



## Georgia Manufacturing Sector Competitiveness Assessment

### Identification of Most Promising Manufacturing Sectors and Priority Actions to Accelerate Investment and Growth: Preliminary Recommendations to Government of Georgia

#### Executive Summary

Prepared by World Bank Group Investment Climate Advisory Services (ICAS)

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#### Project background and objectives

With liberalization and deregulation, the Georgian economy has taken off in recent years. The government has implemented wide-ranging reforms to reduce regulation and corruption, improve public administration, and streamline taxes and so on. As a result, Georgia has risen from 120<sup>th</sup> position in 2005 in the World Bank's Doing Business Rankings to 15<sup>th</sup> position in 2008, and GDP has taken off, more than doubling in nominal terms from \$5 billion in 2004 to over \$12 billion in 2008. Both foreign and domestic investment have boomed, as investors have tapped into the growing market opportunities. Total private capital inflows have risen from less than \$500 million in 2004 to almost \$3 billion in 2008, and net inflows of Foreign Direct Investment (FDI) have increased from less than \$500 million in 2004 to a peak of \$2 billion in 2007.

The vast majority of foreign and local investment has flowed into domestic infrastructure (transport, telecom, energy, real estate) and domestic-oriented services (financial services, retail, construction, etc.). With privatization of ports, airports, telecom networks, etc., and growing local consumption, this type of investment happens almost automatically – if they want to capture a share of this market, global banks, retailers, port operators, telecom companies, etc., have no choice but to invest in assets in Georgia. Persuading investors to set up production operations in Georgia, either to serve the local market or to export, is more challenging. Investors need to be convinced not just that Georgia is a good place to do business, but also that production in Georgia will be more competitive than producing elsewhere and then exporting product from that location to Georgia or to other countries.

As investment has flowed into infrastructure, construction, retail and so on, domestic demand (for construction materials, food, consumer goods, etc.) has boomed, but domestic production of these inputs has not kept pace. And there has been very little investment in export-oriented agribusiness and manufacturing. As a result imports have soared, while exports have grown much more slowly. Despite Georgia's rapid economic growth, there has been very little new job creation – in fact, the total number of employed people has marginally declined over the last 5 years, while the number of unemployed has increased slightly.

The Government therefore asked the World Bank Group's Investment Climate Advisory Services (ICAS) to conduct a rapid preliminary analysis of the competitiveness of Georgia's agribusiness and manufacturing sectors, in order to identify those sectors where Georgia has the best opportunity to be competitive and attract investment. Rather than completing in-depth analysis of all sectors, the aim has been first to identify the most promising sectors, so that resources can then be focused on more detailed research and recommendations in these sectors. The objectives of this study are therefore to:

1. Identify all agribusiness & manufacturing sectors where Georgia has some trackrecord or potential
2. Assess the relative competitiveness/attractiveness of these sectors
3. Identify key issues holding back growth in each sector and recommend the types of actions that the government and other players may be able to take to accelerate growth – these will need further elaboration, but this report should provide pointers for further study.

## Project Scope and Approach

The Government initially proposed 3 priority sectors for analysis, based on their historic importance to the economy: secondary agribusiness production, paper, and mechanical sectors, particularly automotive. After input from stakeholders, the ICAS team decided that the assessment should cover additional agribusiness and manufacturing sectors where Georgia has some track record or potential – rather than just evaluating legacy sectors which may be found to be uncompetitive today, the objective is to identify any sector where Georgia may be competitive, even if they have not been large sectors in the past. The team therefore evaluated the following sectors:

Agribusiness	Traditional Industries	New Industries
<ul style="list-style-type: none"> <li>• Wine</li> <li>• Nuts</li> <li>• Tea</li> <li>• Vegetables</li> <li>• Fruit</li> <li>• Meat &amp; Dairy</li> <li>• Fish &amp; Sea Products</li> <li>• Grains &amp; Pulses</li> </ul>	<ul style="list-style-type: none"> <li>• Automotive Equipment</li> <li>• Aircraft Equipment</li> <li>• Railway Equipment</li> <li>• Shipbuilding</li> <li>• Wood &amp; Pulp</li> <li>• Glass Packaging</li> </ul>	<ul style="list-style-type: none"> <li>• Apparel (&amp; other skilled manual operations)</li> <li>• Construction Materials</li> <li>• Pharmaceuticals &amp; Medical Devices</li> <li>• Plastic &amp; Paper Packaging</li> </ul>
Sectors where Georgia traditionally had significant exports and/or where large enterprises employed significant numbers		Sectors where regional or global demand growth suggest opportunity

To evaluate the competitiveness of these sectors, the team drew on three sources of information:

- **Stakeholder Interviews:** the ICAS team met and interviewed more than 50 stakeholders (policy-makers, donors, business organizations and individual firms in each of the sectors) and conducted site visits to key enterprises in Tbilisi, Kutaisi, Batumi and Poti
- **Existing Reports and Studies:** the team reviewed and consulted more than 70 existing reports by government agencies, donors, industry associations and others - on Georgia's overall economic performance, as well as studies of specific sectors and competitiveness factors
- **Data Analysis:** the team collected and analyzed key data that provide indicators of potential market opportunity and relative competitiveness in each target sector:
  - Data on exports, imports and FDI for Georgia and neighboring countries
  - Import data for major regional blocs (EU and CIS)
  - Key competitiveness drivers for Georgia and relevant competing countries in each sector: factor costs, skills supply, business environment, etc.

Drawing on these sources, the team asked 12 questions about each of the target sectors:

### **A. To what extent is the market opportunity attractive?**

1. Is there good export potential for this product in major global markets (EU, CIS, Mid East, etc.)?
2. Is there good import substitution potential for this product in Georgia, Armenia and Azerbaijan?
3. Are prices attractive and/or rising?
4. Is supply from key competitors being constrained?

### **B. To what extent can Georgia be competitive?**

1. Are there existing enterprises successfully competing in this sector in Georgia?
2. Does Georgia have better cost factors (labor, infrastructure, taxes) than key competitors?
3. Does Georgia have resources or other natural advantages?
4. Does Georgia have market access advantages (due to location, logistics or trade deals)?
5. Does Georgia have the skill base to compete in this sector?
6. Are any barriers to competitiveness in this sector relatively simple to remove?

### **C. To what extent will focus on this sector generate impact?**

1. Will investment in this sector impact jobs, incomes, exports, etc.?
2. Are we aware of prospects already interested in this sector in Georgia?

Each sector was scored on a scale of 1-5 against each of these 12 questions (with 5 indicating very attractive/competitive, and 1 indicating very unattractive/uncompetitive). A total weighted average score was then calculated to reveal the relative competitive potential of each sector.

## **Recommended priority sectors for further development**

Two tables summarizing the relative competitive potential of each sector according to the 12 evaluation criteria are attached to this executive summary. Based on this analysis, ICAS recommends that government, donors and other players focus particular attention on the following sectors, which appear to offer the most potential for local and foreign investors:

### **Wine, Fruit and Vegetables**

- These are traditional lead exports of Georgia; while the main historical market (Russia) is now closed, alternate markets (rest of CIS, plus EU) are larger and higher income. In the case of fruit and vegetables, despite Georgia's assets, Georgia has become importer in recent years – the opportunity exists for local producers to replace imports, as well as export
- Georgia has good growing conditions, established infrastructure (orchards, vineyards, etc.) and underlying know-how. All cost factors are favorable vs. alternate locations. Main weaknesses are small scale, inconsistent quality/standards, but attracting large investors is key to changing this
- Growth in these sectors will have very high employment impact

### **Construction Materials**

- Despite the global slowdown, the construction sector in Georgia, Azerbaijan and Armenia is likely to remain relatively robust due to oil and gas, infrastructure and public sector projects
- Most larger volume, lower value materials make sense to manufacture in region vs. import (e.g. aggregates, metal/wood/plastic components, stone and ceramic, electrical, etc.)
- Georgia has the best cost factors, logistics and business environment for serving the 3 countries, and some key raw materials. Several investors have already established operations in Georgia to target the opportunity – in cement, gypsum, metal components, windows and doors, electrical parts, etc.
- Growth in this sector will have significant employment impact

### **Apparel**

- Turkish apparel firms have established relationships and trust with major EU buyers, but face rising costs and labor shortages; they are therefore looking for expansion locations
- Georgia offers competitive cost factors (labor, utilities, real estate, taxes), privileged access to the EU (and potentially US) markets, plus proximity and familiarity for Turkish investors. Georgia also had an apparel assembly cluster around Kutaisi, although the factories and skill-base are now aging
- Growth in this sector will have very high employment impact

### **Pharmaceuticals and Medical Devices**

- Like construction materials, there is a significant market for imported pharmaceuticals in the Caucasus and Central Asia, with growing demand for lower-cost generics
- Producers from India, China and Russia offer tough competition, but existing Georgia-based producers appear to be gaining share by focusing on quality/image, market relationships and language advantage, while remaining cost competitive

While beyond the scope of the current assignment, the team also noted significant potential for export and job generation in non-manufacturing sectors:

### **Exportable Services**

- Given barriers to competitiveness in many manufacturing sectors (subscale market; limited natural resources and space; logistics constraints – large part of border closed to traffic; conflict risk), there are good reasons for investors in Georgia to focus on exportable services
- Thanks to the success of India, most countries and regions around the globe are now marketing themselves as hubs for “offshore” services: IT programming, business process management, call centers, etc. It is a crowded market, and Georgia is too small to be major supplier to the EU or US
- But with Georgia's high education levels, multilingual population, pro-business environment, there is potential to become a services hub for the region (like Costa Rica for Latin America) – call centers, finance, HR, engineering, architecture, etc., for Caucasus, Central Asia, Turkey, Iran, etc.

### **Logistics / Transport Services**

- As the natural entry/exit point between the Caucasus, Central Asia and the rest of world, Georgia is also the natural logistics and transport services hub for the region: for inbound/outbound shipping, rail and road services; air-cargo hubs; transshipment and intermodal hubs, etc.

- Plans for development of Poti Port, Tbilisi Aviation Park, and the rail and road corridors reflect this opportunity and will further reinforce Georgia's position

### **Tourism**

- Conflict-image issues notwithstanding, tourism should be the largest industry in Georgia: tourism is the largest industry in the world and the fastest growing in absolute terms, and it is clearly the most important sector in similar countries (Turkey, Greece, Bulgaria, Egypt, etc.) blessed with Mediterranean climate, ancient civilizations, good beaches, spectacular mountains etc.

### **Utilities**

- With the new connector to Turkey, projects to export hydro-electricity to Turkey are already under development. Given Georgia's natural resources and liberalized utilities, Georgia could generate more revenues and jobs through further exports of power and even water to neighboring countries

### **Primary Process Industries**

- The government suggested that this current study does not need to cover primary processing industries like metallurgy and petrochemicals, since investment in these sectors is taking off anyway. Nevertheless, it is important to note (given Georgia's oil and gas pipelines, energy supply, mineral deposits, existing metallurgy cluster, favorable business environment and position as a gateway to/from Caucasus/Central Asia) that these sectors could also be major contributors to export revenues and job creation

## **Over-arching issues to be addressed**

Specific recommendations to accelerate growth in each sector are provided in the full report, but six cross-cutting issues that limit Georgia's competitiveness in all sectors are worth highlighting:

### **Education**

- The single most important factor driving investment decisions today is the sustainable supply of skills. It is what keeps many industries in high-cost locations like Silicon Valley or London or Munich; it is what attracts IT operations to India and Ireland; and it is what maintains Israel's agriculture exports or Turkey's textile exports, despite high wages relative to China or India
- With 100% literacy and a reputation for high education levels, skills should be a major asset for Georgia, but by all accounts, they are not: the quantity and quality of technical graduates has collapsed since the end of the USSR
- Particularly in Georgia's traditional engineering sectors (auto, aircraft, trains and ship-building), the main reason for investors to invest would be if there were a strong skill-base of engineering skills which gives Georgia a head-start over alternate locations – the factories themselves and the products are so out-dated that they are of virtually no value. But with all the engineers and managers at these factories over 50 years old, and no new generation coming up, there is little case for investment
- Even in sectors where other factors may be the main motive (e.g. climate and growing conditions for wine, fruit and vegetables; labor costs and market access for apparel), lack of technical personnel will slow sector growth and reduce the benefits to Georgia. If investors have to import the more specialist technicians (e.g. production engineers, chemists, agro-engineers), this means immediate lost income for Georgia, but also limits Georgia's ability to move up the value chain and generate higher incomes from these sectors
- Because of the critical link to long-term competitiveness, governments all over the world tend to invest in education. Even in countries where the private sector provides most higher education, the government plays a major role in stimulating production of science and engineering graduates (through direct subsidies, government-funded R&D programs, promoting science and engineering to school children, etc.)
- Unless Georgia does the same, it will be unable to retain industries like heavy engineering, and it will get limited value from sectors like agribusiness, apparel and pharmaceuticals

### **Promotion (internal and external)**

- In many sectors, there is no need for special government incentives or support; investors just need to be made aware of the opportunities and potential non-commercial risk mitigation instruments

- For example there are many areas where increased local production requires relatively limited investment or simple technology, well within the capacity of local investors (e.g. in vegetable and fruit processing for export; or in dairy and meat production for the local market), but local entrepreneurs are unaware of the opportunities or of the technologies and techniques required
- And in many sectors, potential international investors are likely unaware of Georgia's competitive cost factors (e.g. in apparel, or in veg and fruit processing for Europe) or of the regional market size (e.g. in construction materials, pharmaceuticals, packaging etc.)
- Well targeted promotion of the opportunities in key sectors to local entrepreneurs and foreign investors would likely create significant additional investment at little cost

### **Standards**

- In many sectors (e.g. fruit and veg, wine, pharmaceuticals), Georgia's ability to grow exports and investment will be greatly enhanced if producers meet international standards
- In some cases, meeting minimum standards is a pre-requisite for exporting (e.g. for exporting food products to the EU); in other cases, voluntary standards and quality-grading by industry players will increase quality-assurance and provide Georgian producers with a source of competitive differentiation and potential price premium (e.g. denomination standards in wine, labor standards in apparel, GMP standards in pharma production, etc.)
- Government and donors can aid the competitiveness of key sectors by at minimum providing education on standards, their benefits and the process for meeting them; and, where necessary, imposing industry-wide standards to ensure rogue operators do not damage the image of all Georgian producers – in wine, fruit and vegetables, pharmaceuticals, and so on

### **Collaboration**

- In many sectors, increased collaboration between producers would greatly enhance competitiveness – e.g. shared sourcing and joint marketing in wine and other agribusiness sectors; joint development of supporting industries for apparel, etc.
- At minimum, shared performance of business functions (e.g. joint marketing, sourcing, distribution, training, certification, R&D, etc.) would reduce individual producers' costs. And in some areas, establishment of sector-wide brands and norms (like Colombian Coffee) may be critical to successful market-entry and higher price realization
- In a small country like Georgia, joint action is all the more important to achieve critical mass, rather than competition between multiple small players

### **Access to Finance**

- Investors in several sectors commented favorably on the government's "cheap credit" program, which had enabled them to access the finance to develop their operations
- Given commercial banks' reluctance to lend to start-up manufacturing enterprises (as in most countries, when there are easier returns to be made in government treasuries, real estate and so on), now compounded by the global credit crisis, it is recommended that the government and donors continue (and if possible expand) programs like this that facilitate investors access to finance for agri-processing and manufacturing enterprises

### **Tax Administration**

- While there was widespread recognition of the improvement in the business environment in recent years, in terms of taxes, red-tape, corruption and so on, one area where investors continue to find fault with the government is in tax administration. Across sectors, there is a widespread perception that the tax authorities are overly aggressive in levying taxes and penalties on those companies that are doing their best to comply; and they are overly slow in processing appeals or reimbursing VAT
- While this may be inevitable given a residual culture of tax avoidance, the government needs to be careful not to discourage investment in manufacturing (as opposed to imports and distribution) and/or drive production into the informal and unregulated sector

## **Recommended Next Steps**

Based on this rapid preliminary analysis, ICAS recommends the following next steps:

### **1. Disseminate findings of this preliminary analysis as widely as possible**

- As noted above, in many sectors, the conditions for production in Georgia are very favorable, but local entrepreneurs and/or international investors are simply unaware of the opportunities. There is also a widespread perception among investors and donors that the government prefers a laissez faire approach and does not want to help organize/promote specific sectors
- All stakeholders interviewed during this project were therefore very excited to hear that this project has been launched and expressed great interest in obtaining the results
- Taking the opportunity to present this analysis to private sector groups in each major city and to foreign embassies and donors will help to make more people aware of the opportunities, and will help donors and business organizations to direct their support to the most promising sectors

### **2. Develop and launch coordinated sector strategies for the identified priority sectors: fruit and vegetables, wine, construction materials, apparel, and pharmaceuticals**

- In these priority sectors, detailed sector development strategies now need to be developed:
  - Segment and quantify the competitive opportunities in more detail (e.g. segment which specific fruits in which specific markets offer the best opportunities for Georgian producers; quantify in more detail Georgia's cost advantage in apparel or construction materials over alternate locations)
  - Develop materials to present these opportunities to local and foreign investors
  - Identify specific target investors and develop a practical plan for approaching them
  - Flesh out the recommended actions that the government and donors can take to accelerate growth in these sectors (through supporting skill development, collaboration, standards, etc.)
- In developing these sector strategies, two key principles should be followed:
  - Don't reinvent the wheel: in many areas, donors or private investors (e.g. GTZ in the wine sector; RAKIA for Poti Free Zone) have already identified the opportunities and targets and the barriers to be removed; leverage these studies, and update where necessary, rather than starting afresh
  - Emphasize collaboration from the start: convene sector working groups, bringing together private players, interested donors and others, to develop coordinated, rather than overlapping, strategies for promotion, standards, skill development, etc.

### **3. Repeat preliminary analysis and prioritization for other sectors, particularly IT/BPO, logistics services and tourism**

- As noted above, the ICAS team believes that similar opportunities for increasing exports and employment exist in non-manufacturing sectors, particularly exportable services, logistics/transport services, and tourism
- In these sectors, the government should undertake a similar process to assess the competitiveness of different segments and thereby identify the priority segments for further research and development

Relative Competitive Potential	Market Attractiveness				Georgia Competitiveness						Likely Impact		Overall
	Export market	Import market	Good prices	Competitor constraints	Existing investors	Cost factors	Natural advantages	Market access	Skill base	Limited barriers	FDI impact	Likely prospects	
<b>Wine</b>	2.8				4.5						4.5		<b>3.92</b>
	4	2	3	2	5	4	5	5	4	4	5	4	
<b>Fruit</b>	3.3				4.5						5.0		<b>4.17</b>
	5	3	3	2	5	4	5	5	4	4	5	5	
<b>Vegetables</b>	3.3				4.3						4.5		<b>4.00</b>
	4	3	3	3	4	3	5	5	4	5	5	4	
<b>Nuts</b>	1.8				4.3						4.5		3.50
	3	1	2	1	5	4	5	5	4	3	5	4	
<b>Tea</b>	1.3				2.3						2.5		2.00
	2	1	1	1	2	1	1	5	4	1	4	1	
<b>Fish &amp; Sea products</b>	4.0				3.5						2.5		3.50
	4	4	4	4	2	3	5	5	2	4	2	3	
<b>Meat &amp; Dairy</b>	2.5				2.7						3.5		2.75
	1	4	3	2	4	2	2	3	3	2	3	4	
<b>Grains &amp; Pulses</b>	2.3				2.2						1.5		2.08
	1	4	3	1	2	2	2	3	2	2	2	1	
<b>Wood &amp; Pulp</b>	2.3				2.7						2.5		2.50
	2	4	2	1	3	2	4	3	3	1	3	2	
<b>Plastic &amp; Paper Pack'g</b>	3.0				4.3						2.0		3.50
	1	5	3	3	5	5	3	5	3	5	1	3	
<b>Glass Packaging</b>	2.0				3.2						2.0		2.58
	1	4	2	1	4	2	4	4	4	1	1	3	
<b>Automotive Equipment</b>	2.0				2.0						2.0		2.00
	2	3	1	2	1	3	2	3	2	1	2	2	
<b>Railway Equipment</b>	2.3				2.5						2.5		2.42
	1	3	1	4	2	4	2	4	2	1	3	2	
<b>Aircraft Equipment</b>	2.3				2.7						2.5		2.50
	3	1	4	1	3	4	2	3	3	1	3	2	
<b>Shipbuilding</b>	1.5				2.3						1.5		1.92
	2	1	2	1	1	4	3	3	2	1	1	2	
<b>Construction Materials</b>	3.5				4.2						5.0		<b>4.08</b>
	2	5	3	4	5	4	4	5	3	4	5	5	

<b>Apparel, etc.</b>	3.0				4.3						5.0		<b>4.00</b>
	5	1	2	4	5	4	3	5	4	5	5	5	
<b>Pharma &amp; Med Devices</b>	3.3				4.0						3.0		<b>3.58</b>
	3	5	4	1	4	5	3	5	3	4	2	4	