ECONOMY AND FINANCE

# NEOLIBERAL LOCK-IN

## Why Georgia-EU Free Trade Does Not Work

**Salome Topuria**
**Tato Khundadze**
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Georgia's trade dynamics with the EU have not improved, even though it signed a Deep and Comprehensive Free Trade Agreement (DCFTA) in 2014. The Georgian export basket deteriorated qualitatively since that time. Specifically, Georgia's export basket sophistication has decreased, and the share of low-tech and resource-based products has increased. Moreover, Georgia's exports to the EU have become more concentrated.

The EU does not pay enough attention to the local context of the signature country. The agreement often propagates those very discourses that got Georgia into a stagnant economic position in the first place.

Georgia needs a strong industrial policy to increase export volume and upgrade the export basket. It should choose a 'Pick the Winner' strategy and design a plan to support industry leaders in boosting export. State support should be based on the 'export discipline' instrument.

FRIEDRICH EBERT STIFTUNG

ECONOMY AND FINANCE

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## Why Georgia-EU Free Trade Does Not Work

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# Preface

This policy report analyzes the free trade agreement between Georgia and the EU and tries to identify potential missed opportunities that may hinder Georgia from diversifying and upgrading its export structure. Furthermore, the report scrutinizes some of the salient features of the agreement – such as Non-tariff Barriers (NTBs) - to understand their implications for Georgian exports. The policy study has found Georgia's export to the EU has increased by 26 percent since 2016; however, it is difficult to ascribe these changes to the Georgia-EU Free Trade Agreement (FTA). In effect, Georgia's export to CIS countries has had a higher growth rate since 2016.

Moreover, the share of domestic export[1] has declined by 2 percentage points since the signing of the FTA. The Georgian export basket has also deteriorated qualitatively, which is measured by the export sophistication and concentration indices. Specifically, Georgia's export basket sophistication, measured by the Sophistication of Exports (EXPY) index, has decreased, and the share of low-tech and resource-based products has increased substantially throughout the last decade. Moreover, Georgia's export to the EU has become more concentrated, as shown by the increased Herfindahl-Hirschman index. The top 10 products exported to the EU occupy 85 percent of the total export basket share, and this indicator has increased by 4 percentage points since 2014.

The entrepreneurs we interviewed during the study period claim that having a Georgia-EU trade agreement is essential symbolically; however, it does not change the situation in essence. The major problems frequently mentioned during the conversation with business leaders are access to capital, lack of coordination from government actors, and difficulty achieving the necessary standards and capacity to export to the EU market. We found that these problems are interrelated: to export to the EU market, you need a higher industrial capacity and an upgrade in product quality to meet the local market's standards. In turn, upgrading industrial capacity and product quality requires a high investment rate from Georgian producers, which is difficult to achieve under high economic volatility in the context of regional and internal political developments.

This study shows that Georgia's economy is structurally designed in a way that makes it nearly impossible to tackle its most critical problems: high unemployment and technological underdevelopment. If Georgia continues to follow a mostly neoliberal policy, the maximum that it can achieve is jobless growth. This study demonstrates that the key drivers of Georgia's output growth (such as financial services) are the sectors that generate the lowest number of jobs. In this context, the FTA with the EU is an ideological instrument for the Georgian elite, which plays the role of a 'magical stick' as if it can solve Georgia's economic problems. In effect, Georgia needs a strong industrial policy to increase export volume and upgrade its export basket.

To achieve this goal, we propose restructuring the existing government apparatus responsible for Georgia's trade and industrial policy. Specifically, the 'Enterprise Georgia' program should be reformed and unified with the Partnership Fund and transformed into an industrial planning state body that reports directly to the Prime Minister (PM). Georgia should choose a 'Pick the Winner' strategy and design a plan to support industrial leaders in boosting export. State support should be based on the 'export discipline' instrument. Finally, Georgia needs to establish an indicative planning methodology to help industries coordinate at the national level and avoid duplications. Besides that, indicative planning would enable the Georgian government to coordinate interaction between state, private, and academic institutions, and by doing so, avoid coordination failure. An investment strategy should also be based on indicative planning. Georgia should specifically design an investment policy to attract Foreign Direct Investment (FDI) in the manufacturing sector and spur joint venture initiatives between local and foreign entrepreneurs.

Without strong industrial policy and state mobilization, the FTA between Georgia and the EU would produce only 'small wins,' which would not help Georgia change its export and economic structure. Under the current scenario, Georgia will continue to be entrenched under the neoliberal status quo, and the problems of high unemployment and massive outward migration would remain unresolved.

We also urge the EU to pay more attention to the local context of the signature country. The agreement often propagates the very discourses that got Georgia into a stagnant economic position in the first place. With continuous emphasis on the

1 In 'domestic exports', we imply exports excluding re-exports. It is an important variable for those countries where re-export of goods occupies considerable share of total exports (both quantitatively and qualitatively).

technical side of the legal harmonization process, the DCFTA downplays the importance of the country's much-needed structural economic transformation. Furthermore, our study has shown that some of the most critical clauses of the DCFTA reinforce economic power asymmetries – reproducing the economic dominance of the EU while putting Georgian SMEs in an inferior position. Moreover, FTAs often strengthen new forms of dominance, deriving benefits from resources of the less-developed countries.

The EU policy towards Georgia should be based on the idea of shared prosperity and support of inclusive economic development. This won't be achieved without abandoning the 'Jungle vs Garden'[2] approach towards Eastern Neighborhood countries.

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2 For more information about this narrative, see: Josep Borrell's opening speech at the European Diplomatic Academy October 13, 2022

# 1

# INTRODUCTION

Post-Soviet Georgia experienced massive deindustrialization, leading to the shrinking of its working class, a decrease in population, and a loss of industries. This meant the deterioration of economic activity and switching from manufacturing back to agricultural occupations, largely for self-subsistence (Christophe, 2003) (Wade, 2016). Transition governments - especially after the mid-2000s - started to seek fast solutions for promoting economic growth through extensive liberalization and deregulatory processes and seizing foreign capital through the privatization of public assets (Gugushvili, 2016). Openness to free trade and negotiating multiple FTAs was one of the main principles of the economic development agenda.

The Association Agreement (AA) between the EU, its Member States, and Georgia came into force provisionally in 2014, and fully in 2016. The AA consists of 8 parts, referred to as 'Titles I-VIII' with 432 corresponding articles provisioning the regulatory approximation of Georgia to EU-selected norms and standards. The DCFTA[3] is only one part of the AA that specifically targets trade and trade-related matters. Most of the DCFTA and parts of the AA related to economic cooperation "impose a binding obligation on the partner country to apply, implement or incorporate in their domestic legal order a predetermined selection of EU *acquis*[4], which is annexed to the agreement" (Van der Loo & Akhvlediani, 2020, p. 4). While the AA is an extensive document covering issues on foreign and security policy, political and economic cooperation, justice, transportation, energy, etc., the DCFTA is the largest (15 chapters) and the most meticulous part of the AA. "The general purpose of the AA is to deepen political association and economic integration between the EU and its associated partners. To achieve this objective, the DCFTA provides far-reaching and progressive regulatory alignment with EU legislation in trade-related areas and foresees gradual reciprocal market opening" (CEPS, 2022, p. xi).

Since the mid-2000's, DCFTAs have been negotiated in the broader context of the European Neighborhood including Morocco, Tunisia, and Armenia; however, only three countries have signed the agreement: Ukraine, Moldova, and Georgia. The DCFTA is regarded as the most comprehensive free trade agreement the EU has ever agreed upon (CSD meeting minutes, July 2022). The DCFTA is far more than a trade agreement - it goes beyond opening markets and entails dense, and to some extent prescriptive policy mechanisms influencing the legal harmonization processes of the partner country. DCFTAs trigger institutional transformation, hence, not only do they imply 'beyond border'[5] policies (generally included in all bilateral trade agreements), but "DCFTAs differ from other types of PTAs in that they involve significant convergence towards EU norms and legislation" (Hoekman, 2016, p. 2). In spite of this, DCFTAs "do not offer the partner countries much of a say, if any, on what the rules of the game are. The presumption is that what is embedded in the acquis is appropriate for partner countries even if they are not accession candidates" (ibid.).

To this date, the European Commission (EC) lists[6] 78 countries with bilateral trade agreements that are already in place, 24 countries with adopted agreements that are not in place yet, and 5 countries with ongoing negotiations. It is important to highlight that these agreements are not identical, and that the EU's trade policy has changed over time. Hoekman (2016, p.1) notes that the shift from "'shallow'[7] to 'deeper' trade agreements that also liberalize trade in services, public procurement markets, and cross-border investment and include disciplines on the implementation of national regulatory regimes" was part of the EU's European Neighborhood Policy (ENP) in 2004. The ENP seeks to induce good governance, rule of law and democratic values in partner countries, as well as offer financial and technical assistance and harmonization mechanisms. "A key feature is to offer partner countries the opportunity to converge to EU norms and standards in specific areas of regulation on a à la carte basis without however giving countries a seat at the table in the elaboration of norms. The approach has often been characterized succinctly by the phrase: 'everything but institutions'" (ibid, p. 3).

3 Hoekman, (2016) notes that what the letter A in the DCFTA acronym stands for is not always clear, as both the European Commission and analysts interchangeably use either 'areas' or 'agreements'.

4 Defined by Hoekman as: EU norms and legislation—i.e., competition policy, social norms, provisions to support free trade in services, etc.

5 Non-tariff policies that go beyond customs (border) but substantially affect trade dynamics

6 For more details, see EU's Trade Negotiations and Agreements

7 Trade liberalization that is restricted to goods, excluding services

Within the policy study, we used primary and secondary sources, including an in-depth analysis of the legal documents related to Georgia's trade relations. Specifically, we explored the Association Agreement and other legal documents that corroborate Georgia's trade and investment policy. We used the discourse analysis method to scrutinize official statements and state programs. Besides that, we analyzed other policy papers that cover Georgia's trade relationship with the EU. We also conducted unstructured in-depth interviews with Georgian business leaders, including representatives of SMEs and large enterprises. The authors interviewed current and public officials who are (were) in charge of Georgia's trade and industrial policy. To reveal the strength and weaknesses of Georgia's export performance, we used extensive descriptive statistics and other trade-related measures. Furthermore, within the study, we checked if there was a structural break in Georgia's export since 2016. We used different measures to evaluate export quality, sophistication, and concentration in order to evaluate Georgia's export structure and volume to EU countries. A detailed description of these measures is provided in the Trade Analysis chapter.

While it is beyond the scope of this project to analyze the legislative norms, trade regimes or economic mechanisms the EU uses in a broader context, we aim to scrutinize to what extent the DCFTA has been an adequate trade and economic policy tool in the context of Georgia. Moreover, the project aims to shed a light into a much less studied (Monastiriotis & Borrell, 2012; Hoekman, 2016) aspect of the DCFTA: power structures and political economy. More specifically, we intend to find out who benefits from the DCFTA. Finally, we draft recommendations.

# 2

# MACROECONOMIC OVERVIEW: PALLIATIVE ECONOMY AND POLICY LOCK-IN

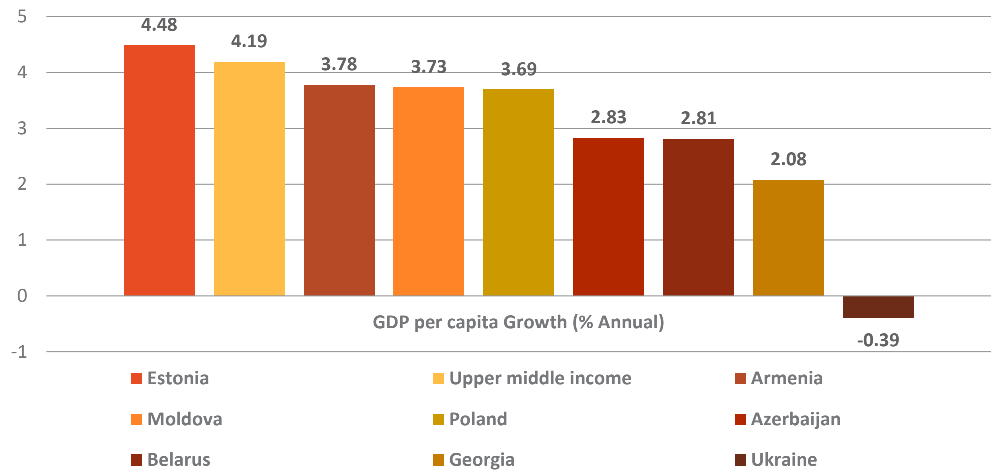
Since gaining independence, Georgia has been under permanent neoliberal lock-in, characterized by a high unemployment rate, massive outward migration, persistent negative trade balance, and a heavy reliance on FDI and tourism. This section summarizes the most important macroeconomic data, which sheds light on the characteristics of the policy lock-in. Theoretically, the lock-in effect is a state of equilibrium, which is difficult to replace even if it is detrimental to the developmental goals of a nation. The concept originates from the natural sciences, also frequently used for describing technological and policy changes. One trivial example of the lock-in effect is the use of the QWERTY keyboard, which may not be the most efficient in terms of learning and use, but isn't easy to replace since users are already accustomed to it.

The lock-in problem can be overcome if there are new technological possibilities and incentives for actors to replace old technology, however, the technical superiority of a new invention (or policy) should be way higher since the lock-in regime is challenging to overcome otherwise. In the broader economic context, the lock-in condition is often described as a policy equilibrium, which traps nations into the mode of high unemployment and upward redistribution of income and wealth. However, if the feedback mechanism from ideas to political change is debauched, sub-optimality of the existing policy does not induce policy changes even if the political outcomes are destructive (Palley, 2017).

## 2.1 GROWTH AND PRODUCTIVITY

There is a shared myth of Georgia as one of the best-practices and showcases of reform for other countries popularized in the western media. Georgia indeed experienced high growth episodes: for instance, during post-civil war era, GDP per capita annual average growth was around 8.3 percent between 1995 and 2003. Georgian per capita output grew by 6.9 percent from 2003 to 2011, and by 4 percent annually under Georgian Dream leadership (2012-2021). Two caveats should be kept in mind while elaborating on the Georgian growth rates, though. First, the contraction of Georgia's economy was higher in comparison to its neighbors during the first years of the post-Socialist transition (1991-1995): specifically, between 1991 and 1995, average economic per capita growth in Georgia was -19%, while in Armenia, Belarus and Azerbaijan, it was -16%, -8%, and -8%, respectively. Second, as mentioned above, Georgia had high growth throughout subsequent phases of the post-Soviet transition, however, how much of it can be attributed to successful economic reforms is debatable, since neighboring economies also grew with similar or in some cases higher rates.

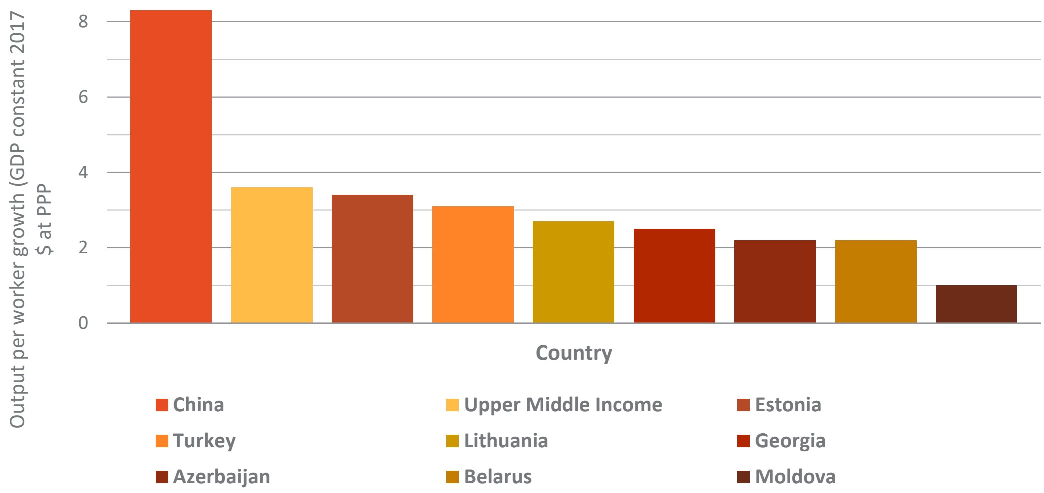
Figure 1
**Average GDP per capita growth (1991-2021),**




Source: The World Bank, 2022

Figure 2 summarizes average productivity growth from 1992 up until 2021. This figure is based on ILO data, which provides the approximation for labor productivity as output (GDP in USD 2017 price PPP) per worker, resulting in more valid country comparisons. Labor productivity is one of the key drivers of output growth and proxy for economic development, especially if productivity growth is accompanied by a respective wage redistribution policy (for stimulating demand). In effect, GDP per capita will not increase without labor productivity growth (Ocampo , Rada, & Taylor, 2009). Georgia performed relatively well in comparison to post-socialist peers, such as Azerbaijan, Belarus, and Moldova in labor productivity growth. However, it lags behind fast growers from post-Soviet countries, such as Estonia and Lithuania, which have also shown considerable progress in human development throughout the last 30 years.

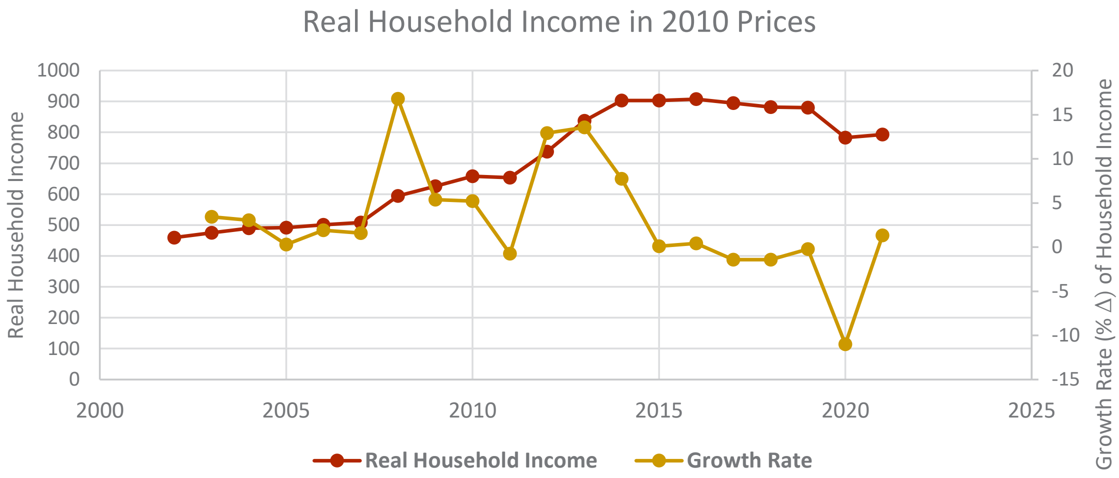
Figure 2
**Average Productivity Growth (1992-2021), % Annual Change**




Source: ILO 2022, Authors' own calculations.

Prior to joining the DCFTA, various studies predicted that Georgia would benefit significantly from the FTA with the EU. For instance, the paper from ECORYS predicted that average income would increase by 3.6 percent and the consumer price index would decline by 0.6 percent. In the long run (the report defines this as the time span required for capital relocation among different economic sectors), Georgian GDP should increase by 4.3 percent thanks to the FTA with the EU. Furthermore, the report states that Georgian total export should rise by 12 percent because of the free trade agreement with EU countries (ECORYS, 2012). However, as it is shown in the next section, export has grown but the diversification and sophistication level did not change. Moreover, an expected increase in national income did not materialize in real terms. As it is shown in the graph below, real household income has declined since 2016.

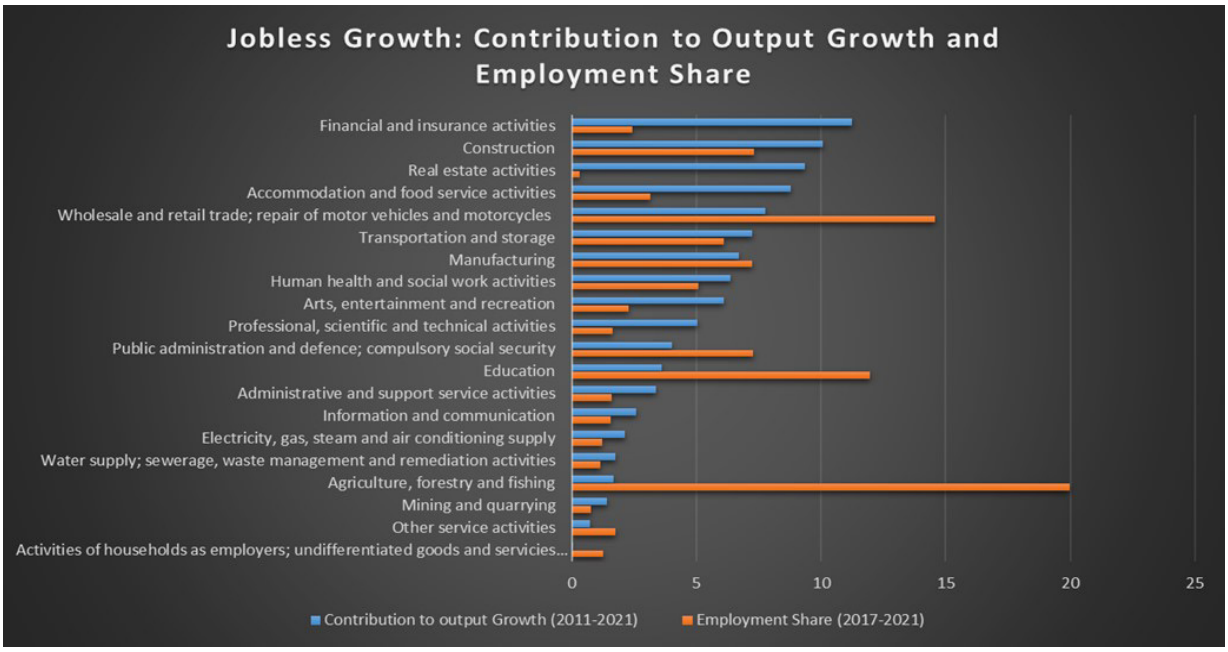
Figure 3
**Distribution of Average Monthly Incomes per Household**




Source: GEOSTAT, Authors' own calculations

In its reports, the IMF indicates a mismatch between the drivers of GDP growth and employment, specifically emphasizing the tendency of jobless growth in Georgia (IMF, 2021). The graph below shows that major contributors to Georgia's output growth occupy a small share of the total employment on average. Specifically, 4 major growth driver sectors (finance and insurance, construction, real estate, accommodation and food service) contributed around 40 percent to output growth, while their share of employment on average is less than 13 percent. Interestingly, the financial sector's average contribution to output growth last throughout the decade and was around 11 percent, whilst this sector on average employs 2.4 percent of total employees. This indicates that Georgia's economic development model is structurally inclined toward jobless growth.

Figure 4
**Sectoral Contribution to Output Growth and Employment Share**

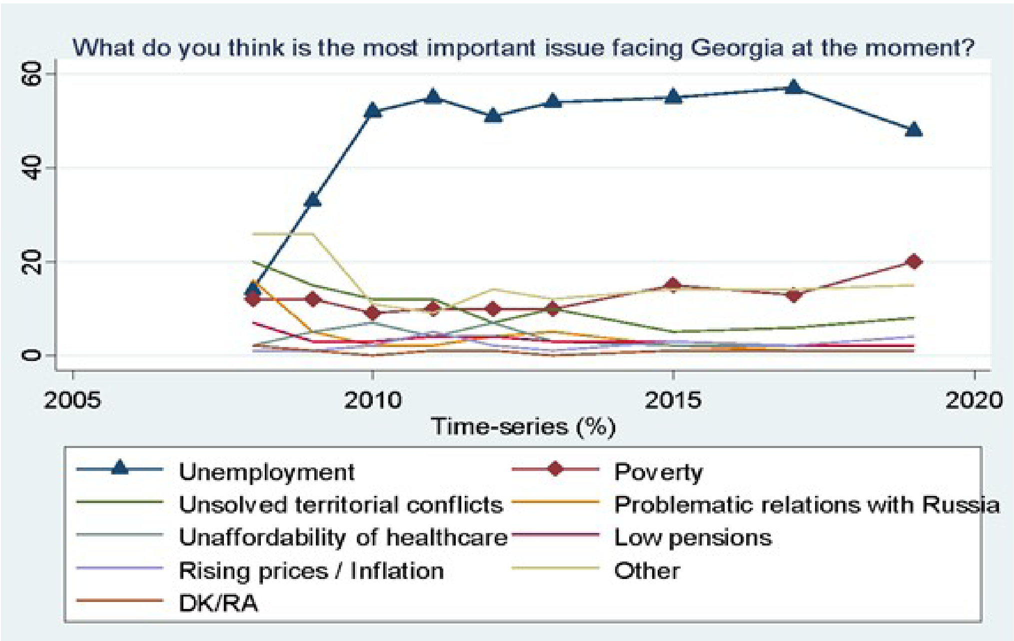



Source: GEOSTAT 2022, authors' own calculations

## 2.2 UNEMPLOYMENT

Public surveys conducted in Georgia overwhelmingly show that the most pressing issue for Georgians is unemployment. The Caucasus Barometer time-series data shows that for years, for Georgian unemployment has been the most important issue the country faces. Poverty is the second most important issue according to the survey (CRRC, 2022). According to this poll (2008-2019), an average of 46 percent of survey respondents ranked unemployment as the most important issue. As the graph shows, the issue of unresolved territorial conflicts has been declining since 2008, while the share of respondents who ranked unemployment as a key issue Georgia faces now has been stable or in some years has increased.

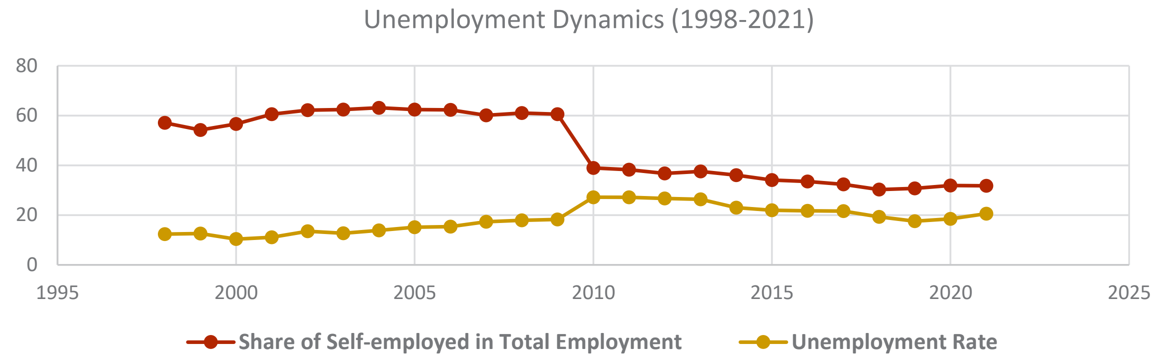
Figure 5
**Most important issue facing Georgia**




Source: The Caucasus Research Resource Centre

The reason for this is unsurprising: the unemployment rate in Georgia has been persistently high, averaging 18 percent since 1998. Furthermore, some experts claim this figure is grossly underestimated and conceals the unemployment problem by including subsistence workers in the employment category (Kakulia & Kapanadze, 2016). The share of self-employed workers was 30 percent in 2021, which is double the self-employment rate in the EU, where it was 15 percent 2019. Additionally, Georgia has consistently suffered from underutilization of the labor supply: the composite measure of labor underutilization was 39.3 percent in 2021, which includes time-related unemployment and actual unemployment. This composite measure of labor underutilization captures the underutilization problem of labor supply more thoroughly in developing countries, due to the high informality level in comparison to developed countries (ILO, 2018).

Figure 6
**Unemployment Dynamics in Georgia**

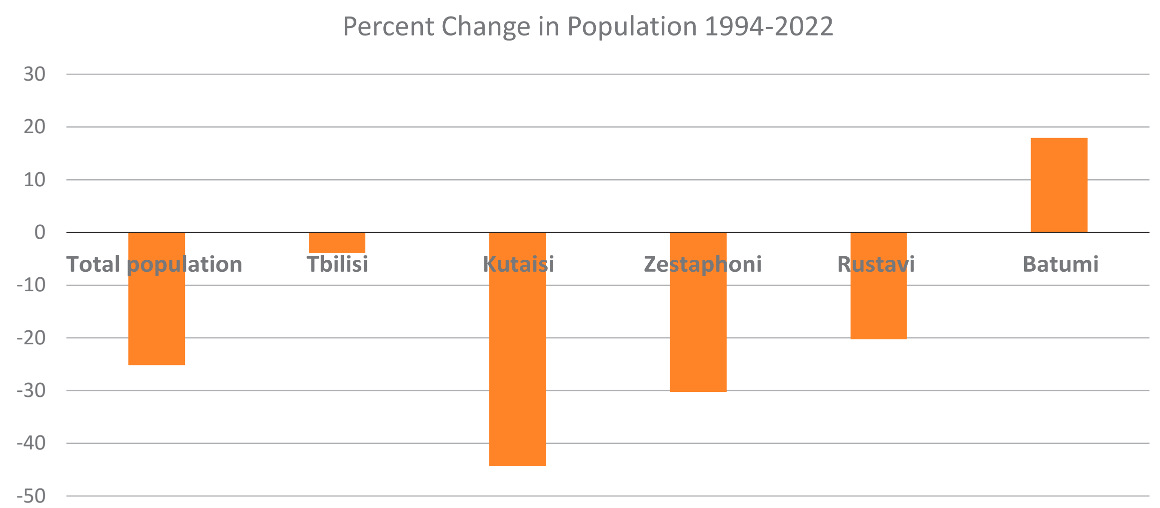



Source: GEOSTAT, 2022

## 2.3 POPULATION DYNAMICS

Population migration dynamics provide an interesting picture of Georgia's economic development since independence. Destruction of the local economic core, massive privatization and political instability contributed to a massive population outflow, with. the population of Georgia shrinking by 25 percent since 1994. Population declined in all cities of Georgia, except for Batumi. The latter became a tourism center, its population increased by 17 percent, and it overtook the title of the second city by population in Georgia from Kutaisi. The latter, known as an industrial powerhouse of Georgia, lost 44 percent of its population mainly resulting from massive outward migration. The same applies to industrial center Rustavi, where population size declined by 20 percent. In the Capital City Tbilisi, population decline was relatively modest as a result of inward migration from impoverished industrial cities and villages. The graph below summarizes this negative population change since 1994 in all cities except Batumi.

Figure 7
**Change in Population**




Source: GEOSTAT, 2022

## Perspective from Balance of Payment (BoP) Account

The neoliberal policy lock-in is very well manifested in the components of the Balance of Payments account of Georgia. Table 1 below shows the dynamics of the key components of the balance of payment as a share of nominal GDP. As the table shows, Georgia suffers from a permanent current account deficit, which is mainly driven by the trade imbalance in goods. Tourism is the major contributor to positive dynamics in the export of services. The negative balance in the primary income component is an adverse side effect of FDI. Specifically, a sub-category of primary income is investment income, which accounts for income from FDI, portfolio, and other investments of foreign nationals. On the other hand, Georgia has positive dynamics in secondary income, which is mainly related to remittances from abroad.

Table 1
**Balance of Payments of Georgia**

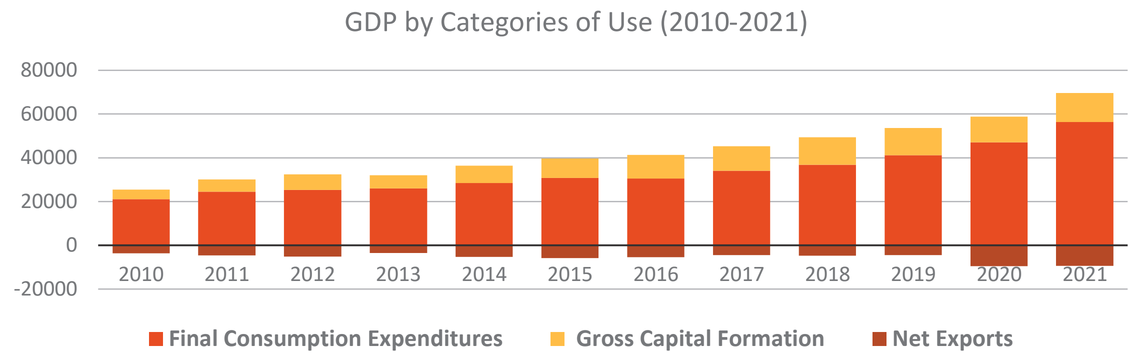
| Balance of Payments of Georgia (BoP components as a share of GDP) | | | | | |
|---|---|---|---|---|---|
| Year | 2017 | 2018 | 2019 | 2020 | 2021 |
| Current account | -8,06 | -6,77 | -5,84 | -12,53 | -10,06 |
| Goods and services | -11,02 | -10,64 | -9,23 | -19,25 | -16,39 |
| Goods | -23,51 | -23,39 | -21,67 | -20,03 | -20,26 |
| Services | 12,50 | 12,75 | 12,43 | 0,79 | 3,87 |
| Primary income | -4,90 | -3,88 | -4,46 | -4,73 | -5,98 |
| Secondary income | 7,86 | 7,75 | 7,86 | 11,45 | 12,31 |
| Capital account | 0,51 | 0,43 | 0,27 | 0,26 | 0,20 |
| Net lending (+) / net borrowing (-) (balance from current and capital account) | -7,55 | -6,34 | -5,57 | -12,27 | -9,85 |
| Financial account | -7,75 | -6,92 | -6,00 | -12,72 | -9,76 |
| Direct investment | -10,56 | -5,55 | -6,02 | -3,48 | -4,44 |
| Portfolio investment | 0,47 | 0,27 | -4,74 | -0,47 | 1,66 |
| Financial derivatives and employee stock options | 0,00 | 0,01 | -0,02 | -0,17 | 0,00 |
| Other investment | 0,85 | -3,23 | 3,63 | -10,54 | -9,40 |
| Reserve assets | 1,49 | 1,58 | 1,16 | 1,93 | 2,42 |
| Net errors and omissions | -0,20 | -0,59 | -0,43 | -0,46 | 0,09 |

Source: The National Bank of Georgia, 2022

In effect, inflows from foreign remittances, tourism, and FDI are three main sources of hard currency that enabled Georgia to avoid BoP crises. While these sources of foreign exchange are important from a short-term perspective, it is still a question if this sort of development model is viable in the long-term. Specifically, the high level of remittances is linked to the level of migration, which has been staggering over the last three decades. A high level of outward migration is usually associated with decreasing human capital, which could become problematic for the overall productivity of the economy. That being said, there is natural limit on outward migration: one cannot just send every citizen abroad for work. Overreliance on tourism also can be problematic for two reasons: a) overreliance on any sector and a lack of economic diversification leads to greater fluctuation of output, especially during economic crises, and b) the tourism sector is subject to "leakage", a process in which part of the revenue generated as a result of tourist expenditures is 'leaked' abroad via import. The empirical work done on this subject indicates that an increase in tourism 'leakage' may contribute to the slowdown of economic growth and employment, as well as broaden income inequality (Wiranatha, Antara, & Suryawardani, 2017).

The graph below shows the GDP of Georgia by category of use. It demonstrates that final consumption expenditures occupy the core of the national economy of Georgia, while the share of investment is modest. Plus, the consumption-to-GDP ratio increased in recent years, and growth of consumption in real terms was higher than the growth of real GDP [8]. In other words, Georgia follows a consumption-led economic model, where the main driver of GDP growth is consumption, backed by foreign remittances, tourism, and FDI (including via massive privatization).

Figure 8
**Unemployment Dynamics in Georgia**




Source: GEOSTAT, 2022

To recap, the Georgian economy is stuck in a policy lock-in: the existing model of economic development is unable to solve the unemployment and underemployment problem. The country is overly reliant on tourism, foreign remittances and FDI. Georgia's radicalism in implementing free market policies has not brought a reduction in poverty or unemployment. The current condition of the Georgian economic state can be best described by the metaphor 'palliative economy' (Reinert, 2006). In the Georgian context, this is a condition in which the existing economic policy does not result in the immediate destruction (death) of the economy, but it locks nations into an underdevelopment equilibrium.

## Small and Medium-sized Enterprises (SMEs) in Georgia: Key Facts

**The "SME Development Strategy for Georgia 2021-2025" classifies SMEs as:**

– Small: up to 50 employees and up to GEL 12 million annual turnover

– Medium: from 50 up to 250 employees and from GEL 12 million up to GEL 60 million annual turnover

SMEs hold a central economic position in Georgia. According to MoESD (2021), the share of SMEs in the country's economy was 99.7% in 2019, employing 65% of the total employed population. According to GeoStat (2021), the share of value added generated by SMEs was 60.7% in 2020. However, more detailed data obtained from the sales figures reveals that the share of turnover by SMEs was only 41.7% of the total turnover in the same year (the OECD average is 60%). Most SME turnover was generated from three economic activities: real estate (SMEs 95.3%, large firms 4.7%), agriculture (SMEs 83.7%, large firms 16.3%) and construction (SMEs 77%, large firms 23%). Herr and Nettekoven (2017) list three types of SMEs: "Schumpeterian SMEs", which innovate and create something new; "normal SMEs", which are able to adapt to the challenges brought about by the Schumpeterian firms; and "poverty-driven SMEs", which emerge in the context of limited economic development, unemployment, and an insufficient welfare state. The data on Georgian SMEs shows that their sectoral concentration is not in innovative or knowledge-based industries, hinting at their 'poverty-driven' character. Furthermore, only one of these sectors has a potential for export. As a matter of fact, according to the Parliament of Georgia's publication (2022), out of 232,000 registered SMEs in the country, only 1000 firms manage to export to the EU. One of the largest concentrations of turnover for large firms is in the mining sector (large firms: 71.9% SMEs: 28.1%), which is a key export industry for the country, including to the EU. Resource-based exports have seen a twofold increase since 2010, further benefitting large companies (more details in the "Trade Analysis" chapter).

8 For more details on consumption-led growth definitions from empirical perspective, see: Kharroubi, E., Kohlscheen, E., Consumption-led expansions, BIS Quarterly Review, March 2017

According to Herr and Nettekoven (2017) there are four major preconditions for sustainable SME development: 1) access to finance, 2) an educational system, 3) industrial clusters and global value chains, and 4) social capital. Most Georgian SMEs struggle to develop, expand, and eventually export because they lack access to all of the above-mentioned resources. Most critically, they lack access to finance. As a state-owned development bank does not exist in Georgia, the vast majority of local companies depend on commercial banks, whose funding comes with very high interest rates (more details in the "Policy Analysis" chapter).

# 3

# TRADE ANALYSIS

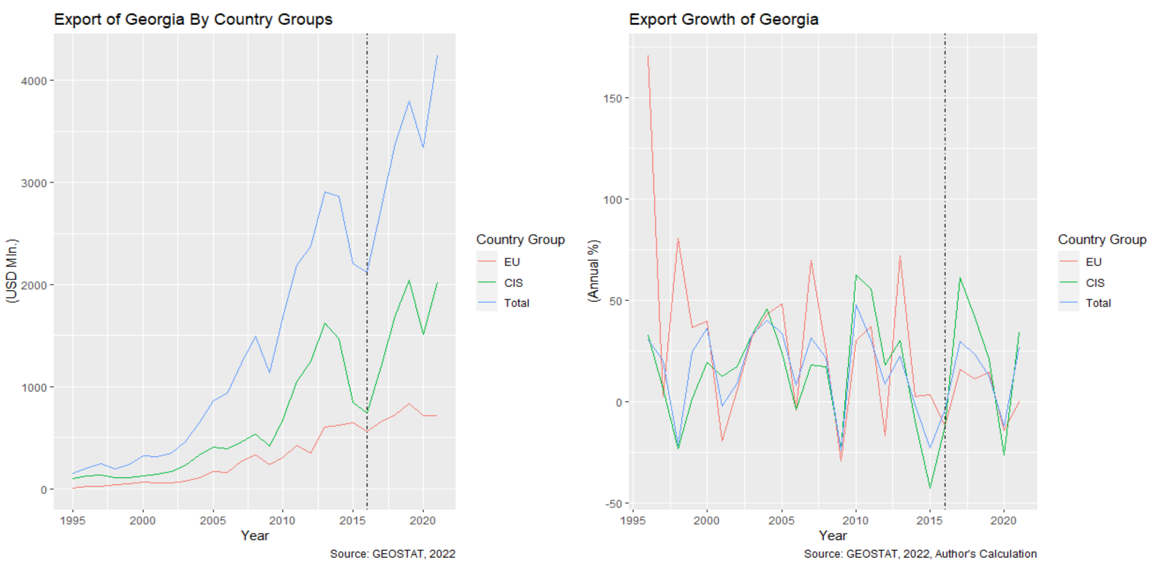
## 3.1 TRADE VOLUME: EXPORTS AND IMPORTS

This section summarizes Georgia's export analysis from a qualitative and quantitative perspective. Specifically, it looks at export value trends and also how export has been progressing qualitatively since the AA entered into force. We cover basic indicators such as export shares and growth rates, as well as export sophistication and concentration indices.

Overall export to the EU (which includes re-export) has been increasing since the signing of the AA with the EU, specifically increasing by 26 percent since 2016. It is difficult to say how much this growth tendency stems from the Free Trade agreement itself, however, since total export growth was much higher than growth exports to the EU.

Furthermore, 26% seems like a minuscule change in comparison to the growth of export to CIS countries, which has increased by 172 percent since 2016. Growth rate dynamics clearly depict that there was no substantial acceleration in Georgia's export to the EU since the AA came into force. Another important aspect is that the export growth rates to EU and CIS countries are correlated (correlation coefficient: 30%), and it might be that there are some underlying forces driving both series, and that the variation with EU trade is not related to the DCFTA.

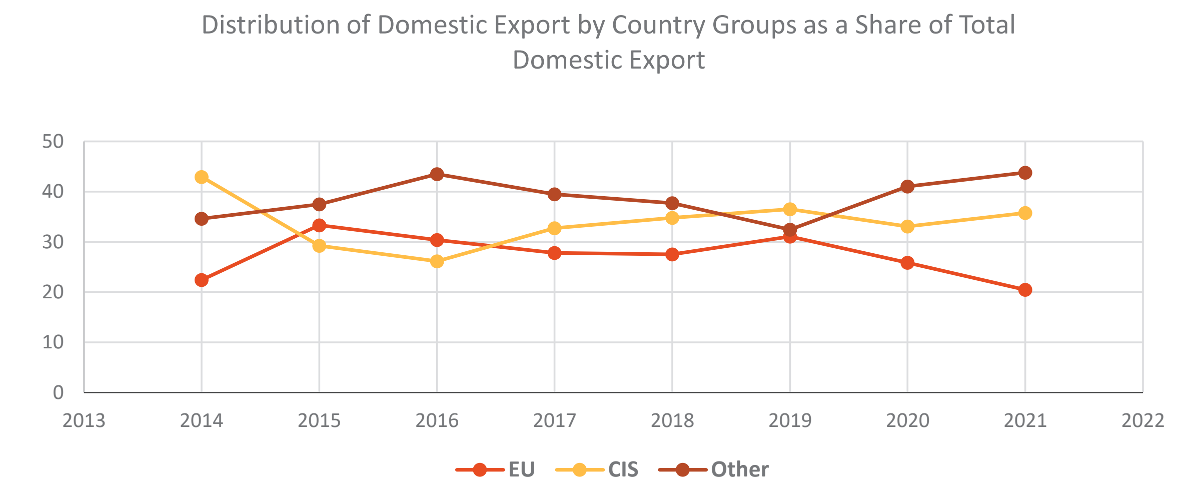
Figure 9
**Export of Georgia by Country Groups**




Source: GEOSTAT, Authors' Own Calculations.

Domestic export is the export of locally produced goods, and it is a better measure in terms of impact on local production and employment. Domestic export to EU countries as a share of total domestic export has declined since 2014 from 22 to 20 percent. There was an upward drift since 2014 (previous data is not available for domestic export) in the domestic export to EU countries, however, this variable has stabilized and started to decline in 2020. The share of domestic export to the EU in comparison to CIS countries was consistently lower and has stayed low since the AA was signed.

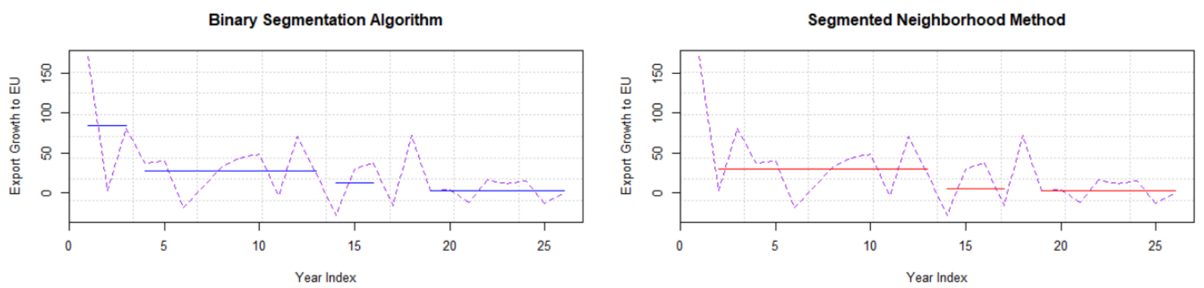
Figure 10
**Total Domestic Export Shares by Country Groups**




Source: The Caucasus Research Resource Centre

Beyond a visual investigation, it is interesting to check whether there are structural shifts in the levels of export or its growth rates. To identify mean change points, we used the Binary Segmentation and Segment neighborhood algorithms, then checked if they revealed breakpoints resembling the Georgia-EU Post-FTA period. The plots below depict a change in mean during different periods: there is downward tendency in the change of exports to EU countries, and the study revealed breakpoints that do not correspond to the Georgia-EU post-FTA period.

Figure 11
**Binary Segmentation and Segmented Neighborhood Algorithms. The index starting year is 1996.**



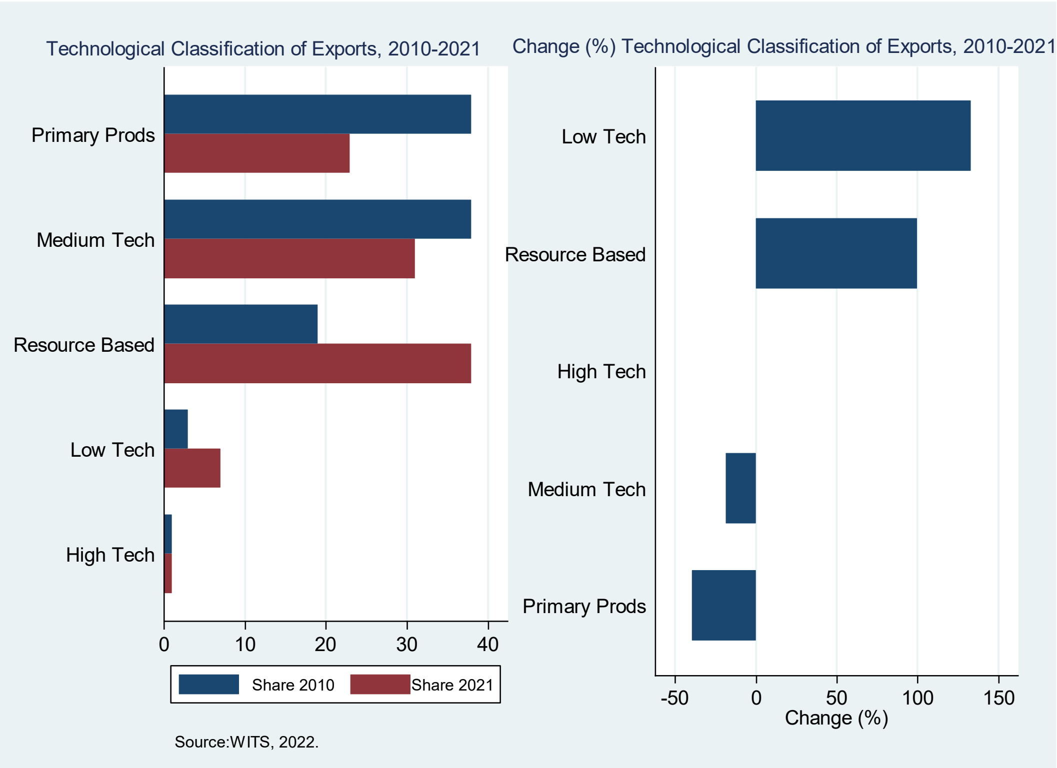

Source: GEOSTAT, the package used: Package 'changepoint' in R, authors Killick, R., 2022

## 3.2 EXPORT SOPHISTICATION

Export sophistication provides a measure for the level and trajectory of economic development. We use two measures to investigate export sophistication trends dynamically and comparatively: a) Technological Classification of Exports (TCE), and b) Sophistication of Exports (EXPY). TCE sorts exports into five distinct baskets: high tech, medium tech, low tech, primary products, and resource-based products (Lall, 2000). The indicator itself is based on the works of Lall (2000). TCE can be expressed mathematically in the following way:

$$\text{TCE}= \sum_{k\in\Omega_{\text{tec}}} \frac{x_{ijk}}{X_{if}} * 100 \qquad (1)$$

In this formula, x is the value of k product from country i to partner country j, while X denotes the aggregate value of exports from i to j. $\Omega_{tec}$ denotes the set of all products and has five subsets (categories): high tech, medium tech, low tech, primary products, and resource-based products. One of the advantages of using TCE is that it enables us to see how export sophistication has changed historically (The World Bank, 2013).




This diagram summarizes Georgia's export technological classification to EU markets for the 2010-2021 period: the left-hand side of the graph portrays the shares of different export categories, whilse the graph on the left shows changes in the share of the technological classification of exports. There is the general tendency of growth in the export of resource-based products: their share has doubled in the export basket since 2010. The share of low-tech products has increased substantially, whilst the share of high-tech products in the export basket has stayed stable since 2010. This means that, according to this indicator, there is no indication of a technological upgrade in the Georgian export basket.

Sorting criteria of the export basket in terms of technological sophistication is not without controversy. For this reason, we also used other criteria to assess the EXPY index with a different approach for measuring the sophistication of products. The EXPY index is based on the methodology of Hausman at al. (2006) and measures the sophistication of exports. The mathematical expression of the EXPY index is the following:

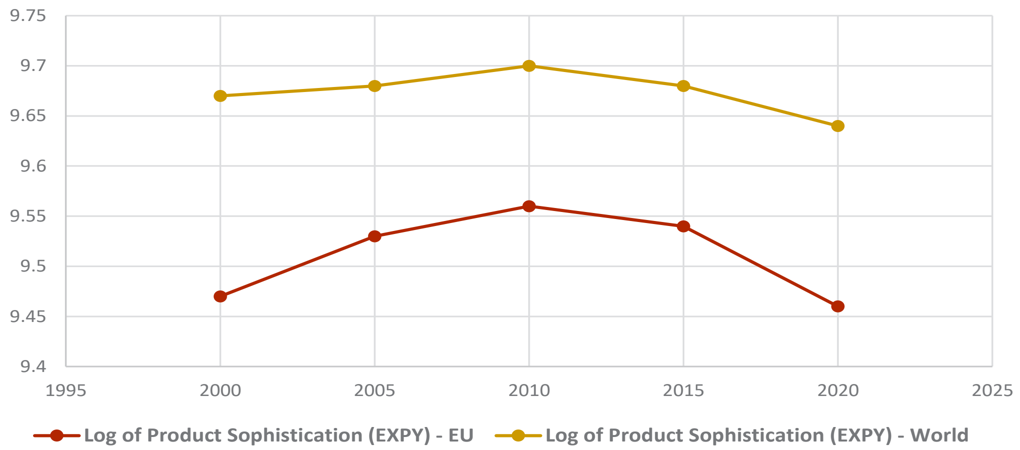
$$EXPY_i = \sum_k \frac{x_{ik}}{X_i} * PRODY_k \qquad (2)$$

Where,

$$PRODY_k = \sum_i \frac{\frac{x_{ik}}{X_i}}{\frac{x_{wk}}{X_w}} * y_i \qquad (3)$$

In this expression, Y denotes the GDP per capita of i country, x is the value of k export product, and X denotes the total value of all export of i country. Subscript w denotes the world. For instance, X_w denotes the total value of global exports. Goods produced by rich countries are considered to be sophisticated products, whilst goods produced by poorer countries are deemed to have lower sophistication. In this expression, PRODY (calculated for each product) is the weighted average of GDP per capita of countries that are producing a given product. EXPY is the sum of all PRODY values for each exported product by a given nation (the products are weighted by their share of total export). The higher the EXPY, the higher the sophistication of a nation's export basket (The World Bank, 2013).

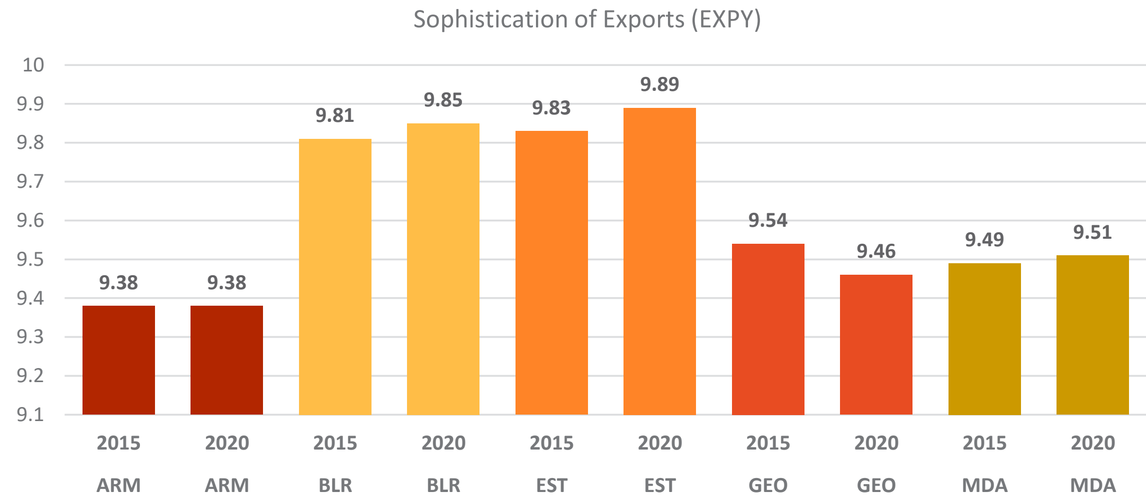
Figure 12
**Sophistication of Exports (EXPY), World Integrated Trade Solution, 2022**




The graph above summarizes the EXPY of Georgia to the EU and world market (specifically, the natural logarithm of EXPY). It shows that Georgia's export basket sophistication to the world market is higher than to the EU market. Second, there is a positive tendency of export sophistication growth from 2000 to 2010, but since then, EXPY has declined and is converging to the rate of 2000. The EXPY index is interesting from a comparative perspective. The following graph shows that Belarus had a more sophisticated export basket than Georgia.[9] Moreover, Georgi lagged behind Moldova in 2020. Estonia has the highest export sophistication in comparison to the other countries in the graph below.

9 However, this may has changed after the EU put sanctions on 70% of Belarus exports to EU.

Figure 13
**Log of Product Sophistication (EXPY) to EU Countries**

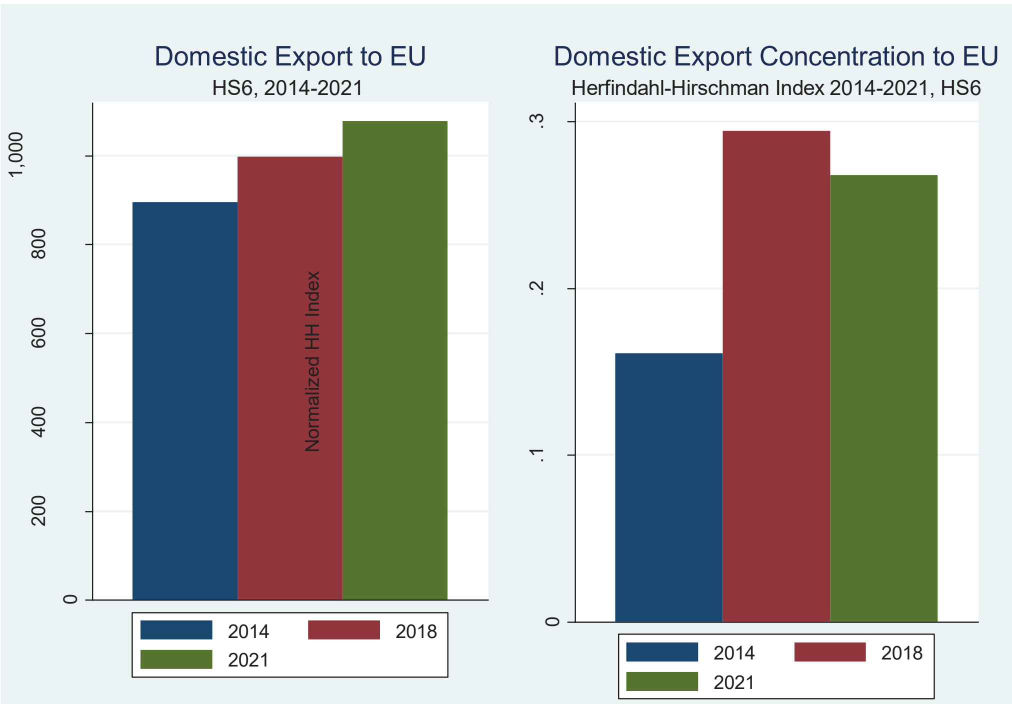



Source: WITS, 2022

## 3.3 EXPORT PRODUCT CONCENTRATION

The problem with Georgian export strategy is that it can't avoid the situation in which the export basket is both less sophisticated and concentrated. There are several ways to investigate export product concentration. The simpler way is to calculate the number of HS6 code lines. If the number of lines increased, it means that a given country is exporting more products. The left-hand side of the graph below shows that Georgia has increased the number of exported goods represented as HS6 code lines.

Figure 14
**HS6 number of lines, and domestic export concentration to the EU**




Source: GEOSTAT 2022, Authors' Own Calculations

However, increasing the number of products does not necessarily mean that the export basket is more diversified in terms of share. The Herfindahl-Hirschman (HH) Product Concentration Index provides an alternative way to measure product concentration. In this equation, X is the total value of exports from country i, n is the number of products exported by country i, and x is the value of export product k exported by country i. The normalized HH index (as specified below) ranges from 0 to 1: the higher its value, the more concentrated the nation's export basket (The World Bank, 2013). As the right-hand side of the diagram shows, even though Georgia's export (domestic export to EU) products increased in number, its export portfolio became more concentrated.

$$\mathrm{HH} = \frac{\sum_{k=1}^{n_i}\left(\frac{x_{ik}}{X_i}\right)^2 - \frac{1}{n_i}}{1 - \frac{1}{n_i}} \qquad (4)$$

The table below adds further weight to the argument that Georgia's domestic exports to the EU need more diversification and a push towards a technological upgrade. Specifically, it shows that the top 10 domestic export products occupy around 85 percent of the total domestic export to the EU, which is approximately 4 percentage points higher than the 2014 level. Besides that, the graph shows that resource-based and primary products occupy the lion's share of this statistic.

Figure 15
**Top 10 Domestic Export Products to EU**

| HS6 | Thsd. USD | Country Group | share2021 | Technological Categories |
|---|---|---|---|---|
| 260300 Copper ores and concentrates | 314949,92 | EU | 49,24 | Resource-based manufactures: other |
| 080222 Nuts, edible; hazelnuts or filberts (corylus spp.), fresh or dried, shelled | 64417,22 | EU | 10,07 | Primary products |
| 310230 Fertilizers, mineral or chemical; nitrogenous, ammonium nitrate, wheth | 47320,6 | EU | 7,4 | Medium technology manufactures: process |
| 220421 Wine; still, in containers holding 2 litres or less | 27993,73 | EU | 4,38 | Resource-based manufactures: agro-based |
| 720230 Ferro-alloys; ferro-silico-manganese | 23674,77 | EU | 3,7 | Medium technology manufactures: process |
| 220110 Waters; mineral and aerated, including natural or artificial, (not contain | 20051,2 | EU | 3,13 | Resource-based manufactures: agro-based |
| 080221 Nuts, edible; hazelnuts or filberts (corylus spp.), fresh or dried, in shell | 15450,87 | EU | 2,42 | Primary products |
| 442199 Articles of wood, n.e.s. | 11383,06 | EU | 1,78 | Resource-based manufactures: agro-based |
| 711299 Waste and scrap of precious metals; waste and scrap of precious metals | 10702,12 | EU | 1,67 | Resource-based manufactures: other |
| 711292 Waste and scrap of precious metals; of platinum, including metal clad w | 8849,83 | EU | 1,38 | Resource-based manufactures: other |

Source: GEOSTAT 2022, Authors' Own Calculations

# 4

# ANATOMY OF THE DCFTA - CONCEPTS AND CLAUSES: WHY DO THEY MATTER?

This section employs a close reading of some of the most important clauses of the Agreement. This is done in order to reveal their implications for Georgian exports and the overall economy.

Much of the Georgia-EU DCFTA is shaped by the WTO's (1994) rules and measures, as well as follows general provisions as per the General Agreement on Tariffs and Trade (GATT). In certain cases, however, it goes beyond the WTO baseline (Hoekman, 2016).

The DCFTA is a complex document. Stipulated clauses and intricate technicalities on food standards or industrial goods are to be met by Georgia if the country wants to take full advantage of EU market access. The Agreement includes chapters that significantly affect national 'beyond border' policies as well as envision concrete actions that Georgian SMEs need to adopt in order to export to the EU. A study commenced by GeoWel (2021, pp. 74-75) notes that "the efforts to bring Georgia into alignment with EU product standards. […] has at least three parts. First, alignment requires the development of the government institutions to support EU-standard production, certification, and policing. Second, alignment needs the development of local Conformity Assessment Bodies (CABs) that can provide the actual testing of products and the necessary EU certification. Third, the private sector's need to adopt new production processes that are in line with EU standards and certify the final products". After a gradual yet successful approximation of EU norms, select Georgian products will be treated with the same conditions as EU products.

Article 26 (AA, L 261/15) on the 'elimination of customs duties on imports' states: "The Parties shall eliminate all customs duties on goods originating in the other Party as from the date of entry into force of this Agreement". While the DCFTA indeed implies a removal of almost all customs tariffs, the EU has multiple NTBs in place that could significantly affect Georgian exports. Building on the United Nations Conference on Trade And Development (UNCTAD) TRAINS[10] database, CEPS's ex-post evaluation (2022, pp. 14-15) notes rather ostensibly that there are 414 non-tariff measures imposed by the EU that might limit Georgia's full-scale employment of a single market. In order to overcome these technical barriers, Georgia will need to approximate its legislation to that of the Union (CEPS, 2021).

We look at some of the most critical concepts and clauses that have the capacity to shape trade dynamics between the EU and Georgia. In order to understand whether they benefit the free movement of goods, or on the contrary are impediments, we undertook a close reading of the DCFTA; we talked to Georgian SMEs, representatives from the Ministry of Economy and Sustainable Development of Georgia (MoESD), and other related stakeholders. Moreover, we reviewed existing literature on DCFTAs (Hoekman, 2016; (Riahi & Hamouchene, 2020); GeoWel, 2021) for better comprehension of the case study.

## TECHNICAL BARRIERS TO TRADE (TBT), STANDARDIZATION, METROLOGY, ACCREDITATION, AND CONFORMITY ASSESSMENT

The chapter on Technical Barriers to Trade (TBT) is concerned with 'the preparation, adoption and application of standards, technical regulations, and conformity assessment procedures' (AA, L 261/20) and provisions Georgia's responsibility to meet EU norms for finished goods in accordance with the WTO's TBT Agreement. The chapter also serves as a good illustration of the increasing significance the DCFTA places on the adaptation of EU acquis. For example, Article 47 (AA, L 261/ 20-21) states that Georgia shall: "progressively approximate its legislation to the relevant Union acquis" and it "progressively transposes the corpus of European standards (EN) as national standards" and "simultaneously with such transposition, withdraws conflicting national standards".

Before entering the EU market, a Georgian finished product must meet two essential requirements: a) health and safety measures for the product group (e.g., toys) must be approximated with EU legislation and b) a product itself (e.g., wooden toy house) must meet EU standards. CEPS's 2021 study differentiates between the two-fold nature of the approximation process:

**1. Directives** (regulations), which can be: horizontal – general principles and regulations for products in accordance with Union acquis; and vertical (sectoral) – health and safety measures applicable for big product groups such as lifts, cableways, con-

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10 The United Nations Conference on Trade and Development (UNCTAD) 's online portal for accessing worldwide data on trade regulations, Non-Tariff Measures (NTMs), etc.

struction products, medical devices, etc. (AA, Annex III, L 261/174). Being binding laws, these horizontal and sectoral directives must be met by Georgia before its products are placed on the EU market. Hence, it is the responsibility of the Georgian government and not the manufacturer to fully implement these regulations on a national scale and harmonize them with those of the Union. Moreover, the government "has to ensure that producers comply with these rules and monitor product compliance with the applicable EU requirements" (CEPS, 2021, p.71).

**2. Harmonized standards** – there are around 25,000 product-specific standards providing various technicalities on how to meet the requirements outlined by the horizontal directives. It is up to the Georgian manufacturer whether to implement these standards or not. When deciding not to do so, "the burden of proof shifts to the manufacturer to prove the 'conformity' of the approach it chooses to meet the requirements of the directive. It is usually a more costly procedure than applying the harmonised EU standards" (CEPS, 2021 p. 69). Regardless of the choice made, Georgian manufacturers need to go through costly and complex conformity assessment processes[11], carried out by an EU-recognized body or laboratory. Only exporters who receive 'the Conformité Européenne (CE) marking to the product' (ibid, p. 70) are permitted to sell products in the EU.

The main argument behind this somewhat complicated process is that approximating EU standards will "increase the potential for Georgian industrial production to become more modernised and internationally competitivee" (CEPS, 2021, p. 68). However, unlike Moldova and Ukraine, Georgia did not sign the DCFTA's Agreement on Conformity and Assessment and Acceptance of Industrial Products (ACAA) (AA, Article 48, L261/21). The latter would have alleviated some of the additional conformity assessment measures and simplified the free movement of Georgian industrial products. It is important to mention that the ACAA obligates a partner country (Georgia) to solely import those industrial products from third countries that meet the aforementioned EU standards. Considering that the vast majority of industrial goods are imported from China and CIS countries, a full approximation of the TBT clause (and ACAA chapter), and a consequent increase of trade costs would have made these imports more expensive[12]. The latter was also the reason why the ACAA was not concluded (CEPS, 2021).

Against the backdrop of Georgia's EU aspirations, one might argue that a gradual convergence with EU law might seem like a good idea. While this is a contested issue, it is already observable that on one hand, the Georgian government is hesitant to fully implement regulations; and on the other hand, Georgian companies are reluctant to adopt EU standards because they lack financial resources. GeoWel's study (2021, p. 12) notes that "the Georgian Government and companies both face a chicken-and-egg dilemma. Companies generally don't want to adopt standards unless they are being enforced, as Georgia is a price-sensitive market and standards adoption brings cost increases that place them at a price disadvantage vis-à-vis their competitors. The government does not want to enforce standards if few companies have adopted them, as this would result in many companies closing".

Nullam dictum felis eu pede mollis pretium. Integer tincidunt. Cras dapibus. Vivamus elementum semper nisi. Aenean vulputate eleifend tellus. Aenean leo ligula, porttitor eu, consequat vitae, eleifend ac, enim. Aliquam lorem ante, dapibus in, viverra quis, feugiat a, tellus. Phasellus viverra nulla ut metus varius laoreet. Quisque rutrum.

## 4.1 SANITARY AND PHYTOSANITARY (SPS) MEASURES

The chapter on Sanitary and Phytosanitary (SPS) Measures provisions Georgia's approximation to EU health standards and safety norms regarding food, animal, and plant products. Once the legislative approximation has been completed, Georgian agricultural and animal products should be granted EU market access, as per the DCFTA. This, however, is not entirely true. Even after approximation has been achieved, Georgian exporters would still be obliged to "obtain certification from the "competent authority" of Georgia, which has to guarantee that the establishment meets the relevant safety requirements of the EU, and which also has the power to suspend the establishment's listing in the case of non-compliance" (CEPS, 2021 p.83).

As imagined, approximating the Georgian regulatory system in SPS measures to that of the Union's well-established norms is a complex, lengthy, and expensive process. While the government must implement regulations and then make sure there are appropriate institutions, such as laboratories or other supervisory state bodies in place, Georgian SMEs have to make sure they adopt and comply with EU-regulated standards regarding food product hygiene and safety. According to CEPS's ex-post evaluation of the implementation of the DCFTA in Georgia (2022, p.28), the approximation of the main horizontal SPS acquis has already taken place in the country, "but further efforts are needed in respect of the so-called vertical regulations, i.e., those for particular sectors and/or products". This is precisely where the main challenge unfolds: Georgian SMEs lack the financial resources to implement EU product standards. While the EU is providing technical and financial assistance (EU4Georgia, 2022), the funds intended to help establishing the 'EU-like' system are neither enough nor adequately targeted. For example, the project "Ensuring further progress of SPS and food safety system in Georgia" that runs for 2 years facilitates funding in the amount of 1.4 million euros. Another ambitious agricultural project aiming "to address structural and systemic challenges that hamper rural development in Georgia and have a negative impact on the rural population and natural environment" has funding of 10 million euros over the span of 5 years. These financial resources are not sufficient,

11 For more details, see EU's Single Market and standards: conformity assessment

12 For more details CEPS, 2021 pp.68-73

undeniably. Moreover, these funds are mainly dedicated to promoting 'good governance', enhancing institutions, or assisting municipalities. The process of tackling the economy's structural problems is often ignored. GeoWel's study (2021, p. 76-77) rightly observes: "the EU does offer support for some private sector entities through its development programming, but at nothing like the scale to match the physical upgrade of facilities required […] Unlike EU-ascension in the early to mid-2000s, there is not a structural adjustment fund to finance the costs to businesses of upgrading plants and equipment, modifying work practices, responding to new administrative demands, etc."

A gradual convergence with the Union's SPS measures also implies an uneven distribution of opportunities, a rise in costs for local SMEs, and in certain cases, their stagnation. Apart from the implementation of national legislative standards in food, animal, and plant products, the Agreement necessitates sector-wide approximation, which is the biggest challenge both to the government and to local firms (CEPS, 2021, pp. 82-94). For instance, if the Georgian government introduces measure X for dairy produce, all SMEs in the sector must comply with the regulation, even those who do not plan to export to the EU. The Georgian agro sector is mainly comprised of micro-enterprises with very limited financial capabilities. This could lead to them not complying with the regulations, and/or market share loss and eventual disappearance. Hoekman (2016, p.9) observes that: "the adoption of elements of EU law may increase costs of domestic production, and as a result force less efficient firms to shut down. Firms that are able to incur the adjustment costs may find it harder to compete in their traditional export markets if consumers there do not value higher-standard products. Approximation to the EU acquis may entail more costs than benefits". Against this backdrop, the government has been somewhat reluctant to implement all of the regulations. CEPS (2021) finds that only 40% of SPS legislation has been approximated by Georgia so far. Basing their argument on the case study of Tunisia's DCFTA negotiations, Riahi and Hamouchene (2020, p. 15) claim that the legal harmonization mechanisms put forward by such agreements give competitive advantages to EU companies. Signing countries must adhere to European standards if they want to export to the EU. This, however, puts domestic and non-EU producers who do not have the relevant certification in the inferior position. This makes the DCFTA discriminatory (Hoekman, 2016).

Some EU directives increase costs that go far beyond the domestic market. A good example of this is described in CEPS's 2022 ex-post evaluation of DCFTA implementation in Georgia (pp. 40-42). The report examines EU regulation 1169/2011 on 'food information to consumers', which was adopted in 2016 but implemented only in 2019. The regulation provisions additional food labelling in order to ensure market competition. Bearing in mind that a large share of food products in Georgia are imported from countries that do not comply with EU labelling (e.g., CIS), the introduction of such a regulation triggered considerable changes in the whole supply chain, predominantly (but not only) affecting the domestic market. Urging for supply chain diversification, the report concludes (p.41): "Considering Georgia's small market size, it is not commercially attractive for suppliers to apply EU labelling to a relatively small volume of products intended for export to Georgia". Another critical aspect to consider is that meeting EU food safety and hygiene norms often implies upgrading existing infrastructure among the Georgian producers, which implies cost increases. As a matter of fact, Messerlin et al. (2011) estimated that the harmonization of food safety norms and processes to EU levels could increase food costs in Georgia by 90 percent (In Hoekman, 2016, p.9).

## 4.2 RULES OF ORIGIN (ROO) AND DIAGONAL CUMULATION

Another issue that deserves attention is a clause on the Rules of Origin (RoO). According to this clause "the product obtained shall be considered as originating in the exporting Party only where the value added there is greater than the value of the materials used originating in the other Party" (AA, Protocol I, L261/615). This is a critical aspect for some of the sectors in Georgia, such as furniture and apparel. These sectoral SMEs import most of their raw materials either from Turkey or China. Even though the final product might be made or assembled in Georgia, domestic value-added is too low, hence RoO prohibits these goods from being exported as "made in Georgia". Consequently, these products cannot qualify for preferential tariffs granted by a DCFTA to Georgia. In this case, general WTO rules with the respective product tariffs would apply.

This has been a sensitive issue for many Georgian SMEs and a vivid example of a significant trade obstacle, at least until recently. Van der Loo and Akhvlediani (2020, p.14) note that in 2018, the RoOs in the DFCTA have been replaced by the Regional Convention on pan-Euro-Mediterranean preferential rules of origin (PEM Convention).[13] However, it was only in 2021 that Georgia, Turkey and the EU finalized a long-awaited agreement on diagonal cumulation. The diagonal cumulation rule will allow Georgian-made products with Turkish origin inputs to be exported to the EU without losing the 'originating' status.

"The diagonal cumulation envisaged by the DCFTA is very important for the diversification of Georgia's exports, given the economy's limited raw-material resources. Activation of diagonal cumulation with Turkey will thus substantially increase the benefits of the DCFTA with regard to export and investment promotion. There is already Turkish investment in the textile industry that is primarily oriented towards exports. It is expected that after enactment of diagonal cumulation, these businesses will further expand, and new investment will be attracted" (CEPS, 2021, p.54).

13 This implies the application of diagonal cumulation rule between the PEM countries (the EU, EFTA, Turkey, the Barcelona Declaration signatory countries, the Western Balkans, and the Faroe Islands); i.e. A final product originating from one PEM country, will not lose its 'originating' status even if the materials used originated in another PEM country

## 4.3 TRADE REMEDIES: ANTI-DUMPING (AD), COUNTERVAILING (ANTI-SUBSIDY) AND SAFEGUARD MEASURES (EXTRA TARIFFS ON IMPORTS)

Even in the era of unfettered markets and free trade regimes, there is still policy space for employing trade defence mechanisms (trade remedies). Ironically, these mechanisms are mostly used by those leading economies that propagate free trade to the rest of the world (Chang, 2002; Chang, 2007). Generally, trade remedies can be used by countries with the aim of protecting domestic industries from import-induced damages. Both the measures and the investigation procedures are applied by national governments according to their corresponding regulations but in compliance with WTO provisions. For instance, an anti-dumping duty is imposed on an importing entity after a national authority demonstrates its detrimental effect on domestic production. "Anti-dumping measures are designed to counteract injurious dumping and restore non-dumped competition in the market of the product concerned" (Kotsiubska, 2011, p. 6). Safeguard measures are designed to avoid import surge risk and normally are represented in quotas (European Commission: Trade Defence).

The DCFTA includes a short but precise chapter on trade remedies (AA, L 261/18-19). Most of it is based on the WTO rules and establishes mechanisms each party can implement in order to protect domestic industries from serious damage. As a matter of fact, the EU pays significant attention to these measures, and has used them at different times. For instance, the European Commission imposed a definitive safeguard measure in the form of a quota of 105% of the average of steel imports from 2015-2017 – a tariff of 25% applied for imports above the quota (EUROFER). Even though this was an emergency short-term measure, it allowed domestic companies to adjust to changes in trade flows (Commission, 2006). Overall, the EU applies anti-dumping, anti-subsidy and safeguard measures according to its Trade Defence Instruments (TDSs) (European Commission: Trade Defence).

Theoretically, Georgia could also use these measures. Article 40 of the DCFTA confirms anti-dumping obligations in accordance with the 'Anti-Dumping Agreement' and the 'Agreement on Subsidies and Countervailing Measures' (SCM) of the WTO (AA, L 261/19). However, following its liberal economic policies, Georgia introduced a law on 'Anti-dumping Measures in Trade' only in January 2021: thirty years after opening-up to free trade. Georgia was obliged to do so in order to fulfil DCFTA commitments[14]. No trade remedies have been used so far between the EU and Georgia (CEPS, 2021, p. 58). Moreover, no application requesting a price-damping investigation has been submitted in Georgia (Business Media, 2022).

14 For more details, see normative acts adopted by Georgia in order to fulfil DCFTA commitments

## 4.4 LIBERALIZATION OF SERVICES

One of the distinctive features of the DCFTA is that not only it implies the liberalization of the trade in goods, but also in services. A rather detailed and extensive chapter (the largest chapter of the DCFTA) - 'Establishment, trade in services and electronic commerce' is dedicated to defining, explaining, and provisioning rules on the liberalization of services between the EU, its Member States, and Georgia. While it is neither our intention nor is it feasible to address all details of the DCFTA chapters,[15] we do detect a prevalent feature that spans across the entire Agreement: power asymmetry reinforced by various clauses. The chapter on the liberalization of services is no exception.

Article 79 (AA, L 261/38) necessitates both the EU and Georgia to implement national treatment (NT) and Most Favored Nation (MFN) treatment for establishment[16] (individuals as well as legal entities) in services: "this means the EU and Georgia must grant, as regards the 'established' enterprises, treatment no less favourable than that accorded to its own enterprises, or those of any third country, whichever is better" (CEPS, 2021, p. 95). Nonetheless, the same article mentions 'reservations', implying that the EU has a list of sectors and economic activities where national treatment and MFN treatments do not apply or are substantially restricted. These restrictions apply to natural persons and legal enterprises covering a variety of services: "these reservations in the DCFTA are placed on a negative list. This means that the EU and Georgia will open up all services sectors, except for those sectors listed where reservations apply" (CEPS, 2021, p. 96). This is a critical issue because the list is long and specific. It covers horizontal reservations in investment, types of establishments, real estate acquisition and ownership, as well as sectoral reservations for economic activities in agriculture, mining, manufacturing, etc. (AA, Annex XIV-A, L 261/203-216). Moreover, some constraints apply at the Union-wide level and some (additional) reservations are member-specific. This cherry-picked approach is a good demonstration of the asymmetric power the DCFTA reinforces; it also discloses the EU's (and Member States') ability to protect sensitive domestic sectors even through a free-trade agreement. It must be mentioned that Georgia also has a right to reservations[17] under the DCFTA (AA, Annex XIV-E), however staying loyal to neo-liberal trends and mainstream economic values, Georgia has long relaxed its regulatory framework. Consequently, the EU has 161 reservations in place regarding national or MFN treatment on establishment in services, while Georgia has only 32 (CEPS, 2021). The implication is that while

15 A detailed overview of the DCFTA's legislative norms has been carried out by CEPS (2021 and 2022)

16 DCFTA defines establishment (L261/37): a) juridical persons (enterprise) - the right to take up and pursue economic activities by means of setting up, including the acquisition of, a juridical person and/or create a branch or a representative office; b) natural persons (individual) - the right of natural persons to take up and pursue economic activities as self-employed persons, and to set up undertakings, in particular companies, which they effectively control.

17 For example, Georgia's horizontal reservation for privatization states: An organization, in which the Government's share exceeds 25 %, has no right to participate as a buyer in privatization process (market access limitation).

European enterprises and/or individuals are able to carry out various economic activities in Georgia (they will be given national treatment or MFN treatment), the same cannot be achieved by Georgian counterparts in the EU.

The chapter also includes another interesting aspect: 'cross-border supply of services' (AA, L 261/40-41). This clause provisions the supply of a service from "(i) the territory of a Party into the territory of the other Party (Mode 1), or (ii) in the territory of a Party to the service consumer of the other Party (Mode 2)" (AA, L 261/38). Reservations apply here, too. CEPS (2021, p. 98) lists 196 EU reservations in Mode 1, and 72 reservations in Mode 2; while Georgia has a mere 14 reservations in Mode 1, and 0 in Mode 2.

## 4.5 PUBLIC PROCUREMENT

Public procurement is one of the most important policy mechanisms countries can use in order to assist domestic companies. This is especially helpful for developing countries, as it enables them to provide growth opportunities for local SMEs. As a matter of fact, state procurement has been utilized as part of industrial policy for protecting infant industries and/or in many cases for developing them (Chang & Andreoni, 2016). Exploiting this mechanism becomes cumbersome when a country concludes a FTA that typically contains a national treatment clause in the public procurement chapter. The reason is clear: FTAs entail openness to foreign capital, hence it is no longer allowed to give special treatment to national companies. The Georgian-EU DCFTA follows this rule.

Chapter 8 of the DCFTA states: "this Chapter envisages mutual access to public procurement markets on the basis of the principle of national treatment at national, regional and local level for public contracts and concessions in the traditional sector as well as in the utilities sector". Even though it clearly mentions 'mutual access', this is not the case. Georgia's public procurement market was deregulated long before the DCFTA (CEPS, 2021), indicating full-scale access for EU companies from the beginning. Georgia, on the other hand, is granted incremental and conditional access, which is described below.

As per the DCFTA, Georgia took on the responsibility to reflect EU acquis in its public procurement law. This implies substantial changes in the current law, amending up to 34 legislative acts.[18] The starting point is the year 2016 – full enforcement of the DCFTA – with a timeline of 8 years for 'institutional reform, approximation, and market access' (AA, Annex-XVI-B). The process has five phases, obligating Georgia to implement pre-selected corresponding legislation. Only after the successful completion of one phase (it is reviewed by the EU-Georgia Association Committee in Trade Configuration. CEPS, 2021, p. 111), can Georgia move to another phase. Each completed stage grants further opportunity for Georgian companies to access the EU's public procurement market, namely:

1. Supplies for central government authorities (after 3 years)
2. Supplies for state, regional and local authorities and bodies governed by public law (after 5 years)
3. Supplies for all contracting entities (after 6 years)
4. Service and works contracts and concessions for all contracting authorities (after 7 years)
5. Service and works contracts for all contracting entities in the utilities sector (after 8 years)

According to the timeline, Georgia should have implemented 3 phases, however, the latest report on ex-post evaluation of the implementation of the DCFTA in Georgia by CEPS (2022, p.36) reveals that the approximation process has experienced significant delays. Georgia has only managed to complete the first phase (originally scheduled for 2019), gaining the right to its first 'reward'. Consequently, in July 2022 the EU (Official Journal, L 195/104) announced its decision "on the granting of reciprocal market access for supplies for central government authorities […] between the European Union and the European Atomic Energy Community and their Member States, of the one part, and Georgia of the other part".

The implication for Georgia is that it has no national policy space to help domestic companies through a state procurement mechanism, even if it wanted to. Neither does it possess the full right to access the EU procurement market. Even if these rights were granted, Georgian companies do not have the ability to compete with their EU counterparts. GeoWels' study (2021, p. 121) follows the case of a Georgian company that produces lighting fixtures and concludes: "they have found the EU to be incredibly difficult from a procurement point of view. They say that many of the EU public procurements that were supposed to be open were incredibly hard to break into".

## 4.6 DCFTA: (WHY) WAS IT IMPORTANT?

An agreement on trade liberalization between Georgia and the EU was in place before the DCFTA. The pre-existing Generalized Scheme of Preferences (GSP),[19] which was granted to Georgia in 1995, as well as the following GSP+[20] implied a removal of import duties for up to 7,200 Georgian products (Meskhia & Seturidze, 2013). Therefore, the DCFTA did not and could not change much vis-à-vis import duties and market liberalization. The distinctive feature of the DCFTA was that it necessitated Georgia to initiate national policy reforms in areas that reduced the cost of trade for firms. Since the mid-2000's, however, Georgia had already implemented several institu-

18 For more details, see: Law on Public Procurement, Georgia

19 he EU's GSP removes import duties from products coming into the EU market from vulnerable developing countries

20 Georgia's inclusion in the EU's European Neighbourhood Policy (2004). In 2008 GSP was prolonged to GSP+ which entailed further tariff reductions and support for sustainable development and good governance (Meskhia & Seturidze, 2013)

tional and legislative reforms significantly deregulating the economy (Monasterski, 2007). Hoekman (2016, p.7) rightly observes that: “much of what could be achieved through a DCFTA could in principle also be obtained through unilateral, autonomously implemented policy changes. This point is illustrated by Georgia, which was already more open to trade and investment than the EU was when it negotiated its DCFTA. […] This raises the question what the value is of a DCFTA to a partner nation.” The author further elaborates that adopting EU acquis and standardization mechanisms makes economic sense for a partner country that has a large share of trade with the EU. Georgia does not. As a matter of fact, it was observed in 2012: “Georgia fails to enjoy GSP+ preferences to its full extent. In 2012 only 34 Georgian goods used this arrangement. In 2012, almost 73% of total goods exported under this arrangement came to nuts and mineral fertilizers; in 2011 this figure stood at 84% and in 2010 – it exceeded 70%” (Meskhia & Seturidze, 2013, p.1420).

The recent ex-post evaluation of the implementation of the DCFTA in Georgia and Moldova by CEPS confirms[21] our findings: against the backdrop of the existing economic structure, it made little economic sense for Georgia to sign the DCFTA. As a matter of fact, the DCFTA primarily facilitates trade in manufacturing goods, while Georgia supplies non-industrial products, “which limits the ability to reap the full benefits of the DCFTA” (CEPS, 2022, xi).

Why, then, was Georgia so keen to sign the Agreement?

21 Based on data presented at the CSD Meeting (online, July 2022)

# 5

# POLITICAL DISCURSIVE POWER: BACKGROUND, ECONOMIC FACTORS, POLITICAL CIRCUMSTANCES

Georgian political leaders have changed throughout the years, but their narratives on Georgia's historic mission to escape the Soviet/Russian[22] past and return to the 'European family' have remained constant. This line of argumentation was equally articulated by the former president when DCFTA negotiations were commenced: "this is the beginning of a very important, decisive, existential political process for [Georgia]; the beginning of materialization our nation's historic dream" (civil.ge (a)); as well as years later, by the current PM when AA/ DCFTA was signed: "Today Georgia is given a historic chance to return to its natural environment, Europe, its political, economic, social and cultural space." (civil.ge (b)). Ironically, these highly abstract and contested concepts were often used to justify very concrete but extensive economic liberalisation processes that have been unveiling in the country since the mid 2000's. Complex notions such as 'Liberalism', 'Westernisation' or 'Europeanisation' were frequently condensed into simple economic messages: in order to get closer to the EU/West, Georgia needs to further deregulate its economy (civil.ge (c)). As a rule, Georgia's (arguably) successful reforms were often measured by the 'Ease of Doing Business" and "Economic Freedom" rankings (civil.ge (d),(e)).

On the other hand, Hoekman (2016, p. 8) notes "in practice, decisions to pursue a DCFTA may have less to do with economics and center more on political and foreign policy motivations – e.g., a hope to eventually accede to the EU (notwithstanding clear statements from the EU that this is not on the table); or a desire to become less dependent on – vulnerable to – Russia". While objectives for becoming a closer partner to the EU indeed existed - for example the Russian embargo of Georgian products in 2005 or the August war in 2008 – this discourse was predominantly driven by political elites and their mainstream understanding of economic ideas, which had become a crucial pillar of Georgia's post-Soviet development.

The unconditional trust in markets and mainstream economic ethics is certainly not emblematic of only the current government, nor it is accidental. Rather, it spans across the whole post-Soviet period and epitomizes a very specific political agenda that embodies, legitimizes, and protects the material needs of a specific political and business class that hardly can be distinguished from each other. Demeaning and reducing the role of the state in economic development has become a prevalent character of transition governments. A most vivid illustration of this is a successful attempt by former president Saakashvili to amend the Georgian Constitution in 2009 and eradicate the state policy space. "The package of proposals, he [*Saakashvili*] told the Parliament, would 'restrict the executive branch of the government to turn away from the course of liberal economy'" and "The government should not be able to use the right of increasing a tax or introducing a new one without public consent", he [*Saakashvili*] said, calling this proposal "the most important principle" (civil.ge (c)).

It is often argued that Georgia's post-Soviet development trajectory was 'natural' because of the cataclysms created by the fall of the system. We argue the contrary – there was nothing natural about it, rather, it came about as a result of political decisions, which on one hand ostracized complex industries, and on the other hand deliberately campaigned for services, the finance sector and tourism. In the early years of the transition, Georgia went through periods of conflict and massive chaos, during which the emergence of crime and the robbery of factories became common. However, the deliberative move not to keep former-Soviet division of labour is connected to the 'identity' politics of nationalism and not to theft. Bohle and Greskovits (2012) righteously show that during transition periods, some countries (Visegrad group, Slovenia) chose to embrace their post-Socialist legacies, which entailed the mobilization of 'substantial resources to compensate for the transformation costs of domestic firms inherited from socialism, and to pamper in their infancy and later assist the expansion of new transnational industries' (ibid. p.22). Other countries (Baltic states) chose to reject all things connected to the Soviet Union, adhering to 'national identity' politics: 'they stressed the need for leaving the East as fast as possible, emphasized the merits of a clear break with socialism's worthless or outright dangerous legacies, and belittled the economic and social losses caused by neoliberal restructuring' (ibid. p.72). These choices were legitimized by political narratives such as returning to the West, hence to 'normality'. The authors conclude that the Visegrad states embraced their past by *embedding neoliberalism;* and by rejecting it, Baltic states fell into 'pure neoliberalism'. The analysis of the Baltic 'trend' could certainly shed light into Georgia's transition as well, at least

22 Often used interchangeably in Georgia

partially. With powerful symbols playing on national identity and sovereignty (that entailed the introduction of a national currency, new national flag, national hymn, etc.) from the early 2000's, Georgia tried to scrap its Soviet past and its legacies. Subsequently, it started to implement rapid liberalization policies in order to overcome political and economic cleavages and get closer to the West. Yet - perhaps more importantly – the political decision to adhere to 'nationalism' went hand in hand with the implementation of an economic regime that largely benefited local business elites or the comprador bourgeoisie[23] (rentier oligarchs[24]).

## 5.1 MYTHS AND DISCREPANCIES: A MOESD POSITION

Multiple interviews were taken from MoESD representatives[25] during our field research. Our main interest was to find out what the national policy is regarding trade, economic and SME development. We also wanted to understand the underlying principles, narratives, or approaches the Ministry follows. Moreover, one of the crucial parts of the research was to find out the perception, challenges, and policy solutions for the current state of the economy as per the Ministry. The interviews unveil results that correlate with the general national policy trends and strategies in Georgia: the mainstream understanding of economic development. Trade diversification, the extent of free-trade agreements, and intensity of market deregulation is perceived as a sign of the 'right path to economic development' among MoESD employees. Furthermore, concluding more FTAs and attracting FDI was described as one of the fundamental principles of the development strategy. Factors (with no particular order) that are important for Georgia's economic development as per Ministry, are:

- Free-trade agreements and trade diversification
- FDI
- SMEs and labour skill development
- Freedom of doing business (high international rankings)
- Tourism and hospitality sector
- Information and Communication Technologies (ICT) and the service sector
- Energy sector
- Transport and logistics (regional hub)
- Small role of the state

While it might not be specifically mentioned in any government documents, our field research has revealed that the MoESD is conducting what we call "pseudo-industrial policy". Namely "Enterprise Georgia" – an agency under the MoESD that was launched in 2014 as part of the DCFTA obligation – was confirmed to be the institution in charge of setting up the industrial policy direction of Georgia.

"Enterprise Georgia" has three main divisions:

1. Business division: or the "Produce Georgia" program, which supports local SMEs by providing financial assistance. A list of sectors the agency has prioritized for financial assistance starts with the hotel industry; followed by building materials, mechanical engineering, rubber & plastics, paper and paperboard, textile production, pharmaceuticals, wood processing, electrical equipment, etc.

2. Export division: in order to promote Georgian exports, the agency provides co-financing to local SMEs for attending international trade exhibitions and missions. It also supports education and training to "increase the professional capacity of export managers working with export-oriented companies within Georgia".

3. Invest division: this division claims to be a "moderator between foreign investors and the Government of Georgia, ensuring access to updated information, an efficient means of communication with Government bodies, and functioning as a "one-stop-shop" that supports investors throughout the investment process".

We find that there are several caveats within this **institutional** and **structural** set up of industrial policy.

## 5.2 INSTITUTIONAL LEVEL

### INCONSISTENCY

There is no clear sign of coordination among institutions or departments. There is no clear message on what kind of industrial policy the country prioritizes or for what purpose. On the one hand official state documents as well as employees of the MoESD speak of the virtues of the free market and importance of the state staying out of the economy; on the other hand, "Enterprise Georgia" is depicted as an industrial policy supervisor. Most importantly, the policy is not coordinated by the highest authority level (such as the Prime Minister), but by an agency that is under one of the many departments of the MoESD. This approach is problematic even on a discursive level. The language it uses for describing what is supposed to be one of the most important state policies is based on commercial/business language. It is not presented as an official document or a formal strategy, rather a few 'bullet-points' on a website describing general activities of the agency. It lacks credibility, value, and importance.

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23 Drahokoupil (2008) defines comprador service class as domestic forces linked to foreign capital who were transformed into major elite segments with considerable influence in the post-socialist CEE region.

24 Riahi & Hamouchene (2020) define rentier oligarchs as the outward-looking political elite

25 Some of the interviewees prefer to stay anonymous, hence the study will only mention names of the departments. 5 MOESD departments (Department for Economic Analysis and Reforms; Department for Foreign Trade Policy; Department for Energy Efficiency and Renewable Energy Policy and Sustainable Development; Department for Economic Policy, Department for Capital Market Development and Pension Reform), 1 MOESD Agency (Enterprise Georgia) and eight respective employees were interviewed in total.

### INADEQUACY

Even though the agency has preselected priority sectors it aims to support, this is far from the "selective industrial policy" model, as the list has 300 economic activities (Enterprise Georgia, Business Support Program). This is not as much an indicator of a vertical or targeted policy as it is ambiguous and lacks a clear vision what kind of economy it wants to develop.

## 5.3 STRUCTURAL LEVEL: THE POSITION OF LOCAL FIRMS

### VERTICAL INTEGRATION

In the interviews our SME respondents indicate that the companies are forced to be vertically integrated, since a corresponding production ecosystem does not exist that would enable them to outsource certain services. These services could be related to logistics, public services or concrete engineering solutions. For instance, one of the interviewees gave the following example: "a good example of this is the fact that the city of Rustavi terminal does not have a stationary crane for heavy cargo transportation. If a company needs to transport heavy cargo, it should first of bring it to Navtlugi Terminal and then transport by truck, which would be very costly. In industrialized countries, this sort of logistical and technical service is abundantly available. In Georgia, there are not enough engineers, logistical support, renovation, or other sorts of services that could be outsourced." The lack of the abovementioned services not only makes the production process costlier, it also diminishes the willingness to invest, our interviewees claim. Our respondent emphasized that it is an insurmountable barrier and huge risk for companies to build vertically integrated production from scratch. In general, the companies who enjoy the services provided by the national production ecosystem and public/private services can minimize their costs by outsourcing certain services.

### CONSISTENCY

Companies competitive on the European market are required to supply goods with consistent quality and volume. Our respondents indicate that it is problematic for Georgian companies to maintain consistency in this regard. One of our respondents mentioned that large European retailers need a consistent supply of products in order make a long-term agreement for the export of goods. According to him, the process works in the following way: initially, a producer introduces its products to a retailer representative and then the respective factory (processing) should pass a technical audit. If the factory can't produce enough product to secure consistent supply, foreign retailers will not set up long-term agreements with the producer. Even if the production facility meets capacity norms, the production of enough goods could be still problematic due to a lack of raw materials, our interviewee complained. For instance, companies in the agricultural processing sector are forced to maintain their own plantations to keep up production due to a lack of raw materials. At this stage, the RoO is not a problem in terms of exporting goods in the EU, because production volume is small and Georgian industries do not require the importation of raw materials from third countries. This could be potentially problematic in the future if production volumes increase, our respondent claimed. Another respondent mentioned problems with maintaining the quality of production, which also requires consistency in terms of raw materials. For instance, the lack of high-quality raw printing materials locally is a risk; however, one respondent claimed this process might be solved through long-term planning and acquiring international suppliers. This leads to another problem, which is the most crucial problem and is related to access to long-term and patient capital.

### ACCESS TO CAPITAL

There are conflicting views between Georgian public officials and entrepreneurs regarding the access to capital problem. A former top official from the Ministry of Economy and Sustainable Development of Georgia, does not agree with representatives of private sector that access to capital is a major problem for Georgian firms. During the interview, he emphasized that Georgian banks have a problem of over-liquidity. In other words, there is not enough demand for credit from private actors. He mentioned that local banks could triple the credit supply if there was demand on the market. He also mentioned that there has been considerable progress made in reducing banking rates for the private sector. The average lending rate for SMEs was around 20 percent (in GEL) in 2012. The current lending rate is 10.89 and 6.5 percent in GEL and foreign currency, respectively. The level of the interest rate does not solely stem from the Georgian government's monetary policy. Rates are also determined by international credit ratings and risk premia. Considering the risk of Georgia's interest rate floor is 3-3.5 percent, Georgian banks that borrow internationally can't lend money lower than this rate. Georgian banks add up their own interest to this base rate, and the final rate is formed in that way. Therefore, Georgia should aim to improve its international rating to achieve a lower lending rate locally, since using other instruments, such public finance, would contain risks of corruption.

This is in contrast with opinions of representatives from the private sector. To increase production capacity, there is a need for large investment in fixed capital. However, the price of money in Georgia is very high in comparison to European competitors. One of our respondents mentioned that one needs to invest on average 30-35 million euros to build a medium-size factory and meet the consistent supply criteria for the European market. Government financial instruments are minuscule in comparison to the existing investment needs and do not meet the needs of entrepreneurs.

The size of government financial support programs is crucial in terms of developing export capability. The government financial instrument under Produce in Georgia, which is called Business Universal, provides credit interest subsidies, however, the amount should not exceed 10 million GEL. The interest rate subsidy is calculated with the following formula: =b -(m-5%), where equals the final interest rate to be paid to private bank, b denotes the banking rate, and m is the monetary policy rate set by the National Bank of Georgia. According to World Bank statistics, the average lending rate for the last 10 years was around 12 percent in Georgia (The World Bank , 2022). Even with government credit interest subsidies, the interest rate for the private sector will be more costly than borrowing from the international markets. To recap, both in terms of the size of support and the interest rate subsidy, the Produce in Georgia subsidy mechanism does not address the problem of access to capital effectively.

The obsession of Georgian policymakers with the idea of financing start-ups could be another source of inefficiency. Business leaders rightly indicate that government financing criteria should be redefined in terms of supporting startups. Government programs should be available only to those beneficiaries who have the knowledge and skills for operating a business. One of our respondents indicated that in Switzerland, the government helps those farmers who passed vocational education in farming. Georgia's public support schemas do not have such criteria, which could lead to wasting taxpayer money. One respondent noted that the government should finance 'winners': in other words, entrepreneurs who have both the soft skills to manage a business and also knowledge of the specific sector.

## LACK OF COORDINATION

As already noted, Georgian policymakers are strong believers of a neoliberal ideology. A former top official claimed during the interview with us that the key reason for fast economic growth in Georgia was the open economy and ease of doing business. According to him, government involvement in the private sector is inefficient and may create the risk of corruption. Moreover, he mentioned that the existence of State Owned Enterprises (SOEs) is a key bottleneck, which could be solved via a new wave of privatization. According to his point of view, a new wave of privatization is deemed to be beneficial since it could bring new FDI into the country. The problem with SOEs is always a risk that SOE managers will employ their relatives or people affiliated with the ruling party, which kills the motivation of other workers and diminishes the overall productivity of SOEs.

In contrast to the ideas mentioned above, one of the business leaders told us that policy makers lack the necessary skills and vision to implement industrial policy – especially those who are in charge of economic development and foreign trade. Another former official from the Ministry of Economy said there were several attempts to impellent an industrial policy, but that all of them failed. Between 2015 and 2018, a small unit of experts working on industrial development existed within the Ministry of Economy (Georgian Industrial Group), which conducted research on various sectors and evaluated the growth potential in the direction of Georgia's industrial development. The group consisted of around 20 people and the annual budget was very small (around 1 million GEL), however, the group managed to discover 21 concrete directions and developed respective business plans. Moreover, for advancing and promoting the idea of industrial policy, the group organized a conference where Harvard economist Dani Rodrik participated and positively assessed the design and operation of the Industrial Development Group. Despite this positive development, the group had little support from the Georgian government and it was dissolved 2018. Our respondent further elaborated on the Georgian political elites' problem of economic thinking in the following way:

> *"The problem of the Georgian political elite is that they don't understand the need for industrial policy – they don't understand that there is no fast economic development without industrial policy. Access to markets does not create new economic activities by itself. Foreign firms will not move their production and will not build value chains from scratch just because Georgia has free trade agreements with the European Union".*

It is important to mention that our respondent from the private sector does not see government support of industrial development as a risk for competition. One of our respondents emphasized that the already existing business sector may not resist an active industrial policy since under this policy, the government would only support new economic activities (and the creation of new sectors), which does not endanger the interests of these businesses. Moreover, one respondent indicated that substantial export support schemes could be an incentive for Georgian companies to export. This sort of policy needs coordinated action between the government, central bank and the private sector, as it is done in industrialized nations, our respondent claimed.

## NATURE OF THE EUROPEAN MARKET

Most respondents claimed that the EU market is highly saturated, and that EU firms have multifaceted advantages over Georgian companies. Usually, local European competitors are larger, and therefore it is difficult to compete with them in price, since the economy of scale works in their benefit. Second, the local ecosystem in terms of available services, knowledge and skills also gives European companies advantage over potential Georgian competitors. This view is line with the findings of the GeoWel paper, which outlines the problem in the following way:

> *"Producers who want to export to the EU are competing with a well-developed eco-system of existing companies. They need to produce according to EU standards, understand particular national tastes and develop networks of clients for their products. They then need to make products and get them to market in consistent quality and volume for those clients. Each of these challenges – production, standards, marketing, client-relations, transport and logistics and much more – are made more difficult by Georgia's physical distance from the EU and lack of networks in the region. Given the challenges, it is perhaps unsurprising that relatively few Georgian companies have managed it so far"* (GeoWel, 2021, p. 8).

The owner of the biggest pharmaceutical company told us that the EU is already a saturated and well-protected market, and it is not easy for pharma producers to access it. He mentioned that his company started registering medicine several month ago in Bulgaria, and the process is still ongoing since registering medicine in the EU is a very long process. To meet the regulatory standards, companies require new investment, and it could be a risky process. Therefore, they are locked into traditional markets which are less saturated and easier to access from the perspective of regulations.

# 6

# A WAY FORWARD? WHY FOREIGN DIRECT INVESTMENT (FDI) AND TOURISM WILL NOT SAVE THE ECONOMY: ARGUMENTS FOR INDUSTRIAL POLICY (IP)

After reviewing Georgia's national development strategy[26] - regardless of whether it is by the incumbent or previous governments - one can easily observe that notions such as industrial policy, industrialization, or industrial development are not mentioned. The fact that there has been a massive level of deindustrialization and brain drain in the country, and that Georgia has an extremely low level of export sophistication (more details in "Trade Analysis" Chapter) is not stated or problematized. What is constantly mentioned is free-market driven development based on mainstream economic values. For instance, a post Covid-19 Government Program (2021, p. 3 and p. 23) that seeks to "overcome the crisis created by the pandemic" states: "the economic policy of the country will again be based on the principles of the free market, where the private sector is the main driving force of the economy". Furthermore, the country's high dependence on problematic and volatile FDI, tourism and remittances are rarely debated. Quite the reverse, as revealed by our MoESD interviews and by a close reading of national development strategies, tourism is one of the most important economic sectors. According to the 'International Tourism, Recipes[27] (% of total exports)' 2019 data, Georgia's share in tourism as opposed to the total share of exports was 39.3% in 2019.[28] (For comparison: Italy 7.3% and France 8.4%.). Ironically, a former Minister of Economy and Sustainable Development, Turnava stated (Netgazeti , 2020) that if she could, she would gladly turn the Ministry of Economy into Ministry of Tourism. As a matter of fact, the only time 'industry' is mentioned in the Government Program 2021-2024 is after the words 'tourism' and 'hotel'.

26 Reviewed documents: a. "Government Program for 2021 – 2024: Towards Building a European State" , b. "Government Program for 2018-2020: Freedom, Rapid Development and Welfare"

27 According to the World Bank: international tourism receipts are expenditures by international inbound visitors, including payments to national carriers for international transport. These receipts include any other prepayment made for goods or services received in the destination country

28 According to the World Bank: inbound tourism has become one of the world's major trade categories. For many developing countries it is one of the main sources of foreign exchange income and a major component of exports, creating much needed employment and development opportunities. This measure reflects the importance of tourism as an internationally traded service relative to other categories of exports. Such a measure reveals the degree of tourism specialization in a country's export structure and the relative capability of tourism in generating foreign revenues.

There are several problems with the above-illustrated pattern:

1. **Reliance on FDI**. FDI could be a useful channel for learning to some extent, but this is not an automatic process. Transnational Corporations (TNCs) might indeed transfer relatively new technologies to a host country, however, as Herr (2019) notes, the type of technology that is being transferred is only suitable for simple tasks and once a local firm reaches satisfactory levels established by a leading firm, no further reasons exist to transfer technology or knowledge. Unless FDI is met with local absorptive capacities (such as a trade policy that is wary of local sectors, where FDI policy ensures its national embedding and human capital development) and national innovation institutions [closely linked to R&D, science, educational systems, and targeted policies for innovation building (Sampath & Vallejo, 2018)], a transfer will not take place and positive spillover will remain extremely limited. Failing to implement any mechanism or national policy for preventing FDI in low-skilled, labor-intensive industries, Georgia ended up in a low Global Value Chain (GVC) position. A good example of this is Turkish FDI in the apparel and textile sector. Georgia's comparative advantage in cheap labor and cheap resources, which was not tackled by any government, has led to its position in the lowest value-added activity of the apparel industry: cut, make, trim (CMT). Furthermore, Herr (2019) notes that FDI can have a negative effect on the domestic economy. Namely, FDI might induce a "crowding out" of local SMEs who are not capable of competing with their foreign counterparts. Another example is FDI in the real estate sector, which might lead to real estate bubbles.

2. **Reliance on Tourism (and services).** This is a highly problematic issue. Apart from its unstable nature (as vividly shown by the Covid-19 pandemic), the tourism sector is not knowledge or innovation-based; neither does it induce the far-reaching spillover effects of the manufacturing sector. Drawing on Hirschman's contributions, Hauge and Chang (2019, p. 25) state: "the manufacturing sector is characterised by stronger backward and forward linkages than other sectors of the economy, thus acting as the main engine of economic development". And because of these linkages it has a higher 'multiplier' effect than services. Moreover, "Kuan's study (2017) shows that in Singa-

pore the manufacturing sector has stronger value-added spillovers to the services sector than vice versa: every 100 new manufacturing jobs are associated with 27 new non-manufacturing jobs. By contrast, every 100 new services jobs are associated with only three additional manufacturing jobs" (ibid.). Another important point made by Hauge & Chang is that even though trade in services has generally grown since the 1980's, the actual increase is very small: 20% in 1980 to 22.5% in 2016. Trade in goods remains the most important feature of international trade; therefore, countries that depend on service sectors (such as tourism or hospitality) for their economic growth "will eventually struggle with trade balance constraints" (ibid.). There is another aspect to consider, namely the **Dutch Disease**. In its original conception, Dutch Disease refers to the process of deindustrialization of the economy caused by the discovery of natural resources. Palma (2014) shows that a high reliance on remittances and service-oriented sectors such as tourism or finance can have the same effect, leading to the country's poor economic performance.

In its most narrow understanding, economic development implies the structural transformation of an economy: the introduction of new technologies, industries, skills, and capabilities. This cannot be delivered by markets or private businesses and requires considerable effort from the state. Herr (2019) lists several reasons why this is the case:

a) information externalities – the implementation of new technologies and industries is risky; private businesses generally do not do this on their own. A good example of it is Germany's move towards renewable energy production in the 2000's, which was predominantly driven by KfW – a state-owned development bank.

b) coordination externalities – technological and industrial upgrading requires the mobilization of new investment that goes beyond the capability of a single firm. Moreover, retraining of labor and further skills development is necessary: "specific skills of employees and firms producing complementary goods or inputs may be needed for new investment" (ibid. p. 3).

c) existence of internal and external economies of scale – internal economies of scale implies that big firms are more efficient than small firms (production for big firms is generally cheaper), hence 'internal economies of scale prevent firms from starting small and then growing slowly' (ibid. p.4). The argument for external economies of scale is that economic clusters are much more dynamic and productive since they are based on network effects and cooperation.

d) ecological dimension –It is no longer feasible to grow at the expense of the environment. Markets do not solve this problem.

Reliance on free-trade, GVCs or FDI does not automatically lead to development. Developing countries lack industrial capacity and technologies (to mention a few), hence imposing trade liberalization at an early stage means that these countries most certainly will end up engaged in the asymmetric distribution of power, which constantly reproduces the dominance of core economies. Academic literature (Chang 2002, Hauge & Chang 2019, Rodrik, 2004, Chang & Andreoni, 2020, etc.) has shown that throughout the history of capitalism, countries that have achieved economic development have always undergone industrialization. Hauge and Chang (2019, pp. 21-22) observe: "By the early twentieth century, the world was clearly divided into two groups of economies: one was rich and industrialised, the other was poor and dependent on agriculture and natural resources. Industrialisation came to be seen as the main driver of economic development. […] This is why the terms 'industrialised country' and 'developed country' are often used interchangeably". Few countries that managed to realize economic development in the post-WWII period - the "Asian Tigers" and China - did it through active and targeted industrial policies. By implementing strategic policies, which entailed both local capability-building and R&D investment as well as the use of foreign capital and technologies, they managed to protect infant industries and diversify export baskets and manufacturing, leading to 'catch-up' industrialization.

As shown in our study, in the context of transition countries such as Georgia, it is crucial to have an institutionalized industrial policy. However, the current development strategy is facing new challenges and constraints related to climate change, financialization, and restrictions induced by WTO and FTA rules. Moreover, Georgia's peripheral position and its dependence on foreign capital vastly challenges the monetary sovereignty of the country in order to mobilize domestic resources. Therefore, a modern and sustainable industrial policy must address these issues.

# 7

# CONCLUSION

The free trade agreement cannot be isolated from the general state of affairs in the socio-economic domain, and it should be discussed in the broader context of neoliberal policy lock-in. To put it more bluntly, we need to use a metaphor. Imagine a family with an obsolete fridge. The fridge frequently needs repairs: sometimes the light inside the refrigerator doesn't work, occasionally the cooling system breaks down, and in some cases, the opposite happens, and the whole fridge is over-frozen. The refrigerator is frequently repaired, but everybody avoids making the fundamental decision to replace it. The reason for this is trivial: buying a new fridge means incurring extra costs; therefore, family members would need to cut back on something else. The neoliberal economic policy looks like the old fridge: everyone understands that it does not work, but for some obscure reason, they avoid replacing it. There are some crucial differences, however: unlike in the family, where everyone loses from having an obsolete fridge, in a nation like Georgia, maintaining the existing neoliberal policy status quo has winners and losers. The winners are the political class and the upper-income groups who benefit from the status quo. Without a strong industrial policy and redistributive mechanisms, Georgian enterprises will not be able to compete with international competitors. Moreover, new economic activities that could become competitive in the international markets will not emerge. This means that the FTA with the EU will not play a "magic stick" role, and it will not rescue the Georgian economy from the ruins created by 30 years of neoliberal economic experiments. Moreover, the FTA with the EU may further undermine the socio-economic fabric and maintain the existing policy lock-in.

The aim of this policy report was to study the effects and trade dynamics of the Georgia-EU DCFTA on Georgia's economy since its introduction in 2014. We found that the increase in Georgia's exports to the EU is trivial, while domestic export to the EU as a share of total domestic export has declined. The country's export sophistication has remained low and export product concentration high, implying that Georgia did not manage to realize structural economic transformation. More importantly, we found that there was a substantial increase in the export of resource-based products, while the level of export in high tech products is virtually non-existent.

Furthermore, the report scrutinized some of the stipulated clauses and enclosed conditionalities of the Agreement. We wanted to understand to what extent the so-called 'non-trade barriers' hinder Georgian exports. We found that the agreement puts too much emphasis on legal harmonization mechanisms. On the one hand, this approach softens the urgency of the much-needed structural economic transformation of the country and on the other hand, increases various operational and administrative costs. As a result, both the government and local SMEs are reluctant to fully implement EU standards and norms. The report found that the DCFTA has an asymmetric character – a majority of terms of the document reinforce the economic superiority of the EU and European SMEs.

We also conclude that the EU should revisit and change its 'neighborhood policy'. If the EU is interested in having a prosperous and peaceful neighborhood, it should abandon the 'Jungle vs. Garden' narrative, and instead build its neighborhood policy on the idea of shared prosperity and inclusive economic development. This would mean supporting Eastern Neighborhood countries such as Georgia in reaching their developmental goals by promoting industrial and income/wealth redistribution policies. Europe has much experience in this regard to share: successful experience in development planning and finance (development bank, such as German KfW), effective public governance, a European-style welfare state, a progressive taxation system, and sustainable infrastructure. Eastern Neighborhood countries including Georgia require international aid, which is based on the spirit of the Marshall Plan. This would mean the developing local production capacity instead of supporting only civil society activities, which merely serves as an instrument of control and appeasing local elites, rather than contributing to economic development.

# 8

# RECOMMENDATIONS

Against the backdrop of the presented case study, we drafted the following policy recommendations.

For Georgia:

- Revisit the country's **development strategy:** reduce emphasis on the virtues of the free-market and mainstream conceptualization of economic development. Acknowledge Georgia's **peripheral position** in the global division of labor and its implications.

- Implement a **national industrial policy** coordinated by the highest authority level. More specifically, the strategy should entail:

  – "Enterprise Georgia" should be reformed and unified with the Partnership Fund, and transformed into an industrial planning state body that reports directly to the PM.

  – Georgia should choose a '**Pick the Winner**' strategy and design a plan to support industrial leaders in boosting export. State support should be based on the 'export discipline' instrument.

  – More emphasis on **selective** (targeted) rather than horizontal industrial policy. Investigate, select and support strategically important economic activities (not 300 sectors). Support **SMEs** in those activities.

  – Mobilize and involve all related state institutions and departments.

  – Consult with civil society, trade unions and the private sector.

  – National **embedding of FDI**. FDI should serve local needs and transfer (at least some) knowledge without exploiting labor or the environment. Georgia's FDI policy should be oriented to attract investment in high value-added sectors.

  – Promote and invest in **cluster creation** – SMEs, research institutions, vocational training centers.

  – Invest in creating **national innovation systems** (e.g., transform Georgia's Innovation and Technology Agency (GITA); promote "learning in production" – create an ecosystem by bringing together GITA, STC DELTA[29] and research institutions).

  – **Trade policy** should be an integral part of industrial policy.

  – Make use of the DCFTA clauses (e.g., Safeguard Measures) to **protect vulnerable** (but strategic) domestic industries. Implement an **import-substitution** strategy.

  – Awareness of the **environment and labor** should be one of the central pillars.

- None of the above will be possible without easy access to capital: establish a National Development Financial Institution (NDFI) in the form of a **development bank**. Reduce SME reliance on profit-driven financial resources from commercial banks.

- Integrate the **National Bank of Georgia** into the country's development plan. Its responsibility can go beyond inflation targeting and price stability.

- Remember that this is a long-term project and does not promise immediate benefits.

For the EU:

- Acknowledge that peripheral countries have **different socioeconomic and political contexts**. They did not have the same development path and they are not economically equal partners of the EU. Give them more space for individual policies and more strategic opportunities.

- DCFTAs/FTAs reinforce asymmetric power relations and reproduce the EU's economic dominance. Discontinue treating asymmetrically FTAs to achieve economic prosperity in the periphery; and devise a Marshall Plan instead.

29 Georgia's State Military Scientific-Technical Center

- More specifically:
  - Incentivize developing countries to implement **state-led** (and sustainable) **industrial policies** to tackle structural economic issues, unemployment, and inequality.
  - Encourage the setup of **national development banks** to access long-term, cheap, and patient capital.
  - Discontinue imposing and supporting economic regimes that only benefit local businesses and political elites. **Shared prosperity** should be the objective.
  - Emphasize **social aspects**: labor issues, minimum wage, trade unions, educational and training programs, and environmental standards. De-emphasize the universality of GDP growth, competition law and free trade.
  - Transfer **knowledge and technology**.
  - Encourage **medium to high value-added** economic activities.

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## LIST OF FIGURES



## LIST OF ABBREVIATIONS

| | |
|---|---|
| AA | Association Agreement (for this case: between the European Union, its Member States, and Georgia) |
| ADA | Anti-Dumping Agreement (WTO) |
| CEE | Central Eastern Europe |
| CIS | Commonwealth of Independent States |
| DCFTA | Deep and Comprehensive Free Trade Area (Agreement) |
| DG | Directorate General |
| EaP | Eastern Partnership |
| ENP | European Neighborhood Policy |
| EC | European Commission |
| EU | European Union |
| FDI | Foreign Direct Investment |
| FTA | Free Trade Agreement |
| GATT | General Agreement on Tariffs and Trade |
| GITA | Georgia's Innovation and Technology Agency |
| GSP | Generalized Scheme of Preferences |
| GVC | Global Value Chain |
| ICT | Information and Communication Technologies |
| ILO | International Labor Organization |
| MFN | Most Favored Nation |
| MoESD | Ministry of Economy and Sustainable Development (Georgia) |
| NDFI | National Development Financial Institution |
| NTB's | Non-tariff Barriers |
| PM | Prime Minister |
| PTA | Preferential Trade Agreement |
| R&D | Research and Development |
| SMEs | Small and Medium-sized Enterprises |
| SOE | State-Owned Enterprises |
| SPS | Sanitary and Phytosanitary Measures |
| TBT | Technical Barriers to Trade |
| TNCs | Transnational Corporations |
| TRIPS | Trade-Related Aspects of Intellectual Property Rights (WTO) |
| UNCTAD | United Nations Conference on Trade and Development |
| WTO | World Trade Organization |

## ABOUT THE AUTHORS

**Salome Topuria** is a PhD student at the University of Kassel, Department of Political Sciences. She received her MA in Political Economy of European Integration from the Berlin School of Economics and Law (HWR). She is an associate member at the Institute of International Political Economy (IPE) HWR, Berlin. Her research interests include political economy of progressive industrial policy, international trade, transition economies in the post-Soviet area, and developmental state.

**Tato Khundadze** is a PhD student at the New School for Social Research in New York, where he also teaches multiple courses and works as a research assistant. He received his MA in Economics from the New School for Social Research. He has extensive research experience in public policy and economic development. He was the head of the Analytical Division at the Georgian Public Broadcaster and a research fellow at the Centre for Social Studies of Georgia. His research interests include sustainable economic development, income inequality, and economic growth models. His latest publications refer to the potential of introducing progressive taxation, Georgia's history of industrial development, and public debt sustainability of Georgia.

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Responsible: Marcel Rötig | Director,
FES Regional Office South Caucasus
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# NEOLIBERAL LOCK-IN

## Why Georgia-EU Free Trade Does Not Work

Georgian Small and Medium-sized Enterprises (SMEs) think that the DCFTA is a figurative agreement. The agreement does not change their situation in essence. The major obstacles to SME development continue to be access to capital, lack of coordination with government actors, and difficulty achieving the necessary standards and capacity to export to the EU market.

Discourses on the importance of the DCFTA were driven by the Georgian political and business elites. Signing the DCFTA made little economic sense. The narratives on its significance were shaped by political elites and their mainstream understanding of economic ideas, which have become a crucial pillar of Georgia's post-Soviet development.

The DCFTA might reinforce economic power asymmetries reproducing the economic dominance of the EU while putting Georgian SMEs in an inferior position. Free Trade Agreements (FTA) often strengthen new forms of dominance, deriving benefits from resources of the less-developed countries. If the aim is to truly support Georgia, tackling the current structural imbalances should be the central point. This cannot be achieved through free-trade agreements through FTA.

Georgia's economy needs structural transformation. Currently, it is structurally designed in a way that makes it nearly impossible to tackle its most critical problems: high unemployment and technological underdevelopment. Under the neoliberal paradigm, the maximum that Georgia can achieve is jobless growth.

More information under this link:
**https://southcaucasus.fes.de/**

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