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Foreign Portfolio Investment and Financial Constraints of Small Firms

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Abstract

The article examines the impact of Foreign Portfolio Investment (FPI) and constrains on small firms. FPI has significant influence on a country's economic development and improvement. In spite of the fact, that the degree of constraints differ across counties and firms, it is mostly small firms that suffer constrains from foreign investment – constraints that are significantly lower in richer, larger, and faster-growing countries.

This paper seeks to shed light on the factors that bring foreign investors to Georgia; on the motives of these investors; on some of the constraints and barriers evidenced in the Georgian investment environment; and on the amount FDI and FPI flow in Georgia in last years. Finally we summarize and provide some recommendations on how to increase the competitiveness of the country's investment climate in retaining existing and attracting new foreign and domestic investors.

Keywords: financial constraints, foreign investment, investments, small firms
JEL: G11

Introduction

In order to increase the level of foreign investment, the government of Georgia must look into the reasons for such investment and seek to enhance such drivers of investment behavior. Open markets give foreign investors the opportunity to diversify their portfolios; thereby improving their risk management and possibly leading to higher levels of savings and investment.

Foreign investors mainly seek investments in a small open developing economy. Generally two types of investment projects occur within this small open economy: FDI is where the foreign investor plans a project that has a long-term payoff and the foreign direct investor's aim is to control the operation of the enterprise. And FPI, where foreign investors invest in financial markets and are considered as having short-term payoffs. The portfolio investors are interested in getting the maximum return for a given level of risk (Evans, 2002). The main difference in these two types of investment is motivation and expectation.

Existing empirical evidences strongly supports the hypothesis that small firms benefit more than large firms. Knill (2005) found that FPI is positively related to small firm growth and that investment constraints mostly affect small firms.

FPI effect on small firms

This section examines the effect of foreign portfolio investment on small firms. The SBA (Small Business Administration) defines a small business concern as one that is independently owned and operated, is organized for profit, and is not dominant in its filed. Small firms often use external financing. Internal funds are the most desirable source of financing. However, when internal funds are not sufficient and external financing is required, financial researchers always prefer debt over equity (Baker & Wurgler, 2002).

Small firms play a significant role in emerging market economies. Whereas it is obvious that foreign portfolio investment has a meaningful impact on firms in emerging markets, it is not quit clear whether or not firms size is symmetrically affected by foreign portfolio investment (Makaew, 2009).

FPI benefits large firms the most. In contrast to small firms, large firms have advanced fractions of foreign ownership and are more likely to have political and business connections. In order to examine how much size effects are due to the difference in other firm variables, we have to control for several factors such as: firm financial characteristics (profitability, investment opportunities, leverage, accounting liquidity), firm international involvements (exchange rate exposure, foreign ownership, and foreign control), and firm connections (both political and business).

Since small firms are less liquid and small firms' stocks are more closely held, accordingly stock prices of large firms might be more sensitive to any negative news that has an impact on the market.

Theoretically, if FPI alleviates asymmetric information and agency problems for all firms, then small firms should benefit more since they are the ones who suffer more from these problems and starve for capital in the first place (Evans, 2002).

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Constraints of small firms

It's generally known that constraints limit the free activity of any firm and have negative effect on countries economic development. The low level of foreign investment is a serious constraint to sustained rapid economic development. However serious question is what constraints foreign investment? The degree of constraints differs across the counties and its' firms. Thus, generally all obstacles are significantly lower in richer, larger, and faster-growing countries, but are significantly higher in countries with higher inflation. Financial constraints are cited as the one of the most important obstacle to doing business, after macroeconomic and political instability. All three obstacles are highly correlated with each other.

Financial constraints

Financial constraints are firm-specific; they do not merely reflect differences across firms with regard to productivity. According to Harrison and McMillan (2004) the relationship between a firms' financial health and investment decisions are strongly connected. The financing constraints are generally attributed to capital market imperfections, stemming from such factors as asymmetric information and incentive problems, which result in differences between the costs of internal and external financing.

Several observable characteristics of the firm's financial health have been used as proxies for financing constraints. The most commonly used variable is cash flow. The problem with cash flow is that it is closely related to operating profits and will measure investment opportunities. The cash stock has an intuitive interpretation as "cash on hand" those firms can use for investment if the opportunities arrive. One theoretical justification for the cash stock measure appears in the Myers and Majluf (1984) model, where the amount of cash holdings, which the authors call "financial slack," has a direct effect on investment in the presence of asymmetric information. This slack allows firms to undertake positive Net Present Value (NPV) projects, which they would pass if they do not have any internal funds.

Unlike the cash flow measure, the cash stock would proxy for the future growth opportunities only in the presence of financing constraints. That is, firms that expect high investment in the future would accumulate cash stock for use when the expansion/investment opportunities arrive. Since holding cash is costly to the firms (because it diverts resources from the productive use and offers zero return), the firms will accumulate cash stock only if they expect to be financially constrained in the future (Opler, Pinkowitz, Stulz, & Williamson, 1999).

Credit constraints

Firms in developing countries typically cite credit constraints as one of their primary obstacles to investment. In particular, we are interested in whether foreign investment has an impact on domestic firm's credit constraints or not. On the one hand, by bringing in scarce capital may actually ease domestic firm's credit constraints. Alternatively, if foreign firms borrow heavily from domestic banks, it is possible that they may actually exacerbate domestic firm's credit constraints by crowding out of domestic capital markets (Harrison, McMillan, & Love, 2002).

We find that productivity and financial constraints have a significant impact on firms' internationalization decision. Economically, productivity and financial constraints are of similar importance, but financial constraints matter only to the subset of firms that consider investing abroad. Mayer, Ottaviano and Gianmarco (2007) show that multinational firms are also more productive, generate higher value added, pay higher wages, employ more capital per worker, and they employ a larger number of skilled workers.

Corruption

Government-owned firms are subject to higher financing obstacles, but are subject to lower corruption. On the other hand, foreign-controlled firms and exporters face lower financing and corruption obstacles. The corruption obstacles reported by firms are generally higher in countries with less-developed financial and legal systems and in countries that are rated as more corrupt. Financial development is significantly correlated with lower corruption obstacles reported by the smaller firms (Beck, Demirgu, Kunt, & Maksimovich, 2005).

Legal constraints

The firm's financing activity is largely based on the financial contracts or securities and the defining feature of these securities are the rights that they bring to their owners. The protections for investors determine their readiness to finance firms. Smaller firms reporting significantly higher obstacles than large firms, in contrast, smaller firms report lower legal obstacles than do larger firms, but these differences are not significant (Beck et al., 2005).

FPI and investment climate in Georgia

According to Cardais and Adam (2008) the "Georgian Government has already undertaken the substantial efforts in meeting the task of creation of favorable conditions for attracting foreign investments into the Georgian economy." In an expanding global environment, the Georgian economy has confirmed a high level of elasticity. After some hard years, Georgia proved the status of "mostly free" country in the last years.

According the Annual Overview of Georgia's Economy (Economic Outlook, 2013) uncertainty regarding Georgia's political future caused by the eventful elections in 2012 and unfriendly relations with Russia has made potential investors more risk adverse. While international investors are currently very cautious regarding their cash holdings, it can be assumed that the confidence of such investors will be restored after the presidential election of 2013 and that these investors will not question the competency of the new regime and will not thereby have reason to question the future strength of the Georgian currency.

Georgia is the number one country in Eastern Europe and Central Asia in easiness of doing business (World Bank report, Doing Business, 2012) – an environment highly conducive to business which continues to be enhanced. Future efforts at improving the investment environment and increasing the level of foreign investment largely depend on the speed with which the global economy recovers from recession and how effectively Georgia continues its open-door strategy towards foreign investment. The economic environ-

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ment of Georgia as a whole remains generally favorable for foreign investment (Cardais & Adam, 2008).

Corruption can be the single most overwhelming obstacle to economic, social and political development in countries that require open political systems. Georgia ranks 51st in Transparency International's 2012 Corruption Perceptions Index (CPI) which measures perceived public sector corruption in 176 countries.

The biggest mistake made by the Government of Georgia which came to power after the "Rose Revolution, 2003" is the infringement of property rights. Under pressure from the law enforcement bodies, property owners were forced to surrender their property upon a "voluntary basis" for the benefit of the state. In reality, the infringement of property rights was aimed at distributing property to the so-called elite businessmen: those "standing close" to the Government. An enhancement of the legislative framework to protect property rights does not suffice (Papava, 2008).

Motivation and research methodology

As long as FPI has significant influence on a country's economic development and improvement we were concerned to analyze investment climate in the county and its effect on the small firms.

For The literature demonstration we chose questionnaires as long we are oriented to analyze Georgian situation. To use quantitative analyze was quite hard because lack of information availability. Interviews and questionnaires are effective tools to gather opinions, attitudes and descriptions. We chose several firms and asked them to give information regarding their understanding and experiences with investing in Georgia. For example, what are some of the investment constraints their firm has encountered and what do they perceive as possible ways that foreign investment can be encouraged. To select appropriate focus groups was challenging. It is significant factor that it was really hard to persuade some of the respondents to interact in this research. They were avoiding answering some of the questions with the excuse of lack of time.

While economic factors usually play the most important role in foreign investor attraction, political stability is also a crucial factor. The survey shows that investing or reinvesting in the region is conditional first upon more market opportunities, followed by Geographical location and availability of cheap workforce, political stability, macroeconomic improvements, and reduced corruption.

Results

Generally, economic factors play the most important role in foreign investment attraction. The survey shows that investing or reinvesting in the region is conditional first upon more market opportunities, followed by Geographical location and political stability, macroeconomic improvements, and reduced corruption. Most of the respondents positively evaluate entrance of foreigners to the Georgian capital market and the degree of transparency and fairness of the political and legal system which is quite pleasant.

Asking about constraints during the investing was pretty confusing for almost all respondents. Looking toward the reason was mostly lack of information. Thus, we were able to draw the approximate results about what are the perceived primarily constraints for foreign investors during entering Georgian investment market.

Significant constraints were political instability because of Georgia's unstable relationship with Russia. Followed by tax system complexity in which's development Georgia's government made quite meaningful effort. During the discussing the FDI it's interesting to analyze which countries made higher investments and in which sectors. Some specific laws regulate business activity in the financial sector (banking, insurance, capital market), agribusiness, energy, transport and tourism and other sectors. In addition important factors were high corruption level and infrastructure constraints in earlier years.

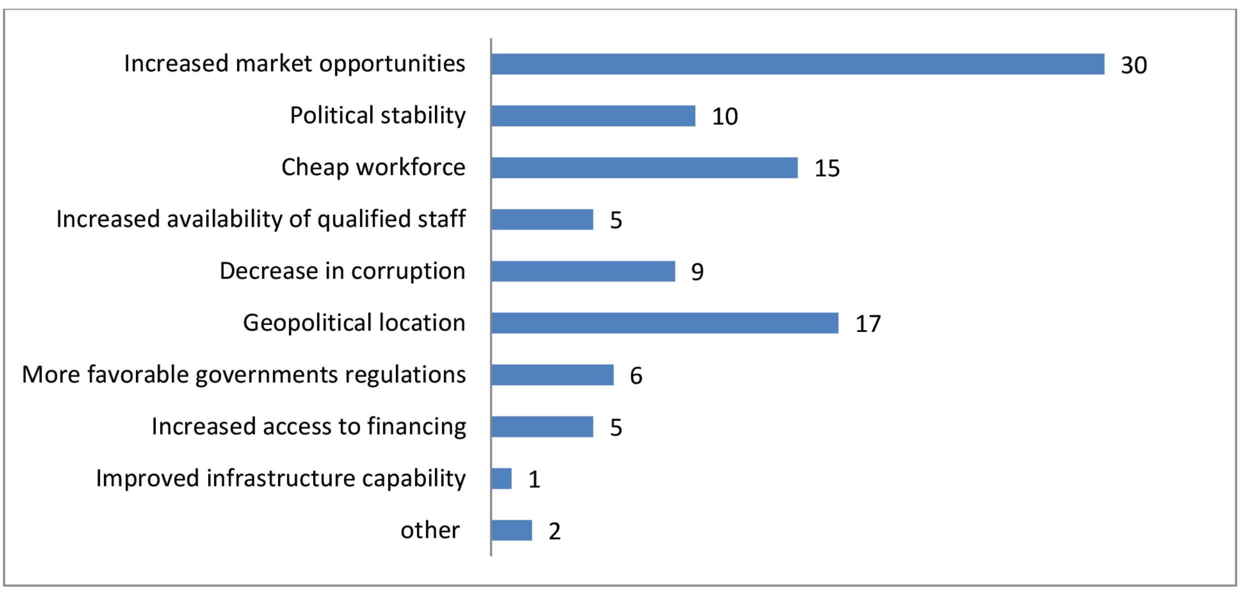

Figure 1. *Primary Reasons for Investing or Reinvesting in Georgia (% of respondents).*

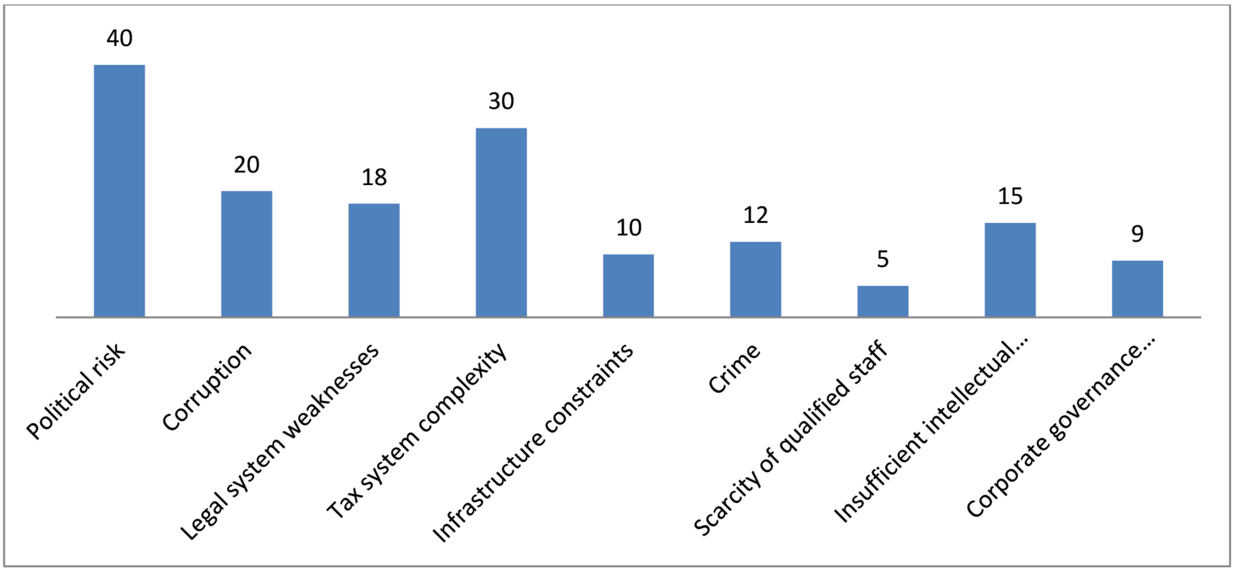

Figure 2. *Which of the following was represented the most significant constraints on your company during investing in Georgia? Select up to four (% of respondents).*

And finally, results on question about the probable constraint on investments, in mostly related with political risk.

In spite of constraints, most of the firms positively evaluate their performance in Georgia and asking about their future plans connected to Georgia, absolute majority admit that country was competitive place for investing their capital. During the analyzing the governments' intervention in foreign investors decisions, they appraise encouraging.

Proper geographic location, concentration of natural and energy resources, cheap and more or less educated workforce, also tradition of production and manufacturing, all these were main factors attracting investors to Georgia. So country should continue using this attractions to bring foreign portfolio investors and improve investment climate, which will be competitive compared to other countries and what is very important, will be established on consequent analysis and encouragement of those investment which will take care of realization of country competitive advantages.

Conclusion

FPI has the potential to influence foreign investment at the country. Small firms play a powerful and influential role in economic situations. Easing foreign portfolio investment restrictions on capital flows; stabilizing these investment cash inflows and improving the treatment of foreign companies and investors could have a very real influence on the longevity of the small firm. Improvements in a country's foreign investment environment serve to increase the probability of financial constraint alleviation, for small firms in less developed nations.

Obstacles might affect large and small firms differently. The difference in the economic impact of specific financing obstacles on the largest and smallest firms confirms significant differences for most of the obstacles that significantly affect the growth of small firms.

We investigate that firms that are constrained by different obstacles depend on the level of development of the financial and legal systems. Taking into account national differences between financial and legal development and corruption, we see that firms that operate in underdeveloped systems with higher levels of corruption are affected by all obstacles to a greater extent than firms operating in countries with less corruption.

Finally, Georgia as a developing country attracts foreign investment with the reason of cheap workforce, geopolitical location, improved infrastructure capability, instable economy, decreased corruption level and ect.

To sum up our findings, we investigate that firms that are constrained by different obstacles depend on the level of development of the financial and legal systems. Factors determining foreign investment are many. Whatever are the precise reasons for constraining foreign investment, the government must look into the reasons and provide a climate for enhanced foreign direct investment. Moreover Georgia has great potential after all.

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