based methods are not likely to capture the possible interrelation between different constraints facing the firms, or uncover the root causes of the problem in question (for example, inadequate access to finance and high interest rates may stem from a variety of causes – such as low competitiveness of the banking sector, problems accessing foreign credit, or the risk of doing business in the country).

In addition, if problems are internal to the firm (such as low quality of management), then self-assessment by the managers would often be biased towards a more favorable view of the firms' prospect.

The non-survey based Growth diagnostics methodology is often used to help overcome the problems mentioned above. Growth diagnostics allows not only to identify a binding constraint, but to analyze the possible causes of the problem. For example, if a country suffers from low levels of capital investment, and lending rates are high, one possible course of action by the government is to establish programs to subsidize or otherwise lower the cost of credit. However, such intervention may be counterproductive, if the root of the problem lies in the lack of adequate human capital, coordination problems among firms in the industry, or political uncertainty – all of which reduce the number of viable projects and increase the investment risk.

In fact, the most recent Growth diagnostics study for Georgia using 2000-2010 data (Babych, Fuenfzig 2012) [1] contended that the high cost of capital in Georgia is likely to stem from the high perceived risk associated with starting and running a business, and has identified the uncertainty about property rights (broadly defined) as the primary binding constraint.

In Georgia, the low capital accumulation and high interest rates are coupled with low levels of domestic savings (see Figures 1 through 3 in the Appendix), but also with relatively low rates on bank deposits. The result is a high interest rate spread (in fact Georgia's interest rates spread was the highest in the region – see Figure 4 in the Appendix). This, according to the study, indicates that the low supply of domestic savings alone is not likely to be responsible for high lending rates (otherwise, banks would try to attract the funding for viable business project by offering higher rates to depositors). Rather, the problem stems from the high risk premiums associated with the uncertainties about property rights, as well as political and institutional instability in the country.

The risk premium is captured in part by the large spread between the government bonds and the commercial lending rate (see Figure 5 in the Appendix). The risk premium remains high despite the fact that default rates in Georgia were lower than in the rest of developing Europe and Central Asia.

The study highlighted that some of the other potential constraints, such as human capital and infrastructure, while not binding at the moment could become binding once the property rights uncertainty constraint has been removed.

While the growth diagnostics methodology is a very useful practical tool for establishing policy priorities, it is designed to identify first and foremost the binding constraints to growth. The results of such studies could therefore be further informed by relying on surveys followed by the structured in-depth interviews with both the suppliers of credit (banks) and potential lenders (firms).

The surveys of banks about their clients have an advantage of providing insights into both the successful and the unsuccessful bank-client relationships, which in turn would help reduce the sample selection bias discussed earlier.

## **Methodology**

For the purpose of the study, we designed an investment climate survey, which was distributed among a group of a few large private firms and large commercial banks. For the firms, the questions were grouped in the following way: a) general information about the firm b) investment climate constraints to the establishment c) financing d) business-government relationship e) capacity innovation and learning f) labor relations

The banks were asked the questions about the constraints to investment facing their clients' operations and growth, and the obstacles to issuing loans on the Georgian market.

The survey answers were followed up by either electronic or face-to-face interviews, where the respondents were asked to elaborate on the nature of the particular constraints they indicated as being significant.

The drawback of this methodology is the obviously small sample size, which precludes statistical analysis. Secondly, the large firms interviewed were also subject to the sample selection bias, as they have successfully overcome the constraints facing other firms on the market. And yet the advantage of such approach is twofold. First, the sample selection bias is reduced in the case of bank responses about their clients – as banks deal with both successful and unsuccessful firms. Secondly, the survey and follow-up interviews can serve to supplement the existing studies by helping to clarify the nature of responses to the survey questions, and expose some “hidden issues” that would have been otherwise missed in the simple survey.

The full survey questionnaire on investment climate and investment constraints is attached in the appendix. The respondents were 2 large private firms (telecommunications and household appliances retail) each with the market size of more than 25%, and 3 largest private commercial banks with the combined share of more than 60% of the Georgian market.

## **Results: the main insights from the investment climate survey**

The top obstacles to doing business by firms (as reported by the banks) were:

- Quality of labor (ability to find qualified/skilled workers) – moderate to severe problem
- Cost of financing; access to financing, economic and regulatory policy uncertainty – moderate to minor problems.
- Macroeconomic instability, tax rates and labor costs were also among the major to moderate constraints for the large firms.

### **List of constraints**

#### **Macroeconomy**

Concerns about macroeconomic environment is mentioned by the companies the context of affecting the revenue uncertainty. Not surprisingly, the banks did not mention macroeconomic stability (inflation, exchange rates) as a problem.

#### **Quality of labor and cost of labor**

Quality of labor, or inability to find qualified workers for the job has been mentioned in all interviews. Hence - existence of high premiums on qualified labor. Although banks do not mention the cost of labor as an obstacle for their

clients (perhaps because clients seeking a loan do not complain of staffing issues), the issues of quality and cost comes to the forefront in the extended interview answers.

In particular, the labor costs in absolute terms may not be a problem, while in relative terms (the gap between wage premium and the set of skills one can expect to get for the premium) is a moderate to major obstacle to doing business. The inability to find qualified labor in the fields of Energy and Physics were mentioned in particular. The respondents also referred to the dynamics of the wage premium growth relative to revenue growth as a source of concern. This might indicate that the human capital constraint is becoming more severe.

### **Uncertainty in the property rights enforcement (PRE)**

Although the uncertainty in PRE is listed as a minor problem in the surveys, the interview extended answers are pointing towards PRE - under the guise of land accessibility and availability of collateral, even access to electricity.

Nationalization of purchased land plots (e.g. Svaneti). Leasing codes for 1 Ha of government land 10 times higher for mobile telecommunication commercial operators. Energy companies not willing to service the lands that have disputed or undefined ownership, with the companies relying on diesel generators for electricity, which are very expensive. These are some of the issues that have come up in the interviews.

In banks' interviews about access to financing, the respondents indicated that unwillingness to officially register property prevents the clients from using their property as collateral and hinders access to loans. While the property registration process is relatively easy in Georgia, the unwillingness to register can be a function of both the cost of registration, and disputed ownership. In either case, the uncertainty about property rights remains an obstacle for businesses to access bank financing.

### **Uncertainty in regulatory policy**

This type of constraint is generally rated as moderate or moderate to severe, particularly by companies themselves. Companies mention regulatory burden – such as attempts to regulate prices in the environment where no natural monopolies exist. Companies argue that there is a need for transparent, independent arbitration process in the case of regulatory disputes, which would rely on sound economic principles and best world practices, not the whims of the regulators.

### **Anticompetitive practices or informal practices**

These are rated as mostly minor, sometimes moderate for bank surveys; nor further explanation given in extended interviews.



## Access to financing and cost of financing

These constraints are generally rated as moderate to major problems, except in the case of the large companies who manage to rely exclusively on internal finances.

The appliance retail company in our survey mentioned access to finance (lack of collateral) as a major problem to growing of the business. If a company leases, but does not own the commercial property, securing a loan is difficult or impossible.

*(The larger companies reported having access to domestic currency borrowing with the value of collateral being 110% of the loan, at the interest rate of 14%. Maturity of the loan average – 1 year. These numbers may not be representative, and in fact more favorable than the reported economy-wide averages. For example, the average annual interest rate on lending from commercial banks in Georgia (2012) was 22.1% in domestic currency, and 14.4% in foreign currency according to the data from the National Bank of Georgia. )*

Banks report that the **leverage** (debt/asset ratio) for the client companies is usually less than 1, more typically 0.5-max. 0.6 or 0.7. Companies with higher than 100% leverage are typically not eligible for a loan, unless under specific circumstances (e.g. service companies). The acceptable leverage ratio ranges from 0.5-1.3 or sometimes 1.5, average client leverage 0.7.

The interesting insight that came out of the interviews was that debt-to-asset ratio typically does not play as much of a role in loan considerations as for example cash flow and profitability. Loan amounts – up to 3 times of net yearly profit.

The main reason to deny a loan as reported by the banks: client's low ability of loan service, in particular instability of income. The problems of collateral become less pronounced, when the income source is stable. Collateral is important while lending to start ups, but less to established businesses, which are evaluated based on their annual profits.

Lack of experience in the line of business that the client is undertaking was stated as one of the reason for denial. If an established company takes up a new line of business, the bank may refuse to advance a loan, even though company may have a good track record in the existing line of business. This of course points to the fact that firms' innovation and experimentation may be very costly or impossible to fund through bank financing.

The company's experience on the market and time in operation is also an important factor in loan decisions. Interestingly, inexperienced and incompetent management was also cited as an obstacle to receiving business loans. This once again points to the existence of human capital constraints, which have been largely overlooked in the simple business surveys.

**Business loans denominated in foreign currency:** from 10% to 63% and 70%. The bank with the smallest amount of loans denominated in foreign currency is rather an exception from the general rule.

The main reason for foreign currency denominated loans – **lack of sufficient long-term deposits in GEL. Local currency resources are usually limited and expensive.** Banks incentivize GEL funding by the significant deposit premiums on GEL deposits.

**Cost of financing:** some banks reported that the interest rates (e.g. 13-14%) are not major obstacle to client's development, considering the 20-25% profit rates of the businesses who apply for loans. This may be the case of a sample selection bias among the larger banks, considering that only firms with high enough profits would consider applying for a loan at all. This can explain why the banks that mainly service small businesses do cite the cost of finance as an obstacle to their client's business development. Small business lenders among the banks are also more likely to report management education and experience as severe limitation to the client's growth.

Overall, however, the lack of initial or seed capital is considered by banks to be a bigger problem for client's business development than access to bank credits or cost of bank financing. The need for alternative financial instruments to provide companies with seed capital has been reported in the interviews.

### **Government-business relations**

Generally, large firms advocate less intervention, property rights enforcement, less bureaucratic burden, less burdensome regulations for specific industries. Government intervention is only supported in the case of agro insurance. Firms do not consider public infrastructure as a problem, but consider impartial court system for firm-government arbitration as necessary. The ambiguity of tax code and lack of cooperation with government on developing sensible regulations were cited a problem.

### **Innovation and Learning**

Banks report clients (in particular agro businesses) introducing new plants, planting new crops, using higher quality pesticides; roughly 50% introduced new technologies that substantially changed the way the product is produced, quarter, 25%, agreed to a new venture with a foreign partner; 15% developed a new product line, while 40% upgraded an existing product line. Government regulations, quality of management; education and experience of the labor force were cited as the obstacles to introducing new technologies and innovation:

### **Labor**

Average premium for a skilled worker was reported to be 50% and in some cases 100-500% over an unskilled worker's wage.

Training beyond the basic on the job training is provided, however, high cost of training (in retail), lack of relevant experience and background education of the workers have been cited as primary concerns when training the new labor force.

**Main obstacles to issuing bank loans (from bank surveys), in the order of higher to lower importance:**

1. Low financial education
2. Lack of stable entrepreneurial initiatives
3. Gap in development of other sectors in the economy (market size)
4. High leverage of clients
5. Maturity of loans
6. Limitations in acquiring financial funds
7. High interest rates
8. Low demand for credit due to lower growth rates

Overall, the results of the Investment Climate Assessment survey and interviews confirm that political stability (uncertainty about regulatory environment and property rights) and access to finance are important constraints to doing business in Georgia.

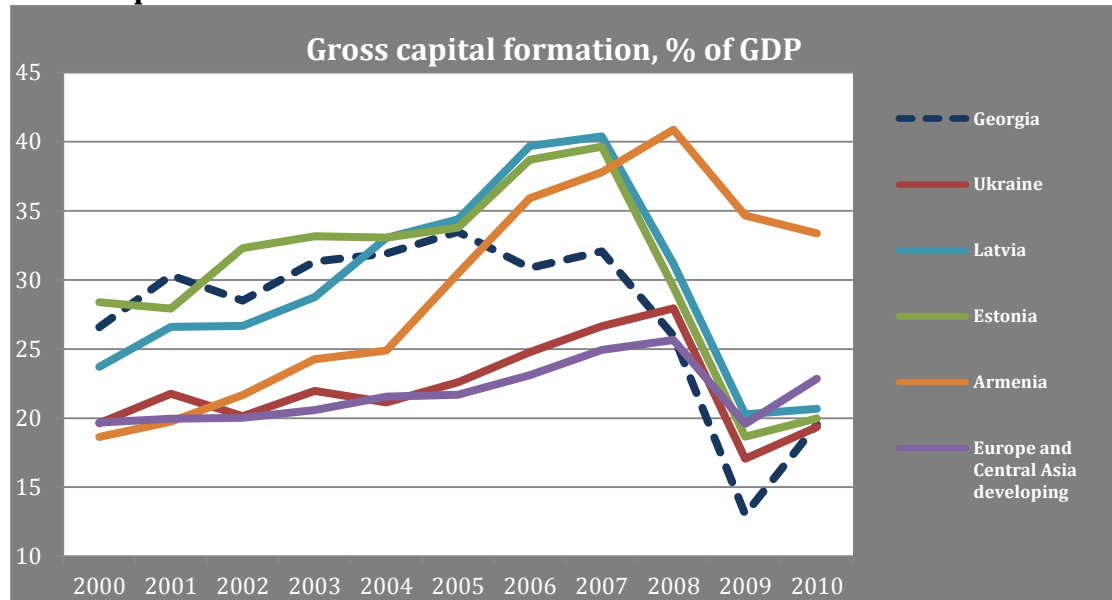
In the same time, the interviews with the banks about their clients revealed other types of constraints, which are typically not registered in regular business surveys. Among them, inadequate human capital (in particular, low financial education of the banks' clients, lack of experience in the line of business, low quality of management), instability of income flow. These constraints appear to be even more limiting to business's development than lack of collateral to finance the loan.

For small and medium size enterprises, the cost of financing, particularly high lending rates continue to be a problem. The evidence from different sources seems to point to the existence of high risk premium as one of the reasons behind high lending rates and high interest spreads. The high spreads, however, can also stem from low cost efficiency of the banking sector, small market size and lack of sectoral diversification in the economy. A more comprehensive diagnostic study is required to pinpoint the determinants of the high cost of finance in Georgia.

As far as recommended policy initiatives, the present study points to the need for alternative, non-bank sources of financing for start-up enterprises as a means to alleviate the credit constraint in the economy. In light of this, the recent launch of the Georgian Co-Investment Fund (GCF) could be an important first step in this direction.

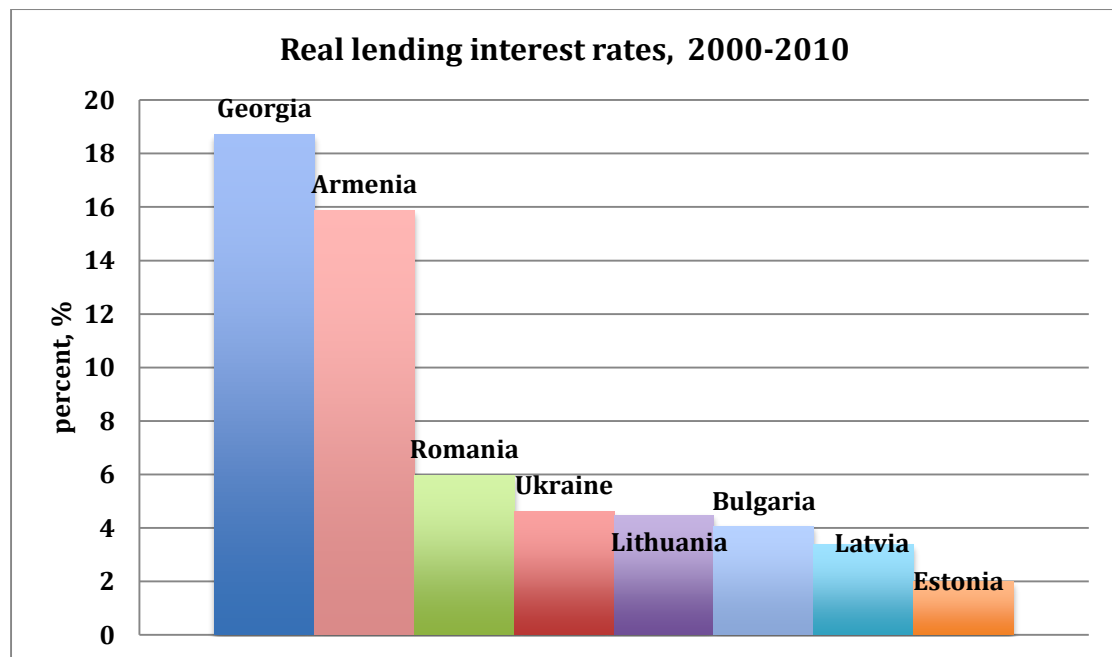
## Appendix:

**Figure 1**  
Gross capital formation as % of GDP



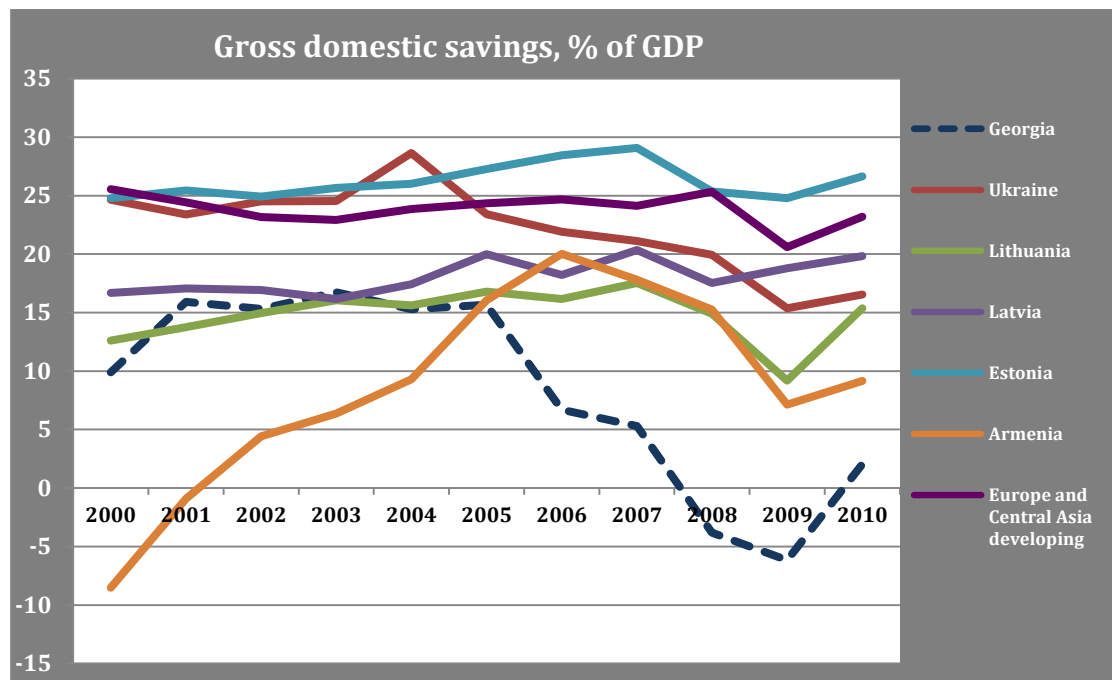
Source: World Development Indicators

**Figure 2**  
Real Lending interest rates, 2000-2010



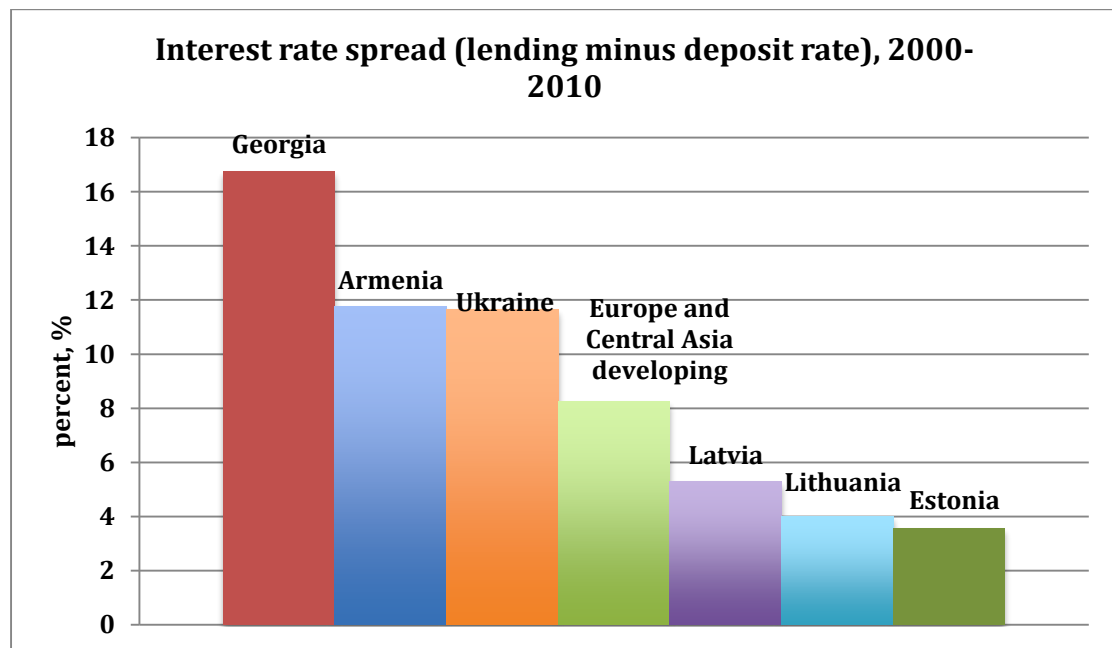
Source: World Development Indicators

**Figure 3**  
Gross Domestic Savings as % of GDP



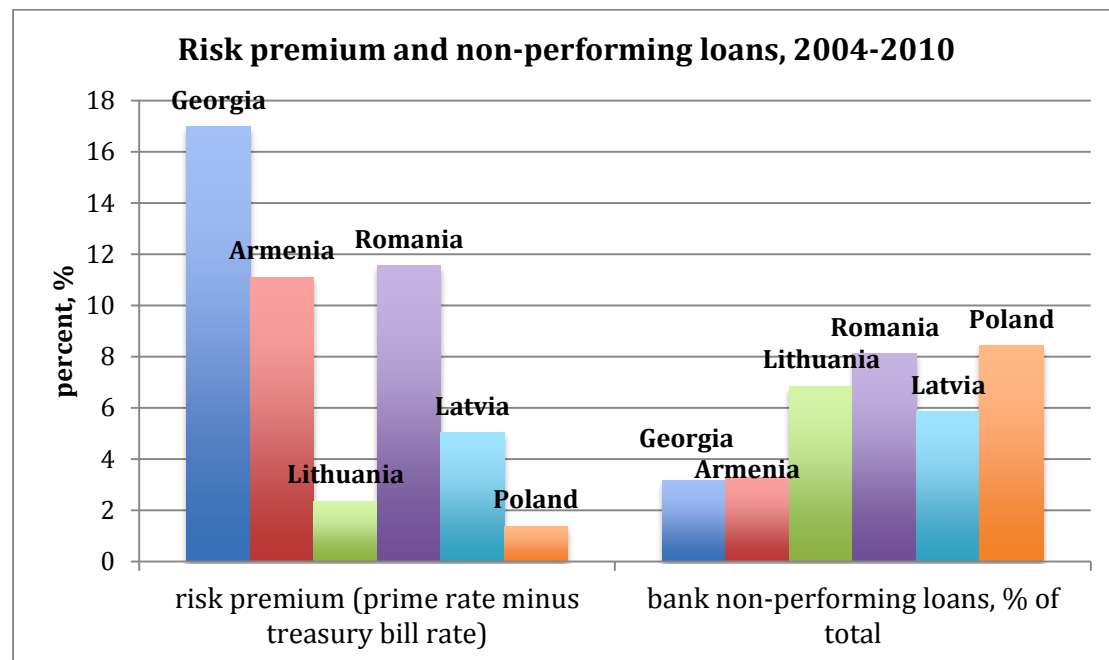
Source: World Development Indicators

**Figure 4**  
Interest rate spread 2000-2010



Source: World Development Indicators

**Figure 5**  
**Risk premium and non-performing loans 2004-2010**



Source: World Development Indicators

## Reference:

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