POLICY BRIEFING 03|2021

German Economic Team
GEORGIA

Adjusting to changing FDI patterns – Leveraging clusters to tap new investment potentials

Bjoern Vogler

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Outline

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3. Role of clusters in investment attraction
4. FDI in Georgia
5. Cluster development in Georgia
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1. Introduction

Based on a review of the COVID-19 related impact on FDI flows, this policy briefing assesses opportunities for adjusting investment attraction measures focusing in particular on the potential of a cluster-oriented approach

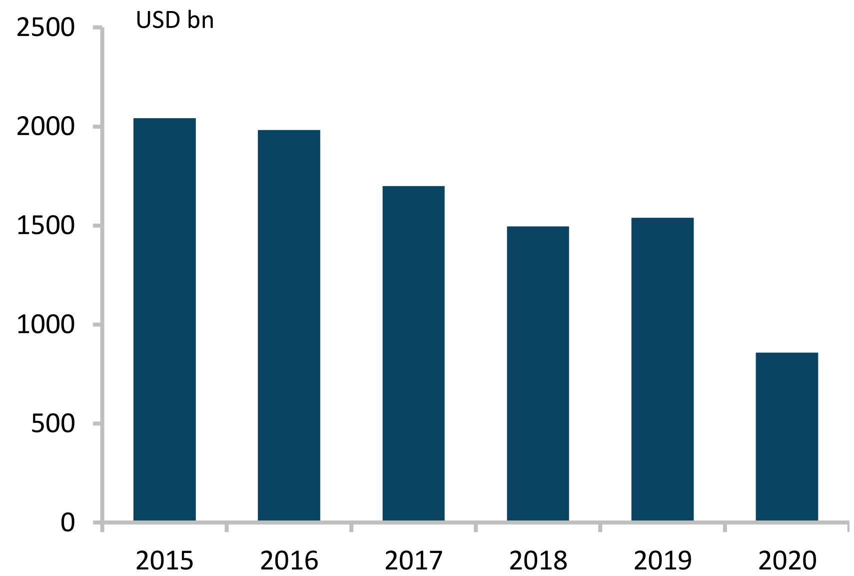
- Current conditions are challenging, with global FDI declining in recent years and the severe impact of the pandemic on investment flows
- At the same time, changes in investment patterns that have been accelerated by the pandemic also open up new opportunities
- In such a situation, it is essential that investment attraction measures are as effective as possible and synergies within the policy and institutional framework are fully unlocked
- Against this background, this briefing identifies opportunities for adjusting investment attraction measures in light of the transformation process
- Particular emphasis is on assessing the potential of leveraging clusters which are playing an increasing role in investment decisions
- Based on a review of international experience and conditions in Georgia, recommendations for a realignment of policy tools are derived

2. Impact of the pandemic on global FDI

Global FDI flows are under severe pressure as a result of the pandemic. FDI decreased by 42% in 2020 at the global level

- The immediate impact varied markedly across industries
  - Traditional sources of FDI such as tourism, energy, automotive, textile and apparel were experiencing severe disruptions
  - At the same time, a number of tech- and knowledge-driven industries, particularly in the life sciences and ICT / BPO sector, are showing robust investment activities
- Global FDI flows are projected to fall by a further 5 to 10% in 2021
- Growth in FDI inflows is not forecast to return before 2022

Global FDI inflows



Source: UNCTAD 2020

2. Impact of the pandemic on global FDI

The pandemic is also accelerating a range of pre-existing trends which strongly affect investment flows and global value chains (GVC)

- Already well before the pandemic, the transformation of investment patterns had started and FDI flows were declining
  - Following two decades of rapid expansion, GVC-related investment in physical assets stopped growing after 2010
  - Tech-driven investments, which do not need a large physical presence, became more prevalent
- The transformation process is expected to continue driven by technological changes as well as global economic governance and sustainability trends
- The combination of pre-existing trends and resilience-oriented restructuring in the context of the pandemic will shape future investment patterns
- While there will be more focus on resilient and sustainable value chains, cross-border investment in physical assets is expected to decline further
- Efficiency-seeking investment will continue to play an important role in global FDI patterns. However, the pool of this type of investment is shrinking

2. Impact of the pandemic on global FDI

Despite several challenges, the transformation process also opens up new opportunities. The following trends, which will play out to varying extents across industries, are of particular relevance for investment attraction efforts

<table>
<tr><th></th><th>Re- / Nearshoring</th><th>Diversification of value chains</th><th>Regionalisation of value chains</th><th>Replication</th></tr>
<tr><th>Description</th><td>Relocation and concentration of activities in hubs at or close to the home countries of investors</td><td>Wider international distribution of locations and suppliers leveraging digital solutions for the coordination of value chains</td><td>Shift from global efficiency-seeking to regional market-seeking investment and from investment in vertical segments towards broader industrial clusters</td><td>Distributed manufacturing close to the point of consumption using advanced production technologies, e.g. additive manufacturing</td></tr>
<tr><th rowspan="3">Related value chains / industries</th><td>• Machinery and equipment
• Electronics</td><td>• Textiles and apparel
• BPO / ICT</td><td>• Food & beverages
• Extractive & chemical industry
• Construction materials</td><td rowspan="2">• Medical devices
• Customised spare parts
• Footwear</td></tr>
<tr><td colspan="3">• Automotive
• Transport & logistics
• Wholesale</td></tr>
<tr><td colspan="4">• Pharmaceuticals
• Biotechnology
• Healthcare</td></tr>
</table>

3. Role of clusters in investment attraction

In light of changing investment patterns, clusters play an increasing role from the perspective of both investors and investment promotion agencies (IPAs)

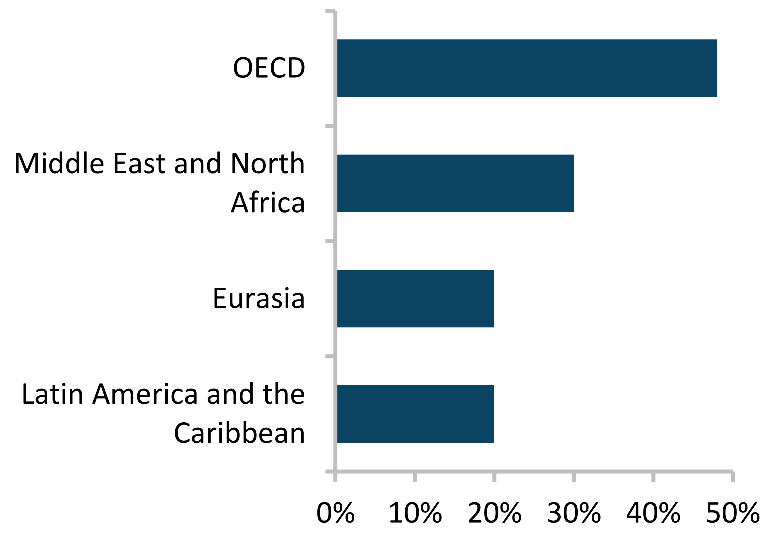
- Clusters are geographical concentrations of interconnected companies and institutions (e.g. research and training) focusing on related value chains
- The development of clusters is typically supported by cluster management organisations facilitating collaborative activities in areas such as innovation, internationalisation, sourcing and skills development
- Clusters are well received by investors. They believe that they can find the right skills, suppliers and infrastructure if they locate in relevant clusters
- In light of the mentioned changes in investment patterns that have been accelerated by the pandemic, clusters will further rise in importance
  - Industries, in which cluster-oriented location decisions prevail such as ICT or pharmaceuticals will account for an increasing share in total FDI
  - All transformation trends entail a focus on clusters. Investors will become more demanding preferring locations with established cluster structures – no matter if they are opting for a nearshoring, regionalisation or diversification strategy

3. Role of clusters in investment attraction

Around the globe, many countries have recently leveraged the cluster approach to increase the effectiveness of their investment attraction efforts

- The cluster approach allows to extract more value from FDI and to enhance the attractiveness for further investment
- The integration of investors into clusters provides opportunities to raise the competitiveness of domestic SMEs
- Linkages can promote the diffusion of technology and knowledge and offer an important avenue for domestic SMEs to integrate into global value chains
- Against this background, a growing number of IPAs has integrated cluster programmes into their service portfolio, including 20% of IPAs in Eurasia

Shares of IPAs offering cluster programmes



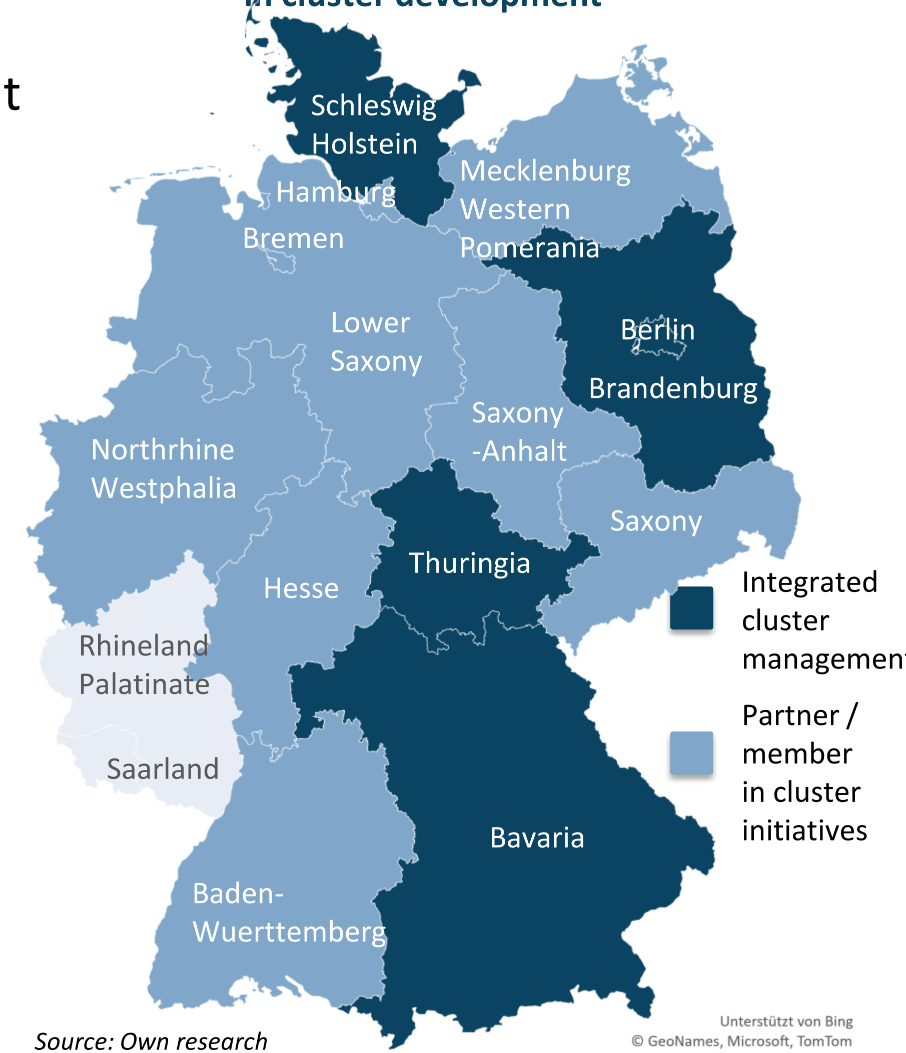
Source: OECD Mappings 2020, 2019, 2018

3. Role of clusters in investment attraction

Most IPAs of German Federal States play an active role in cluster development

- Germany belongs to the countries that pioneered cluster policy 25 years ago
- More than 400 cluster initiatives are active with a particular focus on:
  - Production and clean technologies
  - Automotive
  - Health care / life sciences
  - ICT / digital integration
- Most IPAs of German Federal States are either a partner / member of cluster initiatives or have taken over the cluster management themselves
- This way, IPAs can pool cluster-specific expertise and generate synergies

Role of IPAs of German Federal States in cluster development



Source: Own research

3. Role of clusters in investment attraction

Also in transition countries, a growing number of good practice examples can be found confirming the potential of integrating investors in cluster initiatives

- For instance, in Moldova an automotive cluster comprising approximately 25 companies, various universities and service providers has been initiated by the Free Economic Zone Balti
- Foreign investors such as Dräxlmaier, Fujikura, Coroplast and Confezione Andrea play an import role in the cluster initiative
- With their support, an engineering college has been opened in the zone offering a dual vocational training programme
- Collaborative innovation projects and a supplier development programme also form part of cluster-related activities

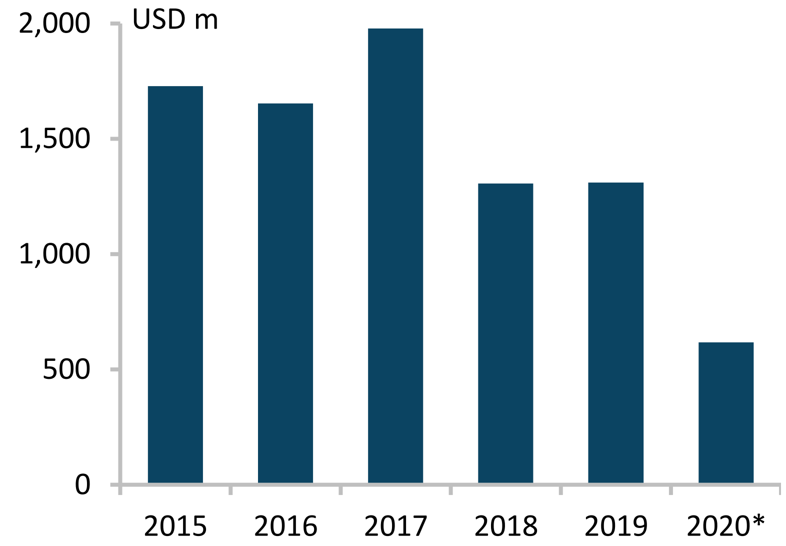
Free Economic Zone Balti

4. FDI in Georgia

FDI inflows in Georgia are also severely affected by the pandemic crisis, but to a lesser extent than in other transition economies

- In 2020, FDI in Georgia fell by 53% compared with 88% in transition economies overall
- In particular, FDI in the manufacturing, energy, tourism, transport and communication sector was severely affected. FDI flows in tourism even turned negative
- Similar to the global level, inflows already showed a declining trend in the second half of the last decade prior to the pandemic, although from a high level
- In the first half of the last decade, FDI inflows in Georgia had doubled

FDI inflows in Georgia



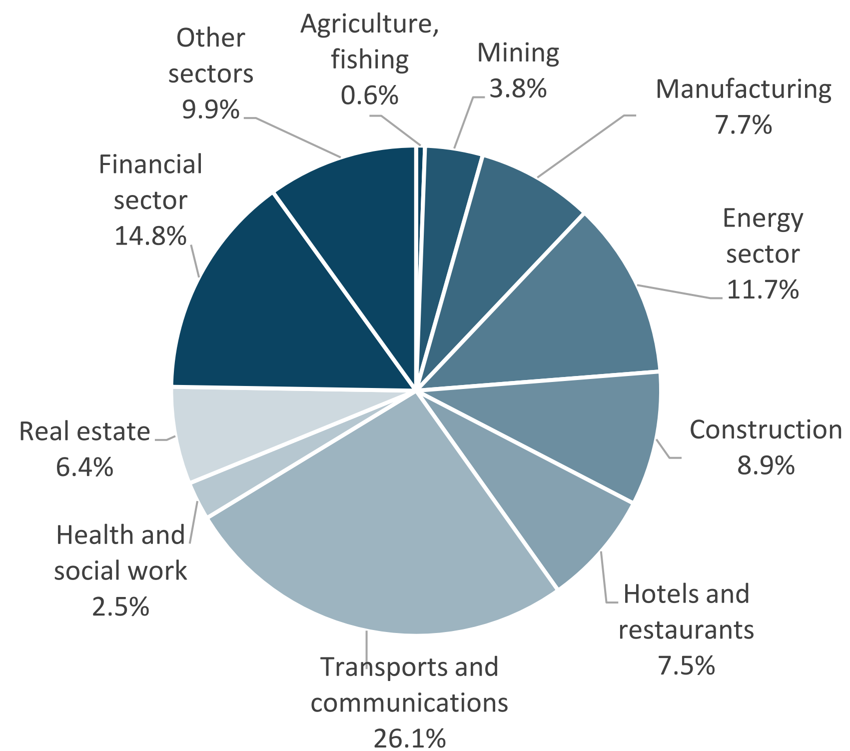
*Source: Geostat 2021; * Preliminary data*

4. FDI in Georgia

Despite the quantitative decline in FDI, progress could be made in the recent past in qualitative terms widening the scope of attracted investment

- Targeted investment promotion efforts were intensified shifting the focus from resource- and infrastructure-oriented towards export- and technology-oriented projects
- Furthermore, the incentive framework was realigned accordingly (e.g. introduction of the FDI grant scheme)
- However, despite a number of success stories, e.g. in the ICT / BPO, electronics and aviation industry, FDI is still largely going into hard infrastructure
- Manufacturing accounted only for 7.7% of FDI inflows between 2015 and 2019

FDI inflows in Georgia by sectors 2015-2019



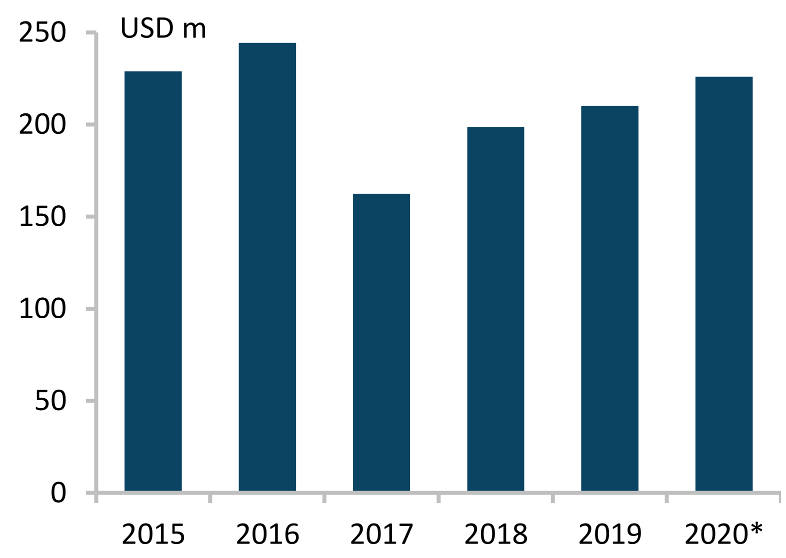
Source: Geostat 2021

4. FDI in Georgia

Although small in quantitative terms, German FDI played a significant role in the diversification of the FDI structure and development of new industries

- In quantitative terms, German FDI plays a rather minor role accounting for 1.2% of the total FDI stock in Georgia in 2020
- However, in qualitative terms, German FDI made an important contribution towards diversifying the investment and economic structure
  - The investments by Majorel and AE Solar stimulated the development of the BPO and electronics industry respectively
  - HeidelbergCement and Henkel are considered key investors in manufacturing
- Furthermore, bucking the general trend, German FDI in Georgia increased in 2020

German FDI stock in Georgia



*Source: Geostat 2021; * Preliminary data*

5. Cluster development in Georgia

In close collaboration with international partners, a range of cluster initiatives was established in Georgia in the recent past

- In total, 8 cluster initiatives were established or are currently planned covering a broad spectrum of industries
- International partners are closely involved in the design and implementation of the initiatives and relevant policies
- For instance, the Clusters4Development (C4D) project, which is implemented by GIZ with funding from the European Union and the German Government, supports:
  - Implementation of cluster initiatives in the construction, apparel and tourism sector
  - Development of institutional capacities and a conducive policy framework at the national level

Cluster initiatives in Georgia

Cluster	Year of establishment	Approximate no. of members
Film	2017	40
Furniture	2017	35
ICT	2018	15
Packaging	2019	40
Apparel and fashion	2020	25
Construction materials	2020	15
Seeds and seedlings	2021	10
Tourism	2021*	n.a.

*Source: Own research; *Planned*

5. Cluster development in Georgia

Despite this progress, cluster development is still at an early stage with a strong focus on SME development and limited involvement of foreign investors

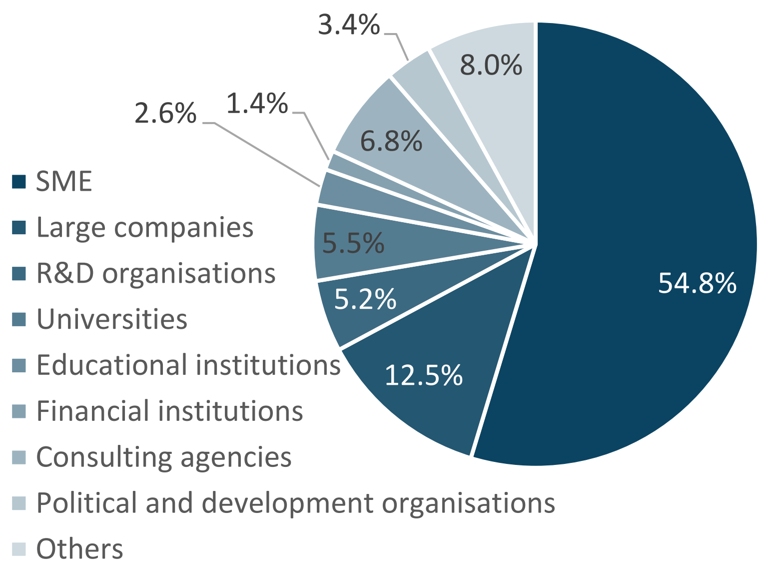
- Naturally, the cluster initatives are still small in terms of membership
- So far, foreign investors and large companies only play a very limited role in the initiatives
- There is strong focus on SMEs with respect to the membership structure and the service portfolio of the initatives (e.g. certification, export promotion)
- The synergy potential between investment attraction and cluster development is only partly tapped in terms of:
  - Promoting linkages between investors and local SMEs as part of cluster initiatives
  - Aligning cluster development measures with the target group focus of investment attraction
  - Integrating cluster initiatives into investment promotion efforts or aftercare services for existing investors

6. Conclusions and recommendations

The changes in FDI patterns also open up new opportunities. International experience shows that the cluster approach allows to increase the effectiveness of investment attraction. However, certain preconditions have to be met

- The cluster approach offers a promising potential to benefit from emerging trends and the resilience-oriented restructuring of value chains
- Preconditions include:
  - Focus on clusters with a high investment potential, a “critical mass”and balanced membership structure (incl. large companies and investors)
  - Integration of linkage promotion measures into cluster activities
  - Alignment of the policy and institutional framework

Membership structure of cluster initiatives in Germany



Source: Institut für Innovation und Technik 2019

6. Conclusions and recommendations

In the recent past, Georgia made considerable progress in terms of targeted investment attraction and cluster development. However, synergies between both areas are only partly tapped

- The shift in focus of investment attraction measures and the establishment of several cluster initiatives are certainly steps in the right direction
- At the same, there are substantial synergy potentials between the two areas that have been only partly tapped so far – especially for the development of export- and technology-oriented industries
  - With respect to existing cluster initiatives, in particular ICT, light industries and in the medium term tourism offer opportunities to attract and integrate investors
  - Regarding further target groups, in particular pharmaceuticals and in the medium term electronics and automotive are candidates for a cluster-oriented approach
- Efforts need to be intensified and aligned to …
  - Fully unlock synergy potentials and benefit from new opportunities in the context of the transformation of investment patterns and value chains
  - Keep pace with the transformation that has been accelerated by the pandemic

6. Conclusions and recommendations

Unlocking synergy potentials between investment attraction and cluster development requires a coherent approach

- Targeted investment promotion efforts should be intensified
  – Integrating cluster-related arguments into the value propositions
  – Drawing on the expertise of cluster actors to refine the target group selection focusing on opportunities to extend and close gaps in value chains
- As part of structured facilitation and aftercare services, foreign investors should be systematically integrated into cluster initiatives
- The service portfolio of relevant cluster initiatives should be refined
  – Reflecting also the needs of investors and large companies
  – Placing more emphasis on promoting linkages between investors and local firms as international experience indicates that a demand-driven approach closely involving investors is more effective than generic SME development initiatives
  – Using, for instance, collaborative skills and supplier development projects to foster innovation transfer and to integrate local SMEs into international value chains and markets

6. Conclusions and recommendations

Such a coherent approach using synergies between the two policy areas is complex and requires the alignment of the policy and institutional framework

- Investment policy tools should reflect the cluster focus – beyond investment promotion
  - A needs-oriented portfolio of investment sites should be developed which can also form the nucleus for (emerging) clusters, e.g. a pharma or life sciences park
  - Building upon the experience gained with the FDI grant scheme, the incentive framework should be further refined with particular emphasis on linkage promotion and skills development
  - Interrelations with investment attraction should be reflected in the new cluster policy framework
- The role of Enterprise Georgia in cluster development should be strenghtened
  - For the integration of cluster-related potentials and services into investment promotion and aftercare, a close collaboration with cluster initiatives is critical
  - Corresponding responsibilities should be clearly allocated in the organisational structure and capacities at the interface between investment attraction and cluster development should be strengthened

About the German Economic Team

Financed by the Federal Ministry for Economic Affairs and Energy, the German Economic Team (GET) advises the governments of Moldova, Georgia, Ukraine, Belarus and Uzbekistan on economic policy matters. Furthermore, GET covers specific topics in other countries, such as Armenia. Berlin Economics has been commissioned with the implementation of the consultancy.

CONTACT

Sebastian Staske, Project Manager Georgia
staske@berlin-economics.com

German Economic Team
c/o BE Berlin Economics GmbH
Schillerstraße 59
10627 Berlin

Tel: +49 30 / 20 61 34 64 0
info@german-economic-team.com
www.german-economic-team.com

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