

AN ANALYSIS OF THE MOTIVES UNDERLYING FOREIGN DIRECT INVESTMENTS (THE CASE OF GEORGIA)

Vakhtang CHARAIA

*PhD in Economics, Invited Lecturer at the Tbilisi State University,
Associate Professor at Grigol Robakidze University
(Tbilisi, Georgia)*

Mariam LASHKHI

*BA in Economics, Junior Researcher and Project Coordinator,
Tbilisi State University Center for Analysis and Forecasting
(Tbilisi, Georgia)*

ABSTRACT

In general, Foreign Direct Investment (FDI) is considered a beneficial factor for local and international economic development. However, it is not always the case. Without taking into account the peculiarities of local economy and MNE motivations, FDI could play a neutral, or in some cases even a negative role in the process of economic development, especially in case of developing countries with small markets. Historically, foreign investments have played a significant role in the economic growth of different countries, by increasing local production and connecting the country to foreign markets.¹ Georgia, as well as the whole world, has long ago recognized the positive

¹ See: J. Kline, *Foreign Investment Strategies in Restructuring Economies: Learning from Corporate Experiences in Chile*, Quorum Books, Westport, CT., 1992.

impacts of FDI on its economy,² especially for an import-dependent country with unstable / unreliable macroeconomic indicators³ and, moreover, with the ambition to become the regional economic hub. It is important to know that FDI has led to significant positive spillover effects on the labor productivity of domestic firms and on the rate of growth of domestic productivity.⁴

² See: V. Charaia, "The Role of Multinational Enterprises' Investments in Emerging Country's Economic Development, Case of Georgia," *International Journal of Economics and Management Engineering*, Vol. 11, No. 3, 2017, pp. 721-724.

³ See: V. Charaia, V. Papava, "Agflation and Other Modifications of Inflation (The Cases of Georgia and its Neighboring Countries)," *Annals of Agrarian Science*, Vol. 16, No. 2, 2018, pp. 201-205.

⁴ See: M. Blomström, A. Kokko, "Multinational Corporations and Spillovers," *Journal of Economic Surveys*, No. 12, 1998.

KEYWORDS: MNE motivations, FDI, IPD, Scott-Kennel's Model, Georgian economy.

This work was supported by Shota Rustaveli National Science Foundation of Georgia (SRNSFG) [YS-2016-66207].

Introduction

Georgia is the number 82 on the list of FDI recipients according to 2017 estimates, based on FDI stock of over 15 billion USD. This figure is not particularly impressive, but still, being at the same level as Latvia, an EU member country, and leaving behind Luxemburg and Iceland, it could be seen as a positive achievement to a certain extent. Moreover, in 2017 while the FDI inflows to developing economies remained stable at \$671 billion, seeing no recovery following the 10% drop in 2016,⁵ FDI inflows in Georgia rose by more than 20% to \$1.89 billion, recovering from the drop of 2015.⁶

However, the extent to which MNEs transfer and/or diffuse their firm-specific advantages to local Georgian firms and the whole economy has not been properly studied yet. On the other hand, a lack of information on MNE motivations and activities, as well as a lack of understanding of the local industries' readiness for open competition creates ambiguity in FDI policy-making not only in Georgia, but in the majority of developing countries in the world.

Literature Review

How does the influx of Foreign Direct Investment (FDI) influence local Georgian businesses? In general, inward FDIs are treated as a positive impulse for the local economy, but very few concentrate on their impact on local industries, which may vary from very positive to very negative, depending on MNE goals and local economy's readiness for foreign investments. In a positive case scenario, FDI may influence the upgrading of local industry via a spillover effect through indirect and direct linkages, however, we should not forget that FDIs can support the stability of local currencies, which is crucial during financial crises. FDIs also play an active role not only in favor of the local market and consumers, but also in balancing the external trade.⁷

This thesis uses Scott-Kennel's model of local industry upgrading, which provides a micro-level explanation of the Investment Development Path (IDP) by J. Dunning.⁸ The Ownership (O), Location (L) and Internalization (I) paradigm (OLI) determines the IDP by suggesting that the extent to which FDI impacts an economy depends on the nature of the following: O-specific characteristics of the investor; L-specific characteristics of the host country; and the extent to which firms choose to internalize cross-border markets for intermediate products.⁹

The Scott-Kennel's model refers to the interaction between the O-, and I-, advantages of the foreign affiliate, and the L-advantages of the host economy.¹⁰ The process includes four different stages. The model suggests a process of local asset augmentation via linkages with foreign affiliates with better technologies, contacts, financial opportunities, etc. Moreover, foreign affiliates can provide local companies with valuable competition, collaborative agreements, new markets, etc., in other words, integration can lead to the prosperity of both local and foreign companies. However, all

⁵ See: UNCTAD, *World Investment Report*, United Nations, New York, 2018.

⁶ See: Georgian National Statistics Office, available at [http://geostat.ge/index.php?action=page&p_id=2231&lang=eng].

⁷ See: F. Wang, V. Papava, V. Charaia, "China-Georgia Economic Relations in the Context of the Belt and Road Initiative," *Bulletin of the Georgian National Academy of Sciences*, Vol. 12, No. 1, 2018, pp. 153-160.

⁸ See: J. Dunning, "Explaining the International Direct Investment Position of Countries: Towards a Dynamic or Developmental Approach," *Weltwirtschaftliches Archiv*, No. 119, 1981, pp. 30-64.

⁹ See: J. Dunning, *Multinational Enterprises and the Global Economy*, Addison-Wesley Publishing Company, Wokingham, England, 1993.

¹⁰ See: J. Scott-Kennel, *The Impact of Foreign Direct Investment on New Zealand Industry*, Unpublished PhD Thesis, University of Waikato, New Zealand, 2001.

this could be seen as a potential threat for local companies, which could lead to them being pushed out from the market.

Scott-Kennel's model recognizes three main types of linkages between MNE and local firms based on their potential for local industry upgrading: low (i.e., competitive effects); moderate (i.e., forward and backward linkages); and high quality linkages (i.e., knowledge and collaborative agreements). Based on the model, the stage of linkage development is directly related to the local economy's upgrade capabilities. The size and speed of progression through stages is determined by the specific OLI pattern of the foreign affiliate, and especially the L-specific advantages of the host country.

- Stage One: Entry of the Affiliate (only the affiliate benefits from the upgrading of its O-advantages by employing full internalization).
- Stage Two: Linkage Formation (indirect linkage with local competitors, direct forward linkages with local agents, etc.).
- Stage Three: Diffusion and Transfer of O-specific Advantages (direct transfer and/or indirect diffusion of O-advantages by foreign and local firms).
- Stage Four: Ownership-Advantage Augmentation (local firm and/or foreign affiliate is able to augment its O-advantages as a result of indirect or direct linkages with foreign companies).

While analyzing the positive and negative effects of MNE motivations and the readiness of local firms to cooperate, a key element is to examine the government policy, especially through the prism of a developing country, which is often more willing to please foreign investors than to analyze the impact of foreign investments on its own economy. Georgia has to build its comparative advantages by forming human capital through strong vocational and general education policies.¹¹

MNEs play a key role in the global economy; the effect of FDIs they are pushing to the host economy has attracted a huge attention of both academics and governments.¹² Especially in developed countries, these issues have generated an immense corpus of literature. Specialists' opinions are divided into positive and negative approaches.

However, many writers are considering both the benefits and the costs of FDI simultaneously.¹³ According to Jenkins, three main approaches towards FDI have emerged: developmentalism, economic nationalism and dependency approaches. Developmentalism underlines the positive effects of MNE activities on host economies. While the economic nationalism and dependency approaches are more critical to MNEs and emphasize the negative effects of foreign investments.

The idea that FDI should be seen as an aspect of an industrial economic structure rather than that of international relocation of production factors was initiated by Hymer,¹⁴ and subsequently developed by Kindleberger,¹⁵ Caves,¹⁶ Vernon,¹⁷ and Dunning¹⁸. An approach that suggests a positive

¹¹ See: D. Sikharulidze, V. Kikutadze, "Location Advantage and Georgia's Potential to Attract Foreign Direct Investment," *European Scientific Journal*, Vol. 9, No. 10, 2014.

¹² See: X. Liu, P. Siler, C. Wang, Y. Wei, "Productivity Spillovers from Foreign Direct Investment: Evidence from UK Industry Level Panel Data," *Journal of International Business Studies*, Vol. 31, No. 3, 2000, pp. 407-424.

¹³ See: R. Jenkins, *Transnational Corporations and Uneven Development: The Internationalization of Capital and the Third World*, Methuen, London, 1987.

¹⁴ See: S.H. Hymer, *The International Operations of National Firms: A Study of Direct Investment*, MIT Press, Cambridge, MA, 1960.

¹⁵ See: C. Kindleberger, *American Business Abroad*, Yale University Press, New Haven, CN, 1969.

¹⁶ See: R. Caves, "Industrial Corporations: The Industrial Economics of Foreign Investment," *Economica*, No. 38, 1971, pp. 1-27.

¹⁷ See: R. Vernon, "International Investment and International Trade in the Product Cycle," *Quarterly Journal of Economics*, No. 80, 1961, pp. 190-207.

¹⁸ See: J. Dunning, "Explaining the International Direct Investment Position of Countries: Towards a Dynamic or Developmental Approach."

effect of FDI and a vital role of MNEs in the latter are widely supported by famous researchers and even international organizations.

The eclectic theory of international production and the concept of investment development path, proposed by John Dunning, are examples of a pro-FDI curve. Blomström claims that MNEs may influence the productivity and growth of local firms; may change the nature and evolution of concentration; may fix financing, marketing, technological and managerial practices in the industries that they enter.¹⁹

Investment Development Path in Georgia

J. Dunning's IDP model analyzes how patterns in FDI respond to changes in the ownership (O) advantages of domestic firms; the O advantages of MNEs; and the location (L) advantages of countries. The IDP model comprises five stages, when investments influence the local economy in different ways.

- The first stage is the case in the least developed countries, where both inward and outward FDIs are very small. The country lacks O or L advantages and is characterized by a limited domestic market, a lack of infrastructure, a low-skilled labor force, absence of required institutions and government policies.
- Stage two, the inward FDI grows significantly in comparison with the first stage. Some L-specific advantages arise and country's attractiveness to MNEs becomes higher. However, the outward FDI (OFDI) remains limited because of weak O-advantages of domestic firms.
- At stage three, the outward FDI increases as domestic firms become more competitive in comparison with foreign firms. At this stage, the inward FDI could be overcome by the outward FDI.
- At stage four, the Net Operation Income (NOI) position turns positive after continued growth in outward FDI, underscoring the development of O advantages. Finally, at stage five, the expected outcome is an unstable equilibrium around zero. So far, only developed countries managed to achieve this level.

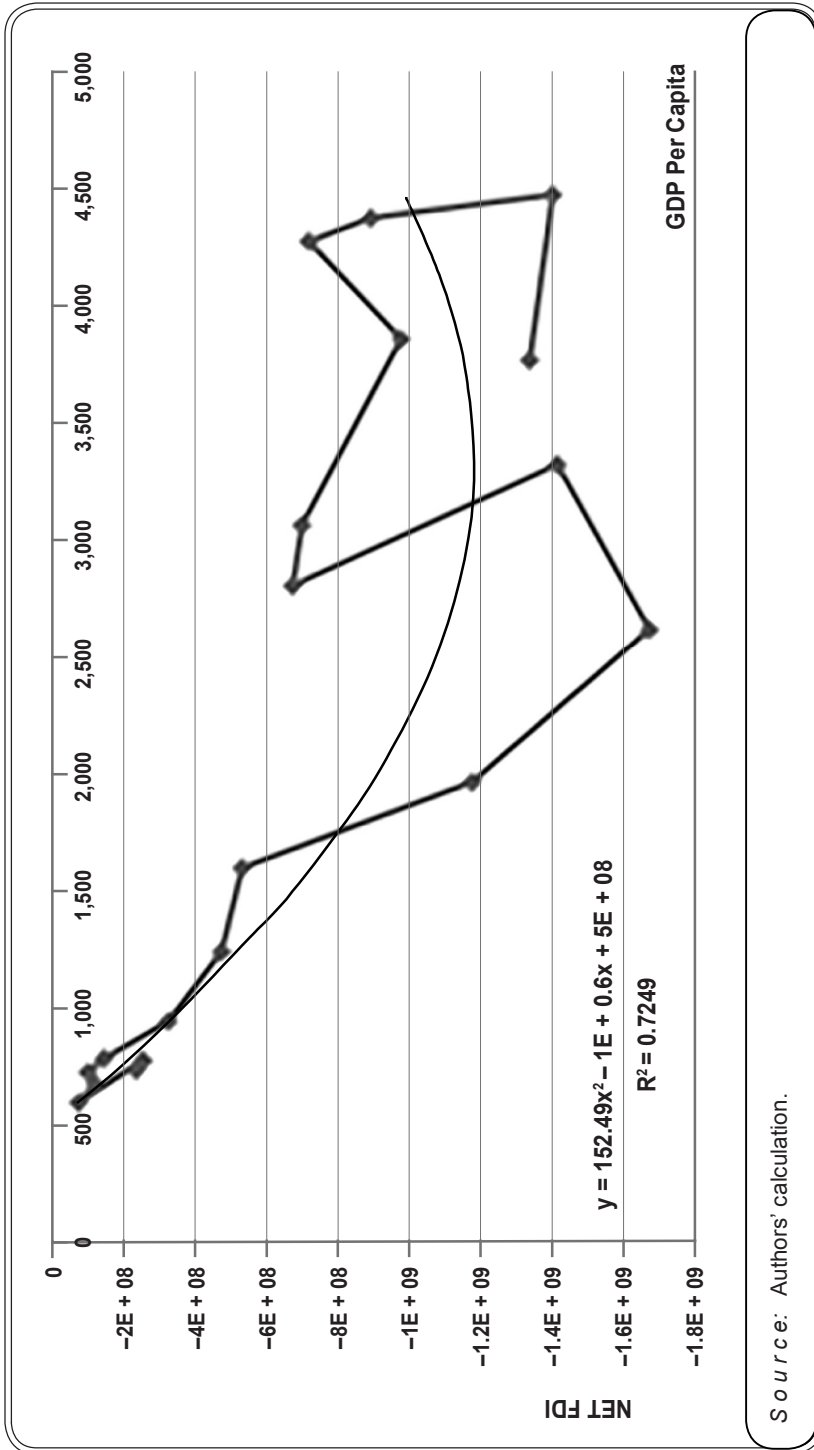
Based on the Georgian IDP model build by the author, it is obvious that the country is still trapped in the second stage of development (see Diagram 1), where Net FDI is still negative and the r^2 for GDP per capita is linked closely to the Net FDI amount. The problem for Georgia at this stage of development is that MNE motivations are mainly oriented towards obtaining the local natural resources and controlling the local markets. The outward FDI is very small (5-6 times less than inward FDI on the average), but the inflows are increasing (almost \$1.9 billion in 2017, 20% more than in 2016) as the size and purchasing power of local markets grow. The local firms have some ownership advantages, but these are not sufficient to generate more FDI outflows than inflows, especially at the time of macroeconomic instability.

This level is also showing that foreign investors are largely motivated by the cheap labor force availability, however it cannot last forever and with the next stages of development this opportunity for foreign affiliates will gradually vanish. On the other hand, Georgia will need to strengthen other aspects of its attractiveness or try to obtain advantages in the fields where it previously had none.

¹⁹ See: M. Blomström, *Foreign Investment and Spillovers: A Study of Technology Transfer to Mexico*, Routledge, London, 1989.

Diagram 1

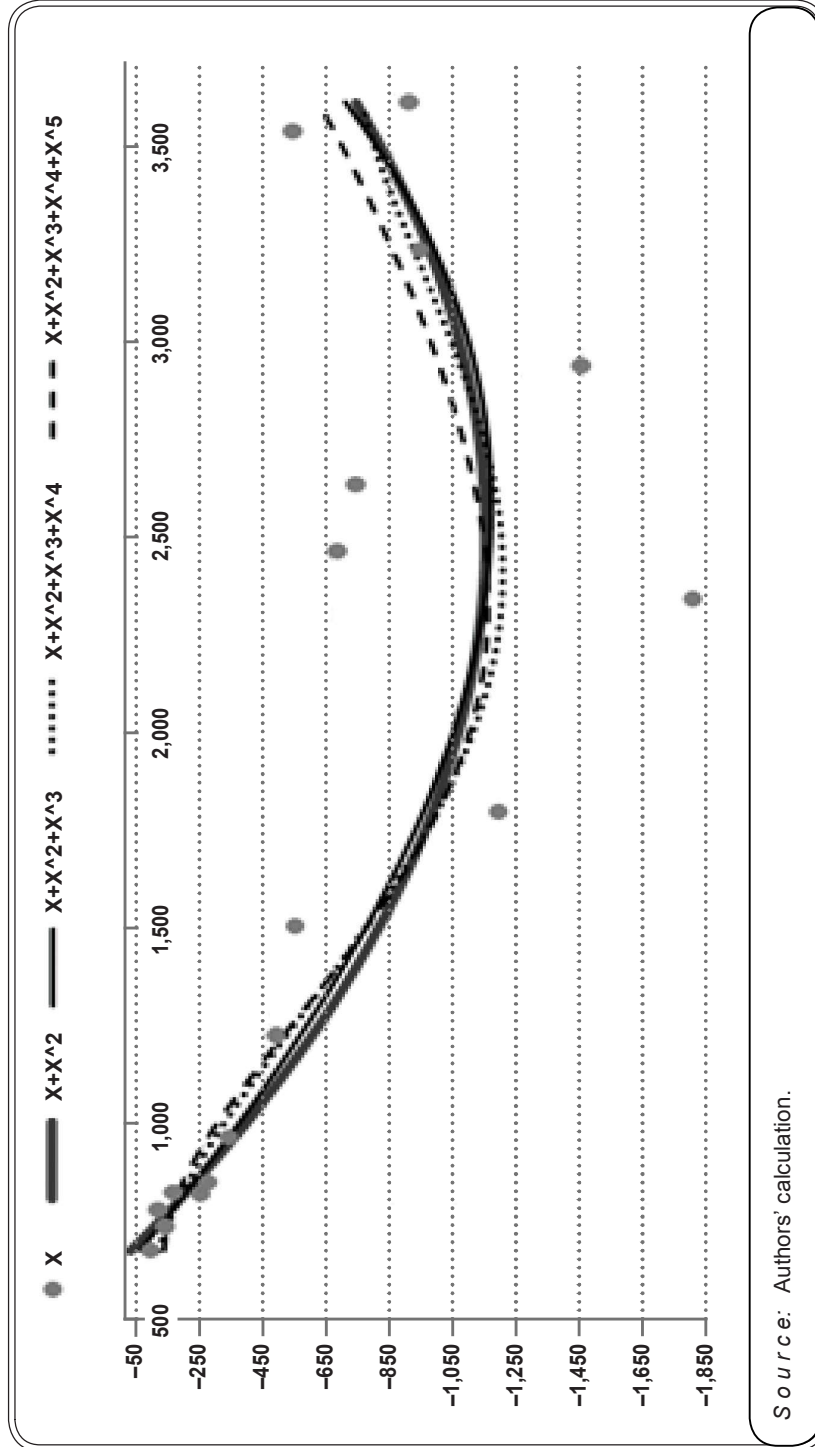
Investment Development Path of Georgia 1997-2017



Source: Authors' calculation.

Diagram 2

IDP Model with Different Specification (Case of Georgia)



Source: Authors' calculation.

Table 1

Statistic Specifications for IDP in Georgia

C	872.99	0.01	629.92	0.47	-381.14	0.87	-1,205.16	0.69
X	-1.62	0.00	-1.13	0.50	1.57	0.79	4.29	0.69
X^2	0.00033	0.00	0.00006	0.94	-0.00230200000	0.64	-0.00555800000000000	0.69
X^3			0.000000413	0.76	0.00000086200	0.61	0.00000264000000000	0.75
X^4					-0.00000000010	0.63	-0.00000000054600000	0.80
X^5							0.0000000000000425	0.84
adjusted R ²	0.65		0.63		0.61		0.57	
AIC	14.35		14.46		14.55		14.67	
SIC	14.45		14.65		14.8		14.96	
HQ	14.36		14.48		14.58		14.7	
RRtP	0.57		0.6		0.97		0.33	
JB prob.	0.6		0.68		0.88		0.85	

The graphic analysis shows (see Diagram 2 on p. 77) that out of the different polynomial functions, the square function is the most suitable in our case, it is the best one to show the relation between the variables. This could be proven with the following:

- Square function coefficient is important, while with other models the coefficient is unimportant;
- Adjusted R² is better in the first model than in the rest;
- According to the Akaike information criterion (AIC), Schwarz information criterion (SIC) and Hannan-Quinn information criterion (HQ) they reach the minimum level under the square function, which shows that this function represents the relation better than any other;
- Ramsey RESET-test Probability shows that model specification is approved even for a 57% importance level;
- Jarque-Bera probability test is also positive (see Table 1).

Scott-Kennel’s Model

To meet the requirements of the research goals, the well-known Scott-Kennel’s model of local industry upgrading was used, which was based on the Georgian case and which applied the framework of the IDP at the micro level. Data were collected by self-administered questionnaires, composed according to Scott-Kennel’s model. Questionnaires lasted approximately 60 minute each, in Georgian, English or Russian languages according to the preferences of respondent. Questionnaires had different sections, where respondents evaluated the business environment, the issue of competitiveness, linkage formation, innovation implementation and other important aspects of Georgian economy and MNE’s influence on it. The study was carried out among twenty companies from the list of top 200 foreign investor companies in Georgia.

Table 2

Obstacles to Doing Business in Georgia

	Min	Max	Mean	Std. Dev.
Macroeconomic instability (inflation, exchange rate, etc.)	3	5	4.3	0.71
Skills and Education of available workers	2	5	4.2	0.89
Cost of Financing (interest rate)	2	5	4.1	0.87
Political Instability	1	4	3.6	0.81
Justice Inefficiency	1	4	3.4	0.78
Innovation and Sophistication	0	5	3.2	1.26
Infrastructure	2	5	2.5	0.85
Access to Land	0	2	1.6	0.37
Labor Regulations	0	5	1.8	1.45
Crime, theft, and disorder	0	1	0.4	0.21

Macroeconomic Instability was named the biggest obstacle (see Table 2). Unfortunately for the Georgian economy and investors in particular, exchange rate instability has become the biggest problem, since it made planning the budget, prices, salaries, logistics, etc. problematic. Since the devaluation process has been started in late 2014, the Georgian Lari has been devaluated by around 60% to 2.6 Gel per USD, but even greater problems come from the main trading partners devaluating their local currencies by 2, 3 and even more times (Turkey, Russia, Ukraine, Azerbaijan, etc.).

The second biggest problem named was **Skills and Education of Available Workers**. Despite the fact that this problem had been known for years, no significant improvement has been observed in this direction so far. By the way, this issue is declared one of the most significant obstacles to doing business in Georgia, according to different international organizations and international rankings. The roots of this problem are hidden deep in the educational system and the Georgian mentality. The fame of older-generation scientists still exists in Georgia, but at the same time qualification and possibilities of the majority of those scientists today are below the world average. Thus, while holding the leading positions at different universities, the majority of older-generation scientists lack knowledge and experience in modern science trends and are not ready to transmit the power into the hands of younger, Western-educated generation, not even ready to cooperate with them.

On the other hand, one of the lowest mean scores was attributed to the **crime level**, which testifies to Georgia being one of the safest places to do business in terms of the low criminal level and high level of trust in police.

The second part of the questionnaire, which was related to opportunities, was also interesting (see table 3). Among the answers to the question of which aspects of FDI policy positively influence the way your firm operates in Georgia, one of the highest mean scores was allotted to the **Easiness of Interaction with Governmental Bodies**.

Low Corruption and Tax Rates were also noted as some of the main advantages of doing business in Georgia. According to Transparency international, Georgia is in the 46 place among the average European countries according to the corruption parameter, which is a positive result. The tax system in Georgia has been simplified, probably to the maximum possible extent, allowing investors to reinvest without paying income tax, with payments required only when distributing the income.

Table 3

Advantages of Doing Business in Georgia

	Min	Max	Mean	Std. Dev.
Ease and Speed of interaction with the governmental bodies	3	5	4.4	0.73
Ease and Speed of different procedures	3	5	4.2	0.71
Business Licensing and Operating Permits	3	5	4.1	0.70
Tax Rates	2	5	3.9	0.84
Labor Force	0	5	3.8	1.34
Corruption	1	4	3.5	0.75
Access to Financing	0	4	3.3	1.17
Customs and Trade Regulations	0	5	3.0	1.19

Customs and Trade Regulations are an important aspect for the companies aiming to settle down in Georgia with the aim of operating in the whole region. For instance, this particular reason was crucial for Toyota. Free trade agreements with EU and China simultaneously make Georgia one of the most unique countries in the world, which could stimulate not only Georgia, but also EU and Chinese economies as well.²⁰

Labor force in general is an obstacle to doing business in Georgia according to many investors; however, in this case, many Local Market-seeking MNEs were quite satisfied with it. For many MNEs it was important to find motivated youngsters with knowledge of foreign languages who are ready to work for a lower salary than in developing countries, or even start with an internship, who were easy to find in Georgia.

Table 4

MNE Linkages with Local Affiliates

	YES	NO
Have resources transferred to the local firms been unique?	10	90
Have your firm assisted other Georgian firms in improving their products or services?	85	15
Have your firm's operations in Georgia led to changes?	95	5

When it comes to the real influence of foreign MNEs on the local Georgian economy, we see that 85 percent of respondents claim that they have assisted local firms in improving their product or service to different level. 95 percent of respondents claimed that their operations in the country have instigated a change in the economy. However, only 10% of resources transferred to local firms were unique (see table 4).

Conclusion

Influence of MNE motivations in Georgia is not identical in all fields of the economy. MNEs are largely motivated by the cheap labor force availability, however it cannot last forever and in the next stages of development this opportunity for foreign affiliates will gradually vanish. On the other hand, Georgia will need to strengthen other aspects of its attractiveness or try to obtain advantages in the fields where it previously had none.

Based on the Georgian IDP model built by the author, it is obvious that the country is still trapped in the second stage of development, where Net FDI is still negative and the r^2 for GDP per capita is very closely linked with the Net FDI amount. At this stage of development, we can state that MNE motivations are mainly oriented towards obtaining local natural resources and controlling the local market, the outward FDI is very small (5-6 times less than inward FDI on the average), but the inflows are increasing (almost \$1.9 billion in 2017, 20% more than in 2016) as the size and purchasing power of local markets grow. The local firms have some ownership advantages but these are not sufficient to generate more FDI outflows than inflows, especially at a time of macroeconomic instability.

²⁰ See: V. Papava, V. Charaia, "Belt and Road Initiative: Implications for Georgia and China-Georgia Economic Relations," *China International Studies*, No. 67, 2017, pp. 122-139.

Scott-Kennel's model used for research demonstrates that the biggest obstacles for doing business in Georgia are: Macroeconomic Instability (inflation, exchange rate, etc.), Skills and Education of available workers, and Cost of Financing (interest rate). On the other hand, the most positive factors for doing business in Georgia are: Ease and Speed of interaction with governmental bodies, Ease and Speed of different procedures, Business Licensing and Operating Permits. We believe that the second stage of IDP is clearly identifying the opportunities and MNE motivations combination in Georgia.
