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Trade policy and Georgian exports

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Trade Policy and Georgian Exports

Volkhart VINCENTZ

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Summary

As a small country among Georgia's growth factors in future might well be foreign trade. The close cooperation with the EU within the European neighborhood policy centers on improving and facilitating trade between the partners. In 2006 the EU granted Georgia the GSP+ status which allows almost duty free imports of Georgian products in the EU. The extension of these trade preferences is negotiated in the realm of a deep and comprehensive free trade agreement between the EU and Georgia.

A closer look on the trade data reveal that no trade enhancing effect of the GSP+ can be detected. The available trade data are significantly blurred by the inclusion of energy trade from Georgia which is likely only transit trade from Azerbaijan and Kazakhstan. If these export items and the movements of some raw material prices are removed from the data no export enhancing effect can be found. In addition, in the past the composition of Georgian exports remained highly biased towards raw materials and simple products.

Improvements in export came from the export of services, namely tourism and pipeline transport service. Later is a significant source of income as well as the transfers of Georgian migrants working abroad? The export of pipeline service might increase in future further if envisaged additional pipelines over Georgian soil realize. Since these are mainly built with foreign capital increasing profit repatriation will result in higher capital outflows in future.

At the moment the EU negotiates an deep and comprehensive free trade agreement with Georgia which foresees beyond the abolition of tariffs the removal of all types of non-tariff barriers (NTBs) . An important part of trade facilitation would be the adoption of EU standards and norms which hinder at the moments Georgian exporters. Although the EU is prepared to contribute with financial and technical help the removal of NTBs is costly for Georgian firms. The available studies forecast however significant positive effects from a comprehensive trade liberalization between the partners. Although not captured by the mentioned feasibility studies on a comprehensive EU-Georgian trade agreement, the strongest export enhancing effect for Georgia will only come from broadening the existing export basket. To do so best chances for Georgian firms are seen in transit services and the production of parts and components as a supplier for multinational firms. The existing range of export goods does not exploit effectively the comparative advantages of the country.

1. Introduction: the export-led growth proposition

The widely accepted hypothesis of export-led growth states that economic growth can be stimulated by encouraging exports. Such an outward oriented strategy became popular by the successful examples of the South-East-Asian growth miracle of the 1970s and 1980s. Export-led growth is contrary to the strategy of import substitution which was popular in the 1960s. While import-substitution calls for protecting temporarily the domestic market, export-led growth tries to use the forces of the world market to stimulate domestic development.

The empirical evidence of the export-led growth proposition is backed by several theoretical arguments: First, foreign demand which supplements domestic demand stimulates domestic production. This is particular valid if domestic demand is restrained by anti-inflationary policy. Second, an outward oriented strategy fosters specialization which in turn leads to productivity gains from the reallocation of resources. In addition it brings closer contact to the world economy and thereby promotes learning by doing, and technology transfer. This is particular true, if intermediates are exported to multinationals which control the quality and production processes of their suppliers. Third, increasing export can loose the foreign exchange constraint which makes it easier to import inputs needed domestically. Foreign trade can be viewed as a specific production technology which transforms exports into imports. The purpose of export is to finance needed inputs. Finally export-oriented policy mostly comes in tandem with the promotion of inward foreign direct investment (FDI). In developing countries FDI is often directed towards industries which use the cheap local resources for export products.

For all these reasons promoting export is seen tantamount to the enhancement of growth.¹ Therefore trade policy is an important element of economic policy. This is particular true if the trading partner as the EU also practices an outward oriented economic policy.

In Georgia, authorities seem to subscribe to the idea of export-oriented policy. The low import tariffs and the liberal domestic policy in recent years are just in line with such an approach. The plan that export growth should outstrip GDP growth in the next years is another indication of export-oriented policy.² The share of exports in GDP should climb to 40%. At present the openness of the Georgian economy, measured by trade (export + import) over GDP, is with about 90% not very high for a small country and lower than in most East-European countries. But the degree of openness increased significantly in the last years and will do so in future if the plans of the government are carried out.

¹ Correlation between growth of GDP and exports does not say anything about the causality. However, statistical tests with Georgian data support the view that causality runs from exports to growth rather than the other way round. (UNDP, p. 86)

² Program of the Georgian government for 2008 – 2012: United Georgia without poverty, 2008, mimeo.

2. Trade policy

The implementation of an export oriented policy has to consider the accession to foreign markets as well as the improvement of the cost and production conditions of the domestic export industry. Both aspects are involved in the negotiation of trade agreements, which specify under which conditions the markets are reciprocally opened to the trading partner. Trade policy is not limited to the conditions of cross-border transactions, as tariffs, customs rules etc., but it also covers issues of domestic economic policy. For example, the accession to WTO involves a set of internal domestic regulations, in particular on subsidies, which have to be fulfilled in order to enjoy the benefits of the most favored nation rule. Therefore, trade negotiations involve not only tariffs and non-tariff barriers, but also legal provisions which regulate and form the markets. Protection of intellectual property, competition policy, or regulations in the financial sector is foremost of domestic concern, but these policies are also directly related to trade. In particular such regulations play a decisive role in the attraction of FDI and technology transfer.

In trade negotiations every partner will look for concessions of the other in those fields where it has a comparative advantage. Georgia's export potential probably lies in labour-intensive, rather simple products which do not show distinct advantages from mass production. Thus Georgia will be mostly concerned about the accession of these products to the European market. The opening of the EU market for agricultural products and labour-intensive manufactures would be the main interest of Georgia. On the other hand, highly industrialized economies like the EU, export mostly differentiated, technologically advanced products with distinct economies of scale. Thus, their interest will likely be on market accession of these products and accompanying services. The EU would stress the access to sophisticated markets as the financial markets as well as technology relevant aspects as the protection of intellectual property. For each partner a different set of markets is of special interest.

At present EU grants Georgia GSP+³ till the end of 2008 which allows almost tariff-free and quota-free exports to EU. For the future EU proposes a so-called "deep and comprehensive free trade agreement". "Comprehensive" means that the agreement should apply to trade with a substantial sectoral coverage, i.e. it should be not limited to specific goods or services. "Deep" means that the agreement should go beyond tariff reduction to include non-tariff barriers and regulatory approximation in trade related issues. We will later return to these important extensions from a simple free trade agreement in more detail.

³ The Generalized System of Preferences + can be granted to vulnerable developing countries if they adhere to a number of international conventions.

3. Simple FTA

A simple free trade agreement (FTA) aims to abolish tariffs. The costs and benefits of tariff-free trade can be traced rather simply in a standard economic framework. If tariffs are abolished revenues of the budget (tariff income) will decline. In addition, markets of domestic producers might lose market shares to foreign competitors, which could cause a reduction of domestic production in some sectors. The resources freed in one sector will be employed in other sectors in which the country specializes. The smooth reallocation of the resources, which is often of political concern, is however a precondition that the gains of trade materialize. The elimination of tariffs reduces domestic prices due to cheaper imports. This will affect the welfare in two ways. Consumers benefit directly from lower prices of consumer goods. As far as intermediate goods are getting cheaper domestic producers can reduce costs and might become more competitive. As a result new export opportunities might arise. In addition, lower prices of capital goods might affect domestic and foreign investments.

The qualitative enumeration of the items affected by trade liberalization does not provide a sufficient guidance for economic policy. The net effect of a FTA between EU and Georgia can only be assessed with the help of empirical models, which allow measuring the size of the respective effects quantitatively. It should be noted that the results produced by these models are the final effects after all adjustments triggered by tariff reductions have worked out. The models state the cumulative outcome after about 3 – 5 years.

For tasks like this usually computable general equilibrium (CGE) models, which are calibrated to the country considered, are used. Several generations of these CGE-models were developed. The simplest models assumed homogenous goods which are produced from labor and capital with constant returns to scale. The next generation took into account the existence of differentiated products which are traded on monopolistic markets. These models allow for increasing returns to scale which in reality prevail for quite a number of industrial products. The latest, third generation are dynamic CGE-models which incorporate inter-temporal decision by which they explicitly model investment decisions.

Results of such simulation models are included in the feasibility studies which the EU commissions before entering negotiations with a prospective partner about an extended trade agreement. Studies of this kind were done for Georgia⁴ as well as for Ukraine⁵. In addition a study on EU-Georgia FTA was undertaken by UNDP (2007). All studies conclude that a simple FTA would only have minor positive effects for the EU-partner. The UNDP study as well as the CASE/GlobalInsight-study concludes that almost no increase of Georgian GDP could be expected in case of a simple EU-Georgian FTA. The result is not surprising given that the tariffs are already very low and almost non-existent for Georgian exports.

⁴ CASE/GlobalInsight (2008)

⁵ CEPS/IFW/ICPS (2006)

Naturally, the results depend on the type of model. The model used in UNDP study assumes perfectly competitive markets and does not consider industries with increasing returns to scale. Although the model is called dynamic, the modeling of the investment decisions is rather sketchy. The EU-study is a static model but incorporates sectors with increasing returns to scale.

If only the Georgian economy and export industry is considered, the choice of constant returns to scale seems to be justifiable. Advantages of mass production and the differentiated products might not be pronounced in Georgian export production. As will be shown later, only few industrial processed goods are exported. The main export goods are minerals and agricultural products. At least as long as the export basket does not change substantially, increasing returns might be neglected. The EU commissioned CASE/Global/Insight study assumes however increasing returns for quite a number of sectors, including textiles, in which Georgia is an exporter.

4. An extended FTA

If a simple FTA provides no or negligible gains as the studies suggest, there is a good reason to consider an FTA+, i.e. an extended trade agreement.⁶ This would go beyond tariff reduction and include the reduction of non-tariff barriers as well as domestic trade-related reform policy. Both above mentioned studies conclude that an FTA+ between EU and Georgia would largely increase the gains from a trade. According to the CASE/GlobalInsight study a deep and comprehensive FTA would cause over time, i.e. after all adjustments have worked out, a 7.6% higher GDP than without such an agreement. This means that over the next five years annual GDP growth could be about 1.5percentage points higher in Georgia.

Although it is widely acknowledged that issues of governance and regulations, which are covered by the word “deep”, are important sources of growth and well-being, it is quite difficult to assess them quantitatively, as all studies on the subject admit. It is not only that little is known how legal regulations enter the production and investment decisions, but it is also extremely difficult to quantify even so simple facts as non-tariff barriers. Therefore, the errors of calculating the effects of a deep FTA are necessarily larger than for studies on a simple FTA. One has to keep in mind that any quantitative assessment in the following discussion of regulatory harmonization cannot be more than a ballpark estimate.

A deep FTA will try to reduce non-tariff barriers (NTB) by harmonizing norms and regulations. The size of these barriers for exports into the EU is sometimes estimated as

⁶ While the simple FTA deals only with tariffs the more comprehensive FTAs include also non-tariff barriers, as well as issues of investment climate or regulations about competition etc. The scope of an extended FTA can vary depending on the country-specific needs. We will use the terms FTA+, deep and comprehensive FTA, and extended FTA synonymously.

high as an equivalent tariff of 20% for textiles and 40% for food.⁷ In general NTBs are higher for agricultural goods than for industrial products. It is obvious that if NTBs are really as high as the given estimates there would be a great effect of removing them.

A large part of NTBs are product standards and regulations. Mandatory standards in the EU apply only to safety issues, as the sanitary- and phytosanitary regulations on meat and other agricultural products. Products not complying with obligatory standards cannot enter the EU market. All other standards are voluntary but have nevertheless an important effect since they facilitate the market access. In many cases the demand for products that do not comply with the industrial standards in the EU will be nil.

The aspired removal of NTBs can only mean the adoption of the EU-standards by Georgia. Thus, costs for compliance with the standards will be incurred by the Georgian economy. Cost come in different forms: The state has to enact new legislation or amend existing one, which needs staff and other resources. Probably training and capacity building are other measures which have to be financed. However the highest costs must be borne by the private exporters who have to adjust their products according to EU-norms and standards. There are only few attempts to quantify these costs. One study finds that investment costs of 2 - 5% of total sales of the economy are needed to comply with technical requirements. These compliance costs are higher for agricultural products and primary metals and ores than for most industrial products. Estimates for the costs of total compliance in the agricultural sector in Poland and Lithuania were at 2 – 2.5% of GDP.⁸ It was estimated that Switzerland has to spend 0.5 -1 % of total export revenue to overcome the NTB to the European Market.⁹ In any case the cost of compliance can be significant, although it is almost impossible to make a general quantitative statement on this issue.

It is noticeable, that the estimates about the foregone sales (profits) due to NTBs seem to be much higher than the estimated compliance costs. If adjustments at the level of the firm would be sufficient to overcome the NTBs it would have been done already since the resulting net effect is positive. This points to a significant potential of reducing NTBs other than compliance to norms and standards. Obviously many NTBs, as smoothening of bureaucratic procedures, recognition of certificates etc., cannot be overcome by endeavors of an exporting firm alone. However, there are no estimates about the size of those NTBs, which demand joint action for its removal, and those which can be dealt with by the single exporter.

⁷ See estimates and discussion in ENEPO: EU Eastern Neighbourhood: Economic Potential and Future Development, D25 Working paper on concepts and definitions of institutional development (harmonisation) and methodology of measuring them, CASE Ukraine, 2007.

⁸ CEPS/IFW/ICPS, 2006, p.58

⁹ www.europa.admin.ch

4.1 Market-friendly environment

The Georgian government liberalized the economy substantially in the last two years. These reforms of 2006 are reflected in the improvements in the “Doing business” rankings of the World Bank.¹⁰ A further strengthening of economic governance, fighting corruption and harmonization with EU-rules is believed to improve the investment climate of the economy. These aspects of a deep FTA should reduce the risk of investment by establishing stable and predictable rules of the game and a level playing field. As a result domestic and foreign investments increase. According to the CASE/Global Insight report the most important welfare and growth effect of a deep FTA are related to the additional capital accumulation. The estimated increase of GDP by 7.6% corresponds to a 16% increase of the capital stock which implies reasonable capital elasticity between .4 and .5.

The Georgian attempt to establish a business-friendly environment by its far reaching liberalization of 2006/2007 came into conflict with the EU agenda of legal harmonization. At issue is the liberalization of the Georgian labor market which might conflict with some ILO conventions. Compliance to these and other international regulations were however the precondition of granting GSP+ to Georgia.¹¹ To comply with EU norms on social and labor issues Georgia may have to revoke partly its liberalization of the labor market. This highlights a general problem of the export of EU rules: namely trade facilitation through approximation to EU rules on the one hand and fostering the internal economic development on the other. It is not self-evident that the adoption of EU-policy rules is also the best country-specific development policy.

A market-friendly environment which attracts investors will also promote exports if the FDI is geared to exporting industries. Two areas of FDI seem to be relevant in this context. Firstly, labor-intensive production might attract foreign investments to produce semi-finished goods for use as inputs in the production process in the home-country of the investor. The integration into the vertical production chain demands however low unit wage costs as well as sufficient and cheap transport possibilities. Both preconditions are only partly fulfilled in Georgia. Labor productivity and supply of skilled labor is still low. Further, the country is rather remote from the EU-market. In a medium and long-term perspective policy can try to attract foreign capital for labor intensive production by investing in education and infrastructure.

Secondly, investments into services can enhance exports. This is obvious in the case of tourism. The transport sector is another potential exporter of services. If Georgia succeeds to become a commercial and logistic hub of the region it will sell the transport and logistic services of a transit country, as it is does already with the pipeline transport.

¹⁰ In regular surveys the World Bank tries to capture large variety of indicators which describe the ease to do business in the country. See: World Bank (2007)

¹¹ At present it is discussed whether the Georgian labour market liberalization breached some ILO requirements.

5. The trade balance

The trade deficit of Georgia is significant and increasing. Net imports are about 24% of GDP. Such a high deficit is sustainable only with sound financing. Otherwise it can easily lead to a destabilization of the whole economy. Therefore the reduction of the deficit in a medium term perspective is of overriding concern. The promotion of exports ranks high on the political agenda towards more balanced trade. Given the dependence on energy and other raw materials curtailing imports does not seem an option to solve the problem.

Table 1 **Balance of trade and its financing, million USD**

	2002	2003	2004	2005	2006	2007	Q1 2008
<i>Trade balance</i>	-444	-577	-846	-1.131	-1.861	-2.734	-814
Factor income	12	13	78	62	164	39	-81
Current transfers	217	180	414	359	524	689	172
Migrants' transfers	-5	-5	-1	2	16	45	3
Foreign investment	156	331	483	542	1.077	1.654	386
Other capital flows	64	57	-129	165	81	307	335

Source: National Bank of Georgia, BoP

Table 1 shows the deficit in trade of goods and services and the sources of its financing. Surprisingly the financing of the Georgian trade deficit is only to a smaller part based on debt creation. Georgian net imports are mainly financed by two sources: current transfers and foreign direct investment (FDI). The non-debt creating capital flow of FDI does not only finance part of the trade deficit but it provides also new capital and technology. Therefore as long as these flows continue a substantial deficit can be sustained.

The contribution of current transfers includes significant government transfers which are grants, gifts or assistance from outside. This source of financing is likely to decline as the economy develops. Higher is the contribution from Georgians working abroad and sending money in their homeland. Workers' remittances, an item of current transfers, amounted to 240 million USD in 2007. Migrants' transfers and part of "factor income" should be also counted as contributions of Georgians living abroad. All forms of transfers from Georgians working abroad, which are together almost as high as "other capital flows", share with FDI the advantage of being not debt creating. Therefore despite the huge trade deficit Georgia is still in a comparatively comfortable debt situation. At present, external debt of Georgia is less than 20% of GDP.

6. Export performance

6.1 Data issues

Before we look at the export performance of Georgia in some detail we have to address some data issues. Data on export of goods are available from the balance of payments (BoP), the Department of Statistics of the Georgian Ministry of Economics and through mirror statistics. However, the BoP data are only available as an aggregate and do not allow for a sectoral or country-wise breakdown of exports. Table 2 provides the data from all three mentioned sources.

Table 2 **Total export of Georgia, in 1000 USD**

	2002	2003	2004	2005	2006	2007
BoP	603.334	830.555	1.092.111	1.472.437	1.666.526	2.104.143
Dep. Stat.	346.000	465.300	646.900	865.454	936.172	1.232.896
Mirror Stat	577.886	931.278	1.139.832	1.345.823	1.543.401	

Source: National Bank of Georgia, BoP, July 2008; Georgian Ministry of Economics, Department of Statistics; ICT (www.intracen.org)

The data in the BoP, which are augmented by estimates for not reported trade, are based on the numbers from the Department of Statistics. These include shuttle trade which is not accounted for by the customs. The extent of underreporting is unclear. Since there are only small fees and no tariffs on exports but even a refund of VAT the motif of underreporting of exports is unclear. It might lay in avoiding any records with customs or fiscal institutions.

Data from the BoP, which enter also the GDP calculation, look more comprehensive. Their reliability seems to be supported by the rather small differences between the BoP data and the mirror statistics which were calculated from the imports of 87 countries. However, this close resemblance of both time series results mainly by construction because the National Bank of Georgia uses mirror statistics to decide on the adjustment of the data from the Department of Statistics.

Considering in more detail the trade data between Georgia and the EU, it becomes clear that the mirror statistics do not necessarily give a more accurate picture. This is revealed by a closer comparison of the Georgian data from the Department of Statistics and the mirror data from Eurostat. Georgia reports exports which are less than half of the respective imports reported by the EU (Table 3).

Table 3 **Georgian exports to EU-27, in 1000 USD**

	2005	2006	2007
Georgian data	216.756	225.354	268.530
EU data	345.447	590.931	655.575
Georgian in % of EU data	62,7%	38,1%	41,0%

Source: Georgian Ministry of Economics, Department of Statistics; Eurostat

The differences can be traced to only a few products. More than 60% of the 400 million USD difference between the two data sets is due to EU imports of fuel which are not reported by the Georgian statistic, but are reported by Eurostat. According to EU-data mineral fuels were by far the most important Georgian export good to EU. This systematic over-reporting in the EU-data was already detected earlier. A joint study of an EU-expert and the National Bank of Georgia concluded:

*“Georgia is not an oil producer, however due to its geographical positioning is in somehow involved in the transit of products belonging to chapter 27. International ship operators are coming to the port of Georgia for filling their tankers and it is probably at this moment that they made errors in customs declarations by indicating the oil as Georgian origin. This could explain the big mirror westbound discrepancy in product “271019” (Medium Oils).”*¹²

Recent data suggest that the same problem still exists and gains in importance. Therefore, any analysis using EU-data should take into account that these data likely grossly overestimate the trade flows. These huge oil re-exports should be taken into account when the Georgian export performance is assessed. Since imports of Georgia are revised upwards in a similar fashion in the BoP, the net effect which enters the GDP calculations is less affected by this energy re-export.

7. World exports

The dynamics of exports are quite similar regardless of the data used. Georgian total exports grew in the last 5 years at an annual rate of 24%. Export growth shortly plunged in 2006 due to the Russian embargo on wine and mineral waters, but resumed again in 2007. The export ratio (goods and services) increased from less than 25% at the beginning of the century to almost 34% in 2005. In recent years the losses in the Russian market reduced the export ratio to 31.4%. Nevertheless, exports developed dynamically and contributed significant to domestic growth.

However, the structural change has been moderate, as table 4 shows. Compared to 2002 five new products entered the top 10 export products. Exports are still dominated by minerals, metals and metal waste. The trade disputes with Russia displaced wine from the top-10 exports in 2007. The exports of automobiles in this list depict the re-exports of cars to neighboring countries. Thus, there are only few processed goods in the current export basket of Georgia. Cement, whose production capacity was expanded by FDI, might be an exception.

¹² Venice Consulting (2006)

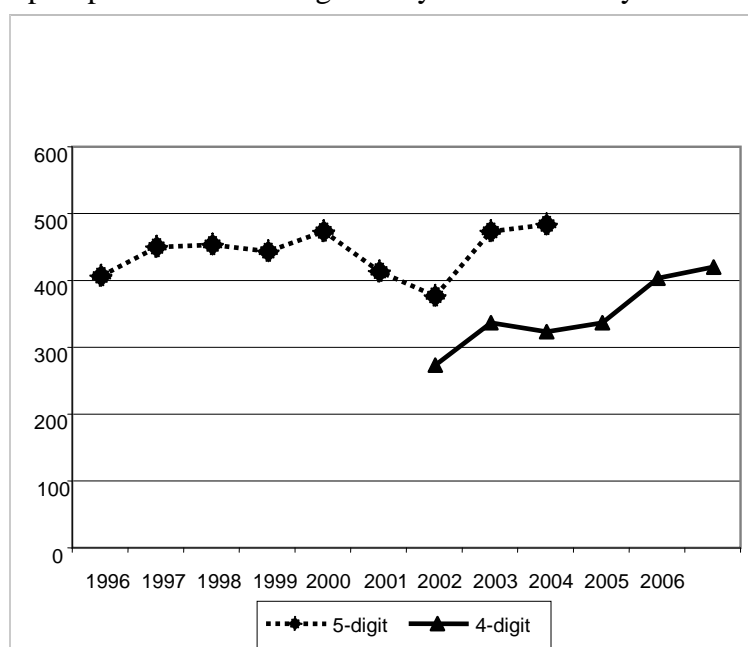
Table 4 **Top 10 export products, in 1000 USD**

2002			2007		
	Total	345.933		Total	1.232.896
8802	<i>Other aircraft;</i>	41.084	7202	<i>Ferro-alloys</i>	159.630
7204	<i>Ferrous waste and scrap</i>	36.482	7204	<i>Ferrous waste and scrap</i>	96.872
2204	<i>Wine of fresh grapes</i>	33.202	2603	<i>Copper ores</i>	79.213
7108	<i>Gold unwrought</i>	28.581	8703	<i>Motor cars</i>	70.176
2201	<i>Waters, natural</i>	17.291	7108	<i>Gold unwrought</i>	69.392
7202	<i>Ferro-alloys</i>	15.502	0802	<i>Other nuts</i>	65.122
1701	<i>Sugar</i>	13.563	2523	<i>Cement</i>	64.002
2603	<i>Copper ores</i>	13.157	2208	<i>ethyl alcohol, spirits,</i>	57.423
3102	<i>Mineral fertilizers,</i>	12.037	3102	<i>Mineral fertilizers,</i>	57.022
8803	<i>Parts of aircrafts</i>	11.477	7404	<i>Copper waste and scrap</i>	37.052

Items in bold italic figures appear in both years on this list.

Source: Georgian Ministry of Economics, Department of Statistics

For economic growth in the medium-term perspective a modernized structure of exports is even more important than the value of exports. On the one hand, one would expect that so called “distress exports” wither when the economy revitalizes after the breakdown. In times of financial hardship exports from stocks of existing goods, which can be easily sold at the world market, rise. In particular the exports of metal scrap and waste belong to this group. On the other hand a sign of reviving entrepreneurship would be the rise of new products which were not exported before. Therefore an increase in the variety of export products would signal a dynamic economy.



Graph 1 **Count measure of the variety of export products**

Source: Own calculations; Georgian Ministry of Economics, Department of Statistics

The range of export goods of Georgia is still limited and has not expanded much over time. The top 10 export categories listed in table 4 accounted for about 60% of total export in 2002 as well as 2007. A count of all exported products reveals a similar pattern. The variety of export products over time has increased only moderately. The differences in the level of the two series shown in graph 1 are due to different aggregation level of the underlying data. The visible increase in the number of exported goods in the last years might indicate some new dynamism. However this cannot be confirmed by other data, as discussed below. The jump in 2006 might just reflect more accurate collection and classification of export items by the customs.

Table 5 **Exports of goods and services, in thousand USD**

	2002	2003	2004	2005	2006	2007
goods	603.334	830.555	1.092.111	1.472.437	1.666.526	2.088.285
services	408.362	457.955	554.762	715.043	885.036	1.094.096
sum g + s	1.011.696	1.288.510	1.646.873	2.187.481	2.551.562	3.182.381
service % of total	40,4	35,5	33,7	32,7	34,7	34,4

Source: National Bank of Georgia, BoP.

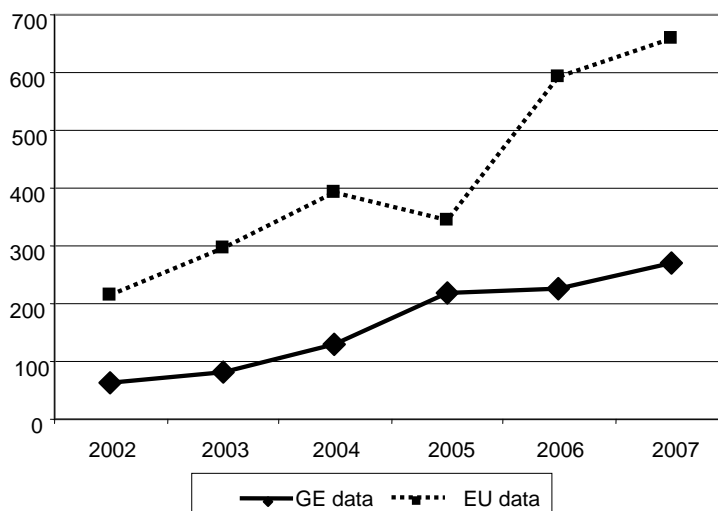
In addition to the export goods there is a significant, although declining share of services which contributes to total exports. In contrast to the merchandise trade the balance of trade in services was mildly positive over the period considered. The two big export items of services are transport, to which we return below, and tourism. The latter shows an increasing trend and had a strong positive balance of 200 million in 2007.

The export potential of tourism in the medium range is quite significant but strongly dependent on the stability and security in the country. In addition, large investments in infrastructure from roads to hotels would be necessary to tap this potential.

8. Exports to EU-27

In 2006 the EU granted Georgia GSP+, which allows for tariff-free exports of almost all products. The overriding question is whether any effect of these trade preferences can be detected in the data. Moreover, quantifying the effect of GSP+ would be important for the present discussion about the prolongation of GSP+ and a more expanded FTA.

The same analysis as before will be repeated for the Georgian exports to the EU-27. As was mentioned, such an exercise is plagued by inconsistencies in the two available data sets. According to Georgian data, exports to EU-27 increased in the period 2005 - 2007 by 11.3%, while Georgian exports to the other parts of the world grew by 21.9%. There is, in particular in comparison to total exports, no export boom related to the GSP+ visible in the Georgian data. (see graph 2) If anything, export growth seems to have slowed after 2005. According to the Georgian data total exports to EU-27 are only twice as much as the Georgian exports to Turkey.



Graph 2 **Georgian export to EU-27, in million USD**

Source: Own calculations; Georgian Ministry of Economics, Department of Statistics; Eurostat

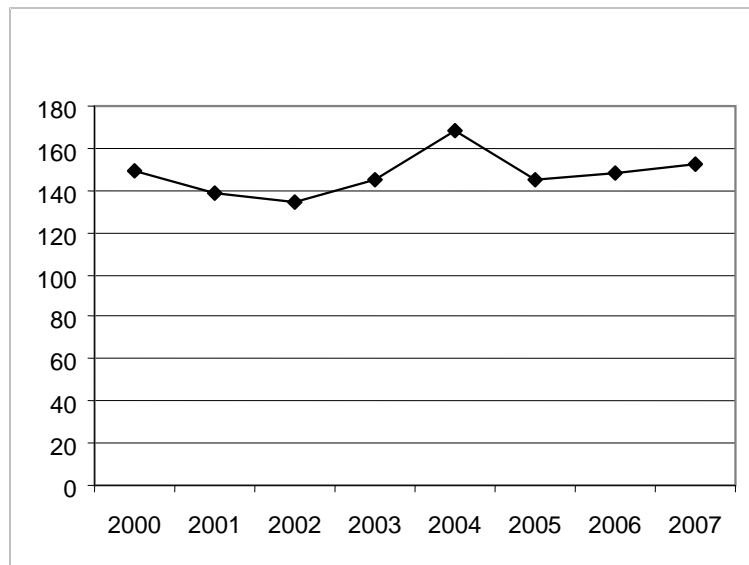
The picture is completely different, at first glance, if Eurostat data are used. EU-data seem *prima facie* to confirm a jump in Georgian exports after the abolition of most tariffs in 2005. Compared to 2005, Georgian exports to EU increased by a staggering 32% per annum.

However, half of the absolute increase of 200 million € in 2006 is due to exports of fuel, which were already identified as an ambiguous export item. Another 35.000 € of the 2006 export jump are due to the doubling price of copper ore. The remaining increase in Georgian exports can be attributed to the sales of aluminum. These three products almost completely explain the increase in Georgian export to EU-27 in the period 2005 – 2007. In the light of this decomposition of exports there is little support for an export enhancing role of GSP+.

This conclusion is supported by a look on the change of the export basket. The number of products at the 4-digit level does not show any trend over time if we use the Eurostat data (Graph 3). The exported variety has not increased after the introduction of GSP+. With slight variations around the average 148 product categories were exported to the EU in the years 2002 – 2007. If the count measure is applied to the Georgian trade data, the variety is more volatile and shows an upward trend. But it is difficult to identify the granting of GSP+ as the cause for the increase of variety. In average the Georgian data show less export items than the EU statistic.

The small changes in the composition of exports to EU is also confirmed if one looks at the top 10 exports to EU-27 which accounted in 2002 and 2007 for about 84% of total exports to the EU. At the 4-digit level seven out of ten products were the same in both years. As already mentioned, Georgian exports as reported by Eurostat are dominated by fuel, which accounted in 2007 for 46% of total Georgian exports to EU. Only

at the end of the top 10 appear two machinery products (group HS 8). Neither technological upgraded product exports nor labor-intensive manufactures entered the Georgian export basket in the recent years.



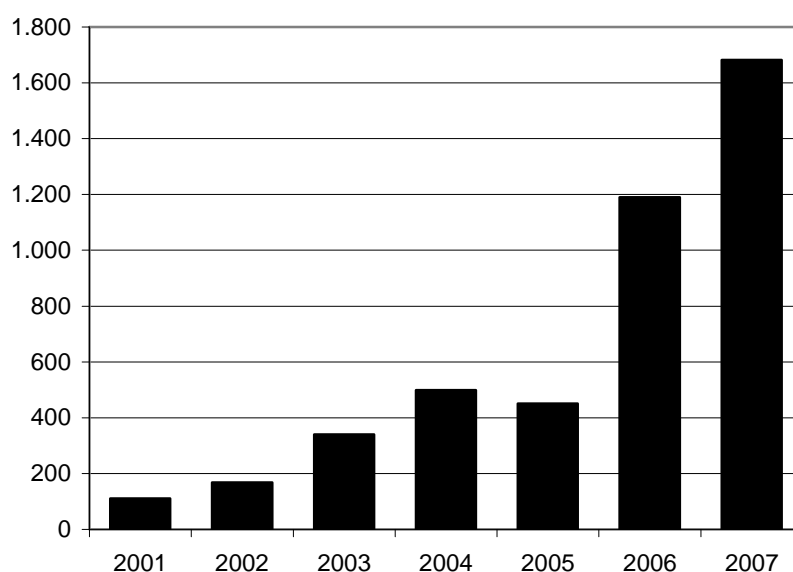
Graph 3 **Variety of Georgian export to EU-27**

Source: Own calculations; Georgian Ministry of Economics, Department of Statistics

In conclusion, we do not find an export enhancing effect of GSP+ in the data. This result can be interpreted in different ways. Firstly, although the GSP was designed to trigger a rather short term effect, the inertia of exporters might be greater than expected and adjustment needs more time. Secondly, the Georgian industry might as yet not have a sufficient export base to expand its sale on the demanding European market. Thirdly, in addition to these structural explanations it can also be the case that very high non-tariff barriers prevent the expansion of exports despite the granted tariff reductions.

9. Foreign direct investment, pipeline service, and processing trade

FDI in Georgia surged in the last two years to more than one billion USD or 15 – 16% of GDP. (Graph 4) About a third of foreign investment in recent years was used for the construction of pipelines by foreign firms. The biggest investors are USA followed by Great Britain. Kazakhstan and Azerbaijan and even Russia contributed large amounts in recent years. Remarkable are the significant investments from the tax havens Cyprus and Virgin Island. The pattern is well known from other CIS countries to which flight capital of the region returns.



Graph 4 **Foreign direct investment flows to Georgia, million USD**

Source: National Bank of Georgia, BoP

The stock of FDI of about 5 billion USD is still small compared to other East European countries. However, if the recent flow of capital stabilizes, this will make a significant contribution to the capital stock as well as to financing the trade deficit. At the moment investments in industry or agriculture are only about a quarter of total investment and therefore cannot have significant employment or growth effects.

In terms of the export-led growth proposition such FDI should be attracted that uses the domestic resources for export production. This is in a particular sense true for investment in pipelines which use Georgia as a transit country of energy transport. This export of transport services became quite relevant in recent years. The export value of pipeline transport, which is given in table 6, amounted in 2007 to 2% of GDP.

Table 6 **Export of pipeline service, in 1000 USD**

2002	2003	2004	2005	2006	2007
44.224	46.017	48.338	51.119	106.640	203.650

Source: National Bank of Georgia, BoP

With the completion of further pipelines these export revenues can easily double in the next years. Given however, that the pipelines belong to foreign firms, the outflow of repatriated profits can rise accordingly. The share of pipeline investments in total FDI was declining in the last years. That trend might be reversed in future since there are still several projects for new pipelines over Georgian soil.

It is not known how much of total FDI are aiming at the creation of Georgian export production. Since most FDI went into the banking and construction sector no significant

contribution to exports can be expected from these capital inflows FDI in the last years was mainly driven by the privatization.

Georgia wishes to strengthen its role as a transit country for goods and energy. If for instance Batumi is gradually developed as a major centre of processing and transportation of fuel from Azerbaijan and Kazakhstan, this would increase the export of transportation services. Another endeavor is to expand the free industrial zone in Poti through container transport turnover of the sea port. 1.5 billion GEL investment should create 20.000 jobs in this zone. The free economic zone should be developed by private investors who can lease the port for 49 years. The proposal of a free economic zone with tax breaks for the firms in the zone were criticized by the EU and other (on grounds of distorting the level playing field).

With or without foreign investment export production can be fostered by the so-called processing trade. Raw materials or intermediate goods are provided by foreign firms to be processed in Georgia and re-exported afterwards. This type of processing trade plays a significant role in the industrial development of Eastern Europe, China, and South-East-Asia. Processing trade is mostly based on sharp differences in labour costs and exploits the cheap labor in the processing countries. However, subcontracting does not end here. As it happened in Eastern Europe, more and more technologically advanced processes are gradually outsourced to labor abundant countries. The example of India and other show the large potential to attract outsourcing of services such as programming, call centers, or book-keeping. Outsourcing by developed countries is one of the major possibilities of integrating a developing economy in the world-wide division of labor.

This trade is difficult to capture in the statistics. A subset of trade from outsourcing is the processing trade which is governed by specific customs regulations. Although this is only a small part of total outsourcing trade, data from EU show how significant it can be. Note that this trade does not exist between members of the EU because the exemption of processing trade from tariffs is not necessary for intra-EU trade. Therefore such trade of the Baltic States ceased with their accession to the EU in 2004.

Table 7 **EU-27 imports from outward processing trade, in 1000 Euro**

	2000	2001	2002	2003	2004	2005	2006
Turkey	3.013	2.297	3.153	6.539	3.327	3.619	2.623
Romania	40.601	57.795	163.981	230.781	199.784	294.134	144.644
Bulgaria	1.020	5.502	9.628	13.012	9.897	11.229	22.743
Estonia	77.958	63.812	194.429	236.185	63.037	1	0
Latvia	15.226	18.613	33.348	43.792	22.030	0	9
Extra-EU	1.708.545	1.955.810	1.396.987	2.456.605	1.455.946	1.549.695	904.817
Georgia	0	1	14	6	8	0	0

Source: Eurostat

As can be seen from the data in the table 7 Georgia does not participate in processing trade with the EU-27. As said, the potential of processing trade might be used more than the data reveal if low tariffs do not merit the utilization of the specific statistical regime.

But some processing trade, mostly textiles, is reported in the Georgian BoP statistics. Data show a rising trend which however stopped in 2007.

Table 8 **Georgian processing trade, in 1000 USD**

	2002	2003	2004	2005	2006	2007
Export	20.017	39.854	23.607	50.203	76.163	31.803
Import	18.392	39.042	20.368	49.926	35.581	27.274
Balance	1.625	812	3.239	277	40.583	4.529

Source: National Bank of Georgia, BoP

10. Prospects for Export

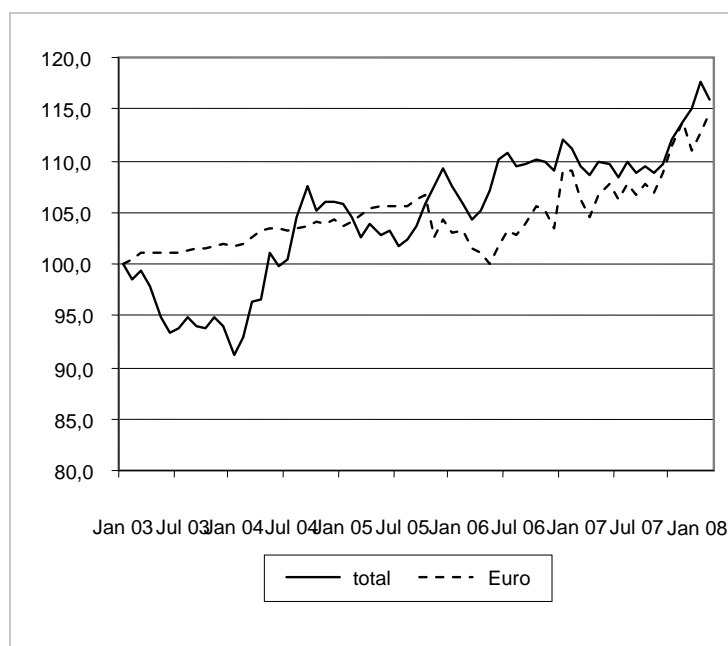
The Georgian authorities count on export as a source of future growth. In average real exports should grow about 13% annually while GDP growth is expected to be 8%.¹³ Agriculture should contribute 25% to total export in five years. Agricultural exports stagnated in the last 2 years, but are expected to grow strongly in the coming years. The government wants to strengthen the role of the Black Sea coast as a centre for handling and transport of transit and other goods. This and expanding energy transport will increase the export of services. Georgia plans to increase its net exports of electricity by 3 times till 2012 compared to 2007. Finally, subsidized loans are available to exporting firms. 25 million GEL are earmarked to expand the export capacities. These government targets over the next 5 years are difficult to assess against the past performance since the targets are given in real terms but there are no real trade data available for Georgia.¹⁴

Any attempt to relate the export prospects to the change of competitiveness is severely hindered by the lack of data. The real effective as well as the real Euro exchange rate appreciated by about 15% in the last four years (Graph 5). However, to gauge how this development has been affecting the competitiveness and exports, one would need data on unit labor costs. Nominal wages more than doubled in the last 4 years while productivity measured by real per capita income increased only by 40%. But real per capita income may be a poor measure of productivity because of the large agricultural subsistence sector. At best unit labor cost remained constant in the recent past.¹⁵ Undoubtedly there were significant improvements in the business climate, as measured by the “Doing business” indicators in the last years. Altogether however it is likely that exports have been hindered rather than enhanced by the development of the real exchange rate. Given the double digit inflation further appreciation is likely. Thus, exports will get little help from exchange rate policy.

¹³ All data are from the government program „United Georgia without Poverty“.

¹⁴ In particular there is still no national account by end-use categories in constant prices.

¹⁵ IMF (2008)



Graph 5 **Real effective and real Euro exchange Rate of the Lari**

Source: IMF, IFS.

To get some more insight into the potential growth of Georgian exports we consider now the statistical and simulations exercises available for Georgia. Based on the data of the last 10 years the earlier mentioned UNDP study concludes that “a 1% increase in EU income per capita or GDP should lead to a 7% increase in Georgian exports.”¹⁶ This would be a pretty high elasticity of Georgian exports on EU’s GDP. Given that EU’s GDP as well as its GDP per capita can be expected to grow by 1 – 2% annually, the predicted annual Georgian growth of exports to EU will be about 14 – 28%. The specification¹⁷ in the quoted study renders the results very optimistic. If productivity improvements in the Georgian export industry and future reduction of trade barriers are added to these estimates, one would arrive at an even higher export growth to EU.

The CASE/GlobalInsight study estimates that the reforms of 2006 will stimulate additional exports of about 15% over a time span of about 5 years, i.e. due to these reforms Georgian total exports will be about 3 percentage points higher than without reforms. A simple FTA would have almost no additional effect on exports according to this study. A stimulus for exports can be only expected from a deep FTA with a complete elimination of barriers to trade and far reaching domestic reforms.¹⁸ In this case growth of Georgian exports might for a couple of years be 5 percentage points higher than without such an FTA+. Interestingly the highest export growth triggered by the

¹⁶ UNDP (2007), p. 82.

¹⁷ GDP and GDP per capita are combined multiplicatively in the estimation model.

¹⁸ The study distinguishes different extended FTAs with varying scope. The most comprehensive or deep FTA includes also measures to enhance the investment climate and governance.

reforms is forecasted for textiles.¹⁹ By construction of the CGE model the depth of different reforms, from simple FTA to a very deep FTA, does not affect the structure of exports. Those sectors that profit from the 2006 reform would also, however to a larger extent, profit from deep reforms and vice versa.

The models assume, as it is usual, that imported and domestic products are similar but not identical. This so called Armington-hypothesis drives to a large extent the results. Two points not included in the model simulations should be mentioned because they might be relevant for the export performance. The harmonization of standards i.e. the legal approximation also makes domestic and foreign products more similar, less differentiated. In economic terms this will change the elasticity of substitution between foreign and domestic products. If this happens it will be easier for foreign products to conquer the domestic market. One of the assumptions of the UNDP study namely that “the effect of substitution of locally produced goods with imported goods should be very weak” (p. 86) will not longer hold if harmonization is considered. A change of the ease of substitution between domestic and foreign goods as a result of a deep FTA is also neglected in the CASE/GlobalInsight study. The concerns of Georgian firms of coping with competitive pressure and market forces of EU firms might be an important point in a policy study that should clarify the feasibility of an integrated free market between EU and Georgia. At least from a political point of view, the speed and smoothness of reallocation of labor which is laid off in import competing sectors is crucial for the design of the trade policy.

With respect to exports the mentioned Armington condition is even more influential.²⁰ In models of this kind export growth can only happen by increasing the export of those goods that are already exported. The possibility of new export products, i.e. an increase in the variety of export goods, cannot be captured in these models. Due the neglect of the so called extensive margin of exports their potential might be underestimated. Some studies suggest that the effects of the reduction of trade barriers are much higher if the creation of new export goods is allowed in the model.

Given the small export base of Georgia one would assume that successful reforms would and should in particular stimulate new export products rather than the expansion of the existing ones. This is particular true if the existing export basket hardly includes any processed goods. As yet several industrial sectors of the Georgian industry stay outside the international division of labor. Export potentials remain still unused. A significant increase in real growth would very likely coincide with significant structural changes in the Georgian export basket. Therefore more of the same cannot be the objective of export promoting policy but rather the discovery and utilization of new export products which can be produced competitively due to lower trade barriers and market friendly domestic policy.

¹⁹ This will however not happen in processing trade but is due to increasing returns to scale assumed for this sector.

²⁰ Cp. Fan (2008).

11. Conclusions

The Georgian government tries forcefully to open its economy to the world market. Foreign investment and higher exports are needed to finance the needed imports. This is supported by the EU, which proposes within the European neighborhood policy a close cooperation and harmonization of trade related issues. The tariff- and quota-free exports to EU as yet did not improve the Georgian export volume or structure. While there are advances in the export of services this does not apply to good exports. They are still dominated by raw materials and some simple, hardly processed products.

According to feasibility studies there are good chances that export and economic growth accelerate if non-tariff barriers are removed and measures for a better investment climate are continued. Georgia undertook already encompassing reforms in 2006/07 to create a market friendly environment.

Since traditional export goods may have only a low growth potential, larger export growth will demand a change in the export structure. New export goods using the comparative advantages have to be developed. Following the world wide trend of integrating into the world market as a supplier of parts and components for multinational firms seems to be an option. In this way Georgia can get involved in the processing of products and the export of intermediates, which govern an ever increasing share of world trade. The government should aim to enable Georgian firms to create new products which are demanded as intermediates by foreign buyers. In the beginning these would be likely rather simple labor-intensive products which, however, can be technologically upgraded over time. Close and enduring supplier-buyer relations lend themselves to exchange of technical, organizational and marketing knowledge which the Georgian export might use to enhance his products and production process.

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