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The Role of the International Community in Improving Investment Climate in the South Caucasus

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Introduction

This paper analyzes the investment environment in the South Caucasus. A particular attention is paid to requirements to improve the investment climate and the role of the international community in this process.

The importance of investment environment in economic and social development of a country is not debatable in economic literature. Indeed, stimulating domestic and international investment has become a major force behind economic progresses in most circumstances.

An investment-receptive environment in the South Caucasus is key for regional development. Numerous difficulties have prevented the countries from succeeding in this area during the transition. Problems with economic and political security, development strategy and prevailing corruption have been and still continue to be major hindrances for stimulating investments. The countries have been working in cooperation with international organizations to resolve some of the prevailing problems, but much remains to be done in the near future.

Why investments Matter

Investments are an important component for stimulating economic development in a country. As the well known economist Dani Rodrik points out “Countries that are able to engineer increase in their investment efforts experience faster economic growth¹”. High

¹ Dani Rodrick “The new global Economy and Developing Countries. Making Openness work” *Overseas Development Council*, Washington DC, 1999, P. 64

investment and economic growth is followed by increased trade and the country's integration into world economic system. Moreover, increased investment and economic recovery positively affects the social environment in the country.

There is no doubt that economic growth supports establishment of a prosperous country with rising income and living standards. Human development indicators, such as life expectancy, infant mortality rate and poverty have improved as a result of economic growth. The economic literature also demonstrates that these impressive developments directly follow an increase in domestic and international investments. The best example has been the miraculous economic and social progress of the South East Asian countries mostly stimulated by the high investments rates.

An important link between investments and economic growth suggests that stimulating investments can become a major driving force behind economic development of South Caucasus. Therefore it is very important that countries of the region place an increasing emphasize on creating a receptive environment for domestic and international investments.

Investment Environment in the South Caucasus

The South Caucasus has experienced positive and negative repercussions from the breakup of the Soviet Union. The positive aspect of creating new independent states with opportunities to build democratic, market oriented systems was almost counter balanced by its negative counterparts.

Indeed, weak state and institutional capacity, poor economic foundations and high corruption rendered the South Caucasus states especially vulnerable to tensions and conflicts during the early stage of transition. As severe political conflicts demonstrated, weak institutions were unable to overcome internal and external disturbances, causing the collapse of regional security.

As a result, the South Caucasus was incapable of coping with posed economic challenges. The national income in the region has fallen by more than 60 percent, with Georgia experiencing fall by more then 70 percent². Severe political difficulties has exacerbated economic challenges and transformed the region into a source of conflicts and failure.

The economic recovery of the region became possible after the mid 1990s, when an economic stabilization package was put forward in countries with the help of international institutions. Relative political stability made it possible to resume economic progress in the countries. However, results achieved since then are far from satisfactory.

² Data taken from, the World Bank, World Development Indicators, 2000

Economic policies of the South Caucasus countries failed to adjust to market economy requirements and produce effective results. The region failed to create attractive environment for investments. Only the Azerbaijan oil sector was capable of attracting large international investments in the region, in particular in Azerbaijan and in Georgia at a lesser extent. However, Azerbaijan's impressive success of attracting investments in the oil sector has not been matched by the non-oil sector³, suggesting important deficiencies in the investment environment in the country. Despite a large investment potential of the region, expressed in rich human resources and a strategic geopolitical position, international investments in the Caucasus (excluding oil related investments in Azerbaijan) fall short of the analogous number in the Eastern Europe (see annex 1).

At present, the region demonstrates a need and concern to stimulate high economic growth. The authorities also understand the role of investments in the economic growth. However, improving the investment environment is by no means an easy task. It requires effective implementation of a comprehensive package of political and economic measures. A stable political environment and rule of law principles are preconditions for creating a receptive investment environment. This should be accompanied by investment friendly economic policies, sound fiscal and monetary standing and improved administration.

These necessary reforms are hard to implement with the present institutional capacity of the region. Therefore, close cooperation among authorities and international institutions are key for initiating and carrying out successful measures. Only continued cooperation between the international community and countries can yield effective results. In addition, achieving noticeable results requires implementation of an elaborate operational strategy from countries and close coordination among activities of all international organizations.

Improvement of Investment Environment and the Role of International Organizations

The South Caucasus today is a clear example on how a region with great potential can be trapped into political and economic struggles which hinders economic development. Although more than a decade has passed since it started its economic transition, many important reforms are still incomplete (or even not yet started).

Since the end of military conflicts, the region has been elaborating strategy for the economic and social development. The process that has been underway has significant deficiencies. A package of investment climate improvement actions has not been carried out or even properly identified. A few isolated efforts have been carried out but these separate measures could not produce positive change, as demonstrated by recent less-successful attempts. A comprehensive package of carefully coordinated political and economic measures can be the only successful strategy.

³ Azerbaijan Poverty Reduction Paper; 2003; p. 116

The required package of actions should target (1) regional security and cooperation, (2) coherent economic policies, and (3) combating corruption and illegal economic activities.

- **Promoting Regional Security and Cooperation**

The role of political and economic security in stimulating investments is difficult to underestimate. Regional security is instrumental in promoting stability – the cornerstone of effective investment climate. It is also evident that without close cooperation among the South Caucasus states, regional economic security can not be realized.

Presently, the economic security occupies a significant place in countries' security agendas. Caucasus, in cooperation with the OSCE and other international organizations has been developing a sustainable economic security infrastructure. However, the damage produced by conflicts and the disarray in the early transition period has not been eliminated yet. Poor institutions and an inadequate treatment of the problems have produced states with weak economic and political security system. A new regional political and economic security system is not still in place. Despite recent progress, Georgia is an example of a country still highly vulnerable to shocks that might cause a collapse of its economic security system. (Please refer to the annex 2 for the theoretical overview and practical demonstration of this issue). The example of Georgia is easily generalized on entire south Caucasus.

Development of the economic security system in the countries can become a precondition of creating an investment friendly environment. Investment can only soar after investors are relatively better insured against political and economic fights and internal and external shocks.

Institutional capacity building is the major factor contributing to development of countries economic security system. Indeed, societies with deep social cleavages and poor institutions are weak when facing economic shocks. Therefore, development of institutional capacity in the region with the aim of promoting security and cooperation should be high in the agenda of international institutions.

The involvement of the OSCE and its comprehensive approach to security issues has been very significant to the states in the South Caucasus. The OSCE has attempted to work in the highly vulnerable regions and promote economic security. The OSCE has extensive experience and comparative advantage in this field. Indeed, the OSCE has been working in the South Caucasus for more than a decade. Political involvement, provision of technical expertise and financial assistance has been high in the security agenda of the OSCE. The OSCE has been employing a combination of activities to meet its objectives in tackling the existing problems. It has been engaged in supporting good governance and combating corruption at various levels. A particular focus has been placed on supporting small and medium size business development, combating illegal economic activities and sustainable economic

development. These areas still face various challenges and continuous OSCE involvement can be invaluable due to its experience and expertise to address the economic security issues.

- **Coherency in Economic Policies**

Another important aspect of promoting investment environment is coherent monetary and fiscal policy. Many countries in transition have an experience of wild monetary expansion resulting in high inflation. With the support of international institutions, conditions improved significantly since the mid 1990s. The involvement of international financial institutions such as International Monetary Fund and the World Bank was instrumental to get countries growing again. Unfortunately, the progress fell much short relative to the successful Eastern European countries.

The low rates of development in the Caucasus should be attributed to the improper economic strategies of the countries at early transition. Moreover, an almost lack of any strategy characterized the south Caucasus countries. Most of attention concentrated on wars and conflict, leaving inadequate consideration to the economic recovery. Only in the middle 1990s, the region has managed to combat hyperinflation and pursue adequate monetary policy with the help of international economic institutions.

Fiscal imbalances have been a major evil in the economy of Georgia for some time. Poor planning and even worse implementation has been a drag on the economy. A large shadow economy has flourished with an environment of a poor taxation system, low incentives and high administrative barriers. All this has served as a hindrance to improving investment climate. The new authorities have started to address these issues by placing them high on the agenda. Although, present capacity of the countries does not allow them tackling numerous problems, without assistance of the international community.

Improving conditions in the financial system in the region deserves special attention. Although a number of international banking institutions have entered the financial market in the Caucasus, the market is shallow, not allowing efficient channeling of savings into investments. Attention to improving the financial infrastructure in the region should be an important prerequisite for channeling international investments into a very promising south Caucasus region. The EBRD, the World Bank and the USAID, among others have paid special attention to the strength of the financial system in Georgia. A number of programs have been either implemented or are underway in this area. The region duly appreciates the assistance in such an important matter. Further support is needed in the banking, insurance and financial markets sectors.

Improvement of the economic standing of the region requires strengthening its human and institutional capacity, where the international community has a clear and continuing role to play. Assistance of the World Bank, International Monetary fund,

development agencies of USA, Germany, Canada and Sweden, among others, has been significant to aid the transition process in the region. Continued support is still needed.

- **Anticorruption agenda:**

Tackling the high corruption in the South Caucasus is vital to improve the investment climate in the region. All South Caucasus countries have suffered much from the prevailing corruption during transition period. Corruption has penetrated all areas of economic and political life, including public administration, judiciary, economic administration, education and even health care. The countries have been constantly rated as having high corruption in the transparency international annual corruption perception index. (Armenia 3.0, Azerbaijan 1.8 and Georgia 1.8, out of possible best score - 10⁴). Corruption has undoubtedly prevented many progressive steps in the countries. Indeed, according to the World Bank estimate, countries that were able to tackle corruption and improve rule of law were able to quadruple their income in the long term period. Converse is also true, 75 % decline of income can follow high corruption in the long term.

Combating corruption has been a major challenge for the south Caucasus during the transition period. With the support of international institutions, the countries have started addressing this challenge since 2000. All three countries have taken some anticorruption initiatives, but with less success than needed. Despite some progress with adoption of new legislation, corruption still continues to destroy trust in government institutions.

Corruption in the South Caucasus has been a systemic problem, so the means to fight it should be comprehensive. Understanding of a complex and systemic nature of corruption is necessary to target all affected sectors and institutions.

The international organizations have a significant role to play in supporting countries to address those challenges. The international community can provide countries with the needed experience and expertise in this area. However, ensuring success of the anti-corruption activities requires close cooperation of all international organizations and the authorities. *As corruption has rendered vulnerable all areas of society, isolated efforts of the organizations will be unsuccessful. It is essential that the organizations in close cooperation with the government have a comprehensive, all – involving strategy, rather than relying on solitary actions of any one of them.*

Conclusion

The investment environment in the South Caucasus needs improvement. Although countries are willing to make efforts in this direction, they alone lack a capacity for this.

⁴ www.transparency.org, CPI 2003; cited May 27, 2004

The major role for international organizations should address capacity building of the local authorities that will eventually support increasing regional cooperation and security, elaborating and implementing proper economic policies and combating corruption.

Improving the investment environment and stimulating domestic and foreign investment is a precondition for economic development of the region which translates into gradual social development.

Annex 1. Level of Foreign and Domestic Investments in the selected transition economies (1999)

Country Name	FDI/GDP 1999	Gross Investments/GDP 1999	FDI/ Gross Investments 1999	FDI net, USD, 1999
Caucasus				
Armenia	6.6	19.5	34.0	1.2E+08
Azerbaijan	12.7	39.6	32.2	5.1E+08
Georgia	3.0	16.8	17.8	8.2E+07
Eastern Europe				
Bulgaria	6.5	19.0	34.1	8.1E+08
Czech Republic	9.6	28.4	33.7	5.1E+09
Estonia	5.8	24.5	23.8	3.1E+08
Hungary	4.0	28.8	14.0	2.0E+09
Latvia	5.6	26.3	21.1	3.5E+08
Lithuania	4.6	22.9	20.0	4.9E+08
Poland	4.7	26.4	17.8	7.3E+09
Romania	3.1	19.9	15.4	1.0E+09
Other				
Russian Federation	0.8	15.5	5.3	3.3E+09
Turkey	0.4	23.3	1.8	7.8E+08
Ukraine	1.3	19.8	6.5	5.0E+08

Source: WDI 2000, CD ROM

Table 1

Annex 2. Economic Security Aspects in Georgia

The issue of economic security has attracted much attention during the last decade⁵. The definition of economic security is not a uniform one and various authors have provided different perspectives on the subject.

From many varieties of definitions, a few are especially interesting. They describe the economic security as:

- An economic system guaranteeing security of national interests (including social interest) during an unexpected disturbances
- A system guaranteeing independence, stability, sustainability and constant evolution of the economy
- A system possessing sustainability and immunity from internal or external disturbances

The synthesis of these various economic security aspects has led authors to the following definition of economic security⁶:

- Economic security implies sustainability of the national economic system against economic or political shocks, either internal or external. Moreover, economic security should mean the ability not only to cope with such threats, but also the ability to identify and neutralize them.

This definition puts these risks into the following matrix: (table 1)

<u>RISKS</u>	Internal	External
Economic	Internal Economic System Disturbances	External Economic System Effects
Political	Economic policy actions, affecting the system adversely; Social or Political crisis;	External Political Pressure

Theoretical classification of threats to Economic Security

Table 2

The matrix shows that all possible risks to the economic security of the country can be classified as one of 4 types:

1. *Internal Economic* risk implies destabilization of the internal economic system due to its inadequacy. A representative example of such a risk in Georgia is

⁵ A good reference might be: Cable V. What is International Economic Security? *International Affairs*, April 1995. V. 71, # 3, pp 305-24

⁶ See Афонцев С. Национальная экономическая безопасность: на пути к теоретическому консенсусу. *Мировая Экономика и Международные Отношения*, 2002, # 10 с. 30-39

- regular energy blackouts, which contribute to hindering fast development of economy.
2. *External Economic* risk implies frequent economic disturbances outside the country, making every state in the world vulnerable in this era of globalization. The repercussions of the economic crises in Russia and Turkey demonstrated the vulnerability of the Georgian economy to such shocks.
 3. *Internal Political* threats are those political steps having a potential impact on the functioning of the economy. Internal political tension and corruption can be a classic example of this shock in Georgia
 4. *External Political* threats imply political pressure of the international community over a country, expressed by economic means. Economic or energy sanctions can be a good example of such a pressure.

Table [2] summarizes the threats to Georgian economic security from this theoretical perspective.

<u>RISKS</u>	Internal	External
Economic	Regular energy crisis	Terms of Trade Shock; Financial Crisis in Russia, Turkey
Political	Defective Privatization; Corruption; Political Tension	External Political Pressure; Trade and Investment Policy

Threats to Georgian Economic Security

Table 3

The matrix demonstrates that Georgia has been highly vulnerable to threats of economic security. Moreover, the present Georgian institutions are still incapable of neutralizing the possible risks and therefore create significant problems to the economic security of Georgia.