SMEs and Country Growth Strategy: Evidence from Georgia

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Abstract

Last decade in Georgia the main drivers of economic growth were foreign direct investment (FDI) and banking sector development. Since global financial crisis of 2007-2008, business activity in Georgia has been constrained by weak FDI and slow global recovery. The revision of Georgian pre-crisis to post-crisis strategy consists of diversification of investment sources. FDI should be accomplished by internal (private) investment, the main generators of which are SMEs. Nowadays SMEs contribution to economic growth is insignificant. The importance of SME sector is under evaluated by Georgian society and government.

Keywords: Georgia, Post-Crisis Growth Strategy, SMEs
JEL: E20

Introduction

Economic growth is a field that has been the subject of intensive research and hot and endless debates. Models and strategies as well as sources and drivers of country's growth are not prescribed but depend on world markets, country's political and macroeconomic environment.

Since 2004 in Georgia growth model has been based on foreign direct investment (FDI) and banking sector development as key GDP drivers. Global financial crisis of 2007-2008 formed a new world GDP trend, New Normal, the concept that reflects new economic reality when advanced economies are growing very slowly (Davis, 2009; Gross, 2009). For developing and emerging countries this negative global trend has been translated into increase in financial market volatility, lack of financing available from international credit markets, shrink of FDI flows, and so on. According to the McKinsey Global Institute, in 2007 financial flows among the G-20 were about 18 percent of their GDP while in 2013 only 4,5 percent or shrank by about 60 percent. Cross-border lending to emerging markets fell by more than 80 percent from 2007 to 2012 (Manyika et al., 2014, p.28). FDI flows to Georgia shrank about halved during 2009-2010. Additionally, external shock such as tighter financial conditions in the United States, financial contagion and trade disruptions from geopolitical events, and slower-than-expected emerging market growth make unpredictable FDI flow.

Under these circumstances, in many emerging countries including Georgia, pre-crisis growth strategies became inefficient and should be revised.

The paper contributes to a broad academic discussion on the topic of economic growth in emerging country and more specifically, on post-crisis economic growth strategy for Georgia and the role of SME (small and medium enterprise) sector in this strategy.

The goal of the paper is to assess Georgian SMEs actual contribution to growth in order to define the direction for future reform.

The main message of the article is that a post-crisis Georgian GDP growth strategy favors diversified investment-led growth which includes both FDI and private (internal) investment, the lion's share of which is generated by small and medium enterprises.

This paper addresses these issues under the next headings. It first briefly describes the methods that are applied. It then briefly reviews available Georgia's statistics and literature on economic growth. In the next sections it turns to analysis of SMEs contribution to economy and theoretical propositions are verified through surveys. The main findings end the paper.

Methods and Data Collection

The study approach was both qualitative in some parts and quantitative in others. The qualitative research was based on literature review and its analysis. The quantitative approach

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was used to collect data from related statistics provided by National Statistics Office of Georgia (Geostat.ge), internationally conducted surveys and interviews, study reports, and authors' survey. Both, qualitative and quantitative analyses make possible to develop recommendations on further modification of growth strategy for Georgia.

Survey conducted by the authors was done among business firms in Tbilisi in June – July of 2014. So, the survey reflects the situation in Georgia before the last deterioration of political, economic, investment, and trade situation in the region caused by conflict in Ukraine.

Respondents were selected through convenience sampling. 180 questionnaires were distributed and 116 of them returned; response rate is 64,4 percent. We had a good response rate because many of selected companies were small firms of our students' families. 20 questions related to the development of small business in Georgia were asked.

The questionnaire consists of six parts. The first part provides respondents' personal information such as age, education, business experience. The second part depicts general information about the company (enterprise) over the past six years. Such a short period is chosen because in Georgia most businesses are young. To be sure that respondents represent small and medium enterprises, the first sub-questions were on number of employees (workers) and annual turnover. Then, to meet possible discrepancy in answers, the sectors of economic activity was asked to determine. The third part is about SMEs access to finance as one of the main obstacle to SMEs development in the country. The sub-questions start from general classification of the sources of financing as internal or external and then most of external finance sources are listed as used – bank loans and microfinance as the most widely used in Georgia and also debt finance, factoring, leasing, and so on. The fourth part clarifies growth phases and funding cycles. The fifth part contains questions on government support of SMEs in terms of direct measures, programs, and policies. The last, the sixth part explores the respondents' expectations on growth perspectives.

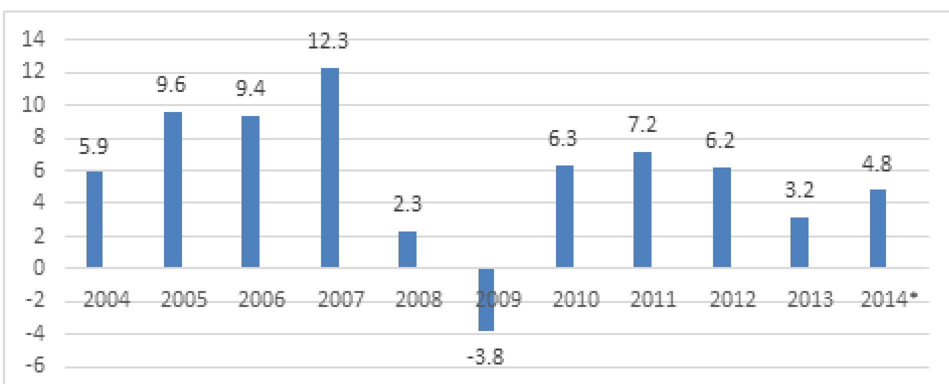
Generally, all the questions were oriented on managers/owners who work for small or medium enterprise and have practical experience. Prior to sending, questionnaire was tested by a panel of experts, and minor adjustments were made where necessary. Face-to-face contacts were used to fill in the questionnaires.

Brief Statistical Observation of Economic Growth in Georgia

Discussion of prospects for growth will be fruitful if we track current trends against past experience. Figure 1 presents Georgian statistics on real GDP growth. The observation is made for the last ten years or the time of the beginning of economic reform to the present available data.

The observed period might be divided into some sub-periods. The first covers the years before the global financial crisis (2004 – 2007) when GPD grew rapidly - by 9 percent in average. The most successful years were 2007 through 2008 with double digit growth rates of GDP (12.3 percent in average) and rocketing FDI inflows (9.4 percent in average), flourishing banking and financial sectors. From the end of 2008 and during 2009, due to the global financial crisis/global recession waves reached the developing world and August war with Russia, the situation changed. Both GDP and FDI demonstrated negative growth rates (Fig. 2). But soon, in the following years (2010 -2011) Georgian economy experienced recovery with FDI and GDP growth rates 6.3 percent and 7.2 percent, respectively. 2012 was quite moderate while in the following, 2013, GDP growth rate was low (3,2 percent) comparable only with 2008 or crisis year.

As we have seen, in observed period FDI were the most significant part of investment and source of GDP growth. Since 2007-2008 global financial crisis, consumption and business activity in Georgia have been constrained by weak FDI (Fig. 2) and slow global recovery. According to the McKinsey Global Institute, in 2007 financial flows among the G-20 were about 18 percent of their GDP while in 2013 only 4,5 percent or shrieked by about 60 percent. Cross-border lending to emerging markets fell by more than 80 percent from 2007 to 2012 (Manyika et al., 2014, p.28). Thus, the lack of financing available from international credit markets caused FDI flows to Georgia to shrink – about halved during 2009-2010. Unfortunately, external shocks such as tighter financial conditions in the United States, financial contagion and trade disruptions from geopolitical events, as well as slower-than-expected emerging market growth make unpredictable FDI sustainable flow and form downward trend.



*** Preliminary Data**
Figure 1. *Real GDP growth rate (%).*
Source: National Statistics Office of Georgia (Geostat.ge).

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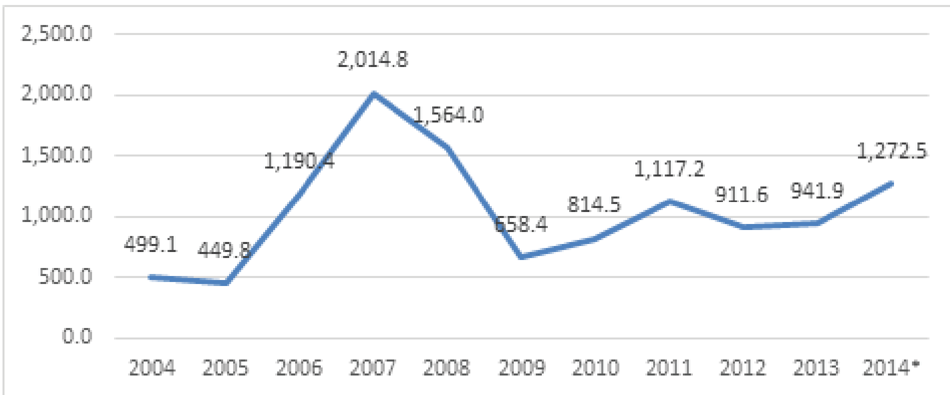

*** Preliminary Data**

Figure 2. *Foreign direct investment in Georgia (million USD).*
Source: National Statistics Office of Georgia (Geostat.ge).

Economic Growth in Georgia: Literature Review

Georgian scientific community discusses prominent proposals how to achieve sustainable economic growth, but national strategies and priorities change as soon as top officials change their offices. Large-scale, all-encompassing program of Saakashvili's government named the Economic Liberty Act (Government of Georgia, 2011) was replaced by more pragmatic but less liberal and not worked up to the end strategy of the new government. The crucial and general difference between these two programs consists in different understanding of role of market and government in an economy. That is, more market and less government vs. less market and more government.

Despite the different and even opposite opinions in general macroeconomic approach, short run strategies still focus on development of a single sector of Georgian economy in which the country has or may have comparative advantages, usually, wine and tourism (Kakulia, 2007; Cordonnier, 2006; Shmidt, 2007; Economic Growth, 2004; Cordonnier, 2010; Samson, 2008). Moreover, in all programs the policy of attraction of FDI is still a priority (Country partnership, 2014).

Important recommendations were developed by international organizations. Particularly, the World Bank recommended Georgia to adopt saving orientated policy, "The low saving rate in Georgia is a key impediment to sustaining adequate investment and rapid economic growth" (Georgia Rising, 2013, p. 16). In another version, economic growth is projected at an average of 5.5 percent a year over the medium-term, on the back of improving trade and investments (Georgia: Adjusting, 2014, p.11-12). The World Bank also proceeds from assumption that Georgia has the potential to increase sustainable and inclusive growth through strengthened focus on private sectorled job creation (Country part-nership, 2014, p.1-9). The program has twin goals - private sector development to generate employment and to provide income opportunities for the bottom 40 percent of the population.

There is no doubt, that each of these plans has a real base to be put into life. In this article their details, strengths/weaknesses are not going to be discussed (see, for example, (Cecire, 2009; Cecire, 2010; Livny, 2009). The discussion finally leads to defining the sources of economic growth .The World Bank summarized, "The central challenges today for the government of Georgia is to find sources of long-run economic growth, particular through private sector development" (Fostering, 2013, p.15). In other words, from entirely external sources of growth, the country has to turn to internal drivers of growth as well.

It is now worth to note, firstly, the original area from which entrepreneurial activity is born, is SME sector; and, secondly, 95-96 percent of all registered Georgian enterprises are small and medium size enterprises (Geostat.ge). It is logically to analyze the role of small and medium enterprises in country's economic growth.

Georgian SMEs Contribution to Economic Growth

The SMEs contribution to growth and employment is widely recognized. For example, in the EU countries SMEs accounted for 99.8 percent of all enterprises active non-financial business sector, 66.8 percent of total employment and 58.1 percent of the value added (Annual Report, 2014, p.14).

Unfortunately, in Georgia there are still no official definition and statistics on small/medium enterprises. As the National Statistics Office of Georgia states, until 2002 different criteria were used for determining the size of enterprises and current classification of large, medium and small enterprises is not in place (GeoStat). The new Tax Code of Georgia which entered into force in 2011 stipulates a new specification of businesses in Georgia as: micro-, small, medium, and large based on workforce and annual turnover output (Tax Code of Georgia, n.d., p. 115-117). Commercial banks have their own standards. TBC bank, for example, does not differentiate between small and medium and considers SMEs as enterprises with an annual turnover of less than GEL 8 million and liabilities of USD 1.5 million (www.tbcbank.ge). Table 1 summarizes SMEs contribution to economy.

As GeoStat announces, in 2012-2013 the main sectors in which SMEs contribution to value added was 20-40 percent and more were trade (wholesale and retail), education, agriculture, hotel and restaurants, real estate and renting, and transport and communication (Entrepreneurship, 2013, p.50; Entrepreneurship, 2014, p.51).

Thus, despite SMEs constitute a considerable number of business enterprises in Georgia, an inadequate growing of SMEs quality relevant to SMEs number, should be emphasized specially. In other words, SMEs have constituted an insignificant segment of Georgian economy according to their contribution to the main macroeconomic indicators - turnover, output, value added, and even employment.

There is clearly conclusion to be made from this statistics. That is, Georgian SMEs are just partly included into country's economic growth model. In short, society does not exploit entirely SMEs economic potential.

Surveys Data Analysis

To complete the picture, the survey was conducted. Our survey respondents are young (78,4 percent are younger than 41) and educated people (59,5 percent got university diploma, 29,3 percent have Master degree and 6,0 percent have Ph.D. degree). According to the Georgian standards the respondents have enough business experiences – 39,7 percent are in business more than five years.

Most of them (81,0 percent) works as a manager for a small firms (number of hired workers is less than 20 and annual turnover less than 1,5 million GEL) in different sectors of economy, mostly hotel and restaurant (22,4 percent), trade (16,4 percent), transport and communication (6,9 percent), and so on. Generally, this distribution corresponds to the distribution of SMEs according to the economic activity in the country.

As a company's planned growth prospects during the coming two years, the most part of respondents (60,3 percent) indicates "gradual growth" taking into consideration that there are many obstacles to SMEs growth in Georgia, for instance, high tax rates, political instability, monopolistic markets, low purchasing power of population, scarcity of foreign investment, and so on. Remarkable is the fact, that just 3,4 percent of all respondents indicate access to finance as a serious problem while in most previous surveys conducted by international organizations (Fostering, 2013) and the authors (Papiashvili & Ciloglu, 2012) limit access to finance was the main barrier to SMEs growth.

Answers to the question, "Over the past two years, which way of finance do you use more intensively?" were the following: 56,9 percent of respondents use internal finance and 43,1 percent external finance, respectively. That is, despite the fact that most respondents (62,1 percent) believe that banking loans are still very important at startups as well as growth stages, but personal and friends savings are still dominant as a source of finance.

Evaluating bank services, respondents indicate that they are still more or less satisfactory (54,3 percent of respondents) but costly and/or very costly (65,6 percent) due to high interest rate and value of collateral. Despite this, the share of bank loans in company's loan portfolio is more than 51 percent in most surveyed companies (in 55,2 percent of firms). Explanation is simple. Other alternatives, for instance, microfinance and client and supplier credit are even more costly and less satisfactory, private equity, external equity, factoring, leasing, and so on, are practically unavailable due to undeveloped financial markets. Overdrafts and bank loans are the most frequently used funding at both start-up and growth phases.

Regarding government support and government policy toward SMEs, the respondents cannot find the priorities and their answers were about equality distributed among provided alternatives (development banks; loan guarantee schemes; fiscal incentives; regulations regarding the treatment of innovations; rules regulating investment by insurance companies and pension funds in equity classes; the provision of loans at preferential rates; the direct provision of risk capital for particular classes of investment as a catalyst for private financing, and so on). The most part of programs goes from central government (65,5 percent). Thus, the role of government in SMEs support policy is too much moderate and unclear for the respondents.

Concerning the expectation of improvement of SMEs access to finance over the next year, most respondents (72,4 percent) are rather pessimistic than optimistic believing that there will be no basic changes or just somewhat will be changed.

The survey conducted by the World Bank (Enterprise Survey, 2013) shows even more pessimistic picture. Specifically, in Georgia the main enterprise financing source for investment is internal finance (about 73 percent) among all other sources (trade credit financing, bank financing, equity and sale of stocks, and so on). In working capital external financing constitutes around 20 percent, one of each three firms have bank loans (Enterprise Survey, 2013, p.11). The last indicator includes all firms, no matter the size. But as statistic shows, bank loans are available mostly for large companies. In 2013 the share of SMEs in gross loans was 20 percent or about two times less comparing to of corporate (38 percent) (National Bank, 2013, p.57).

Therefore, the conducted surveys evidence that for Georgian SMEs self-financing is still prevailed among available sources of financing. Unfortunately, the situation did not

Table 1. *The share of SMEs, percent*

	2008	2009	2010	2011	2012	2013
Turnover	12.3	15.6	16.1	19.9	17.0	18.3
Output	14.3	18.5	18.4	17.3	17.7	19.2
Value added	14.6	18.7	19.3	21.8	19.6	20.6
Employment	37.5	39.6	41.2	43.4	42.9	42.7

Source: Compiled and calculated by the authors; source of data: Geostat.

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change in the course of past years (Papiashvili & Ciloglu, 2012). Limited and scare finance results in inefficiency, non-competitiveness of SMEs, and, finally, in insignificant contribution to the country's economic growth, on one hand; and no visible perspective to enlarge the role of this sector in the future, on another.

Conclusion

In Georgia since 2007-2008 global financial crisis GDP growth became unstable and unpredictable due to pre-crisis growth strategy that was based on foreign direct investment and banking sector development.

The revision of pre-crisis to post-crisis strategy consists of diversification of investment sources. FDI should be accomplished by internal (private) investment, the main generators of which are SMEs. In other words, SMEs can mobilize all small financial funds and transfer them to productive activity. SME development directly causes increase in total investment as a component of GDP, complementing FDI. From this point of view, SME private investment might play a greater role in country's economic growth strategy.

As surveys show the main source of Georgian SMEs financing is still self-financing. As a result, SMEs contribution to economic growth is insignificant. Generally speaking, Georgian SMEs are just partly included into country's economic growth model. Nowadays SMEs are hidden, unexploited source of economic growth in the country.

In this case one cannot expect that the situation will change significantly in the nearest future due to the absence of special government policy toward SME sector. In short, society does not exploit entirely SMEs economic potential and importance of SME sector is under evaluated by Georgian society and government. Time to change!

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