

Investment Climate in Georgia and Attracting Foreign Direct Investment

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Abstract

This paper focuses on the levels of foreign direct investments coming to Georgia. The main areas addressed by this study include: how to create a favorable investment climate in Georgia and on the possible means of encouragement of FDI inflows in the Georgian economy. This paper aims to fill the knowledge gap in the area of foreign direct investment (FDI) research in Georgia. Various dimensions of FDI were analyzed from a comparative perspective drawing on the case studies of investors in Georgia. The analysis first focused on major obstacles that investors face while performing. Then, attractive features of business climate of Georgia were investigated. Finally, performance issues confronting FDI firms were analyzed. The study results indicated that reasons to invest in Georgia are geopolitical situation and having empty market, and incentives to improve the investment climate of Georgia were State guaranties, tax holidays, political stability, development of infrastructure and advertisement. Another result of the study was that Georgian Government does everything to have free market conditions and do not intervene to the economy. Although the issue of safety affects foreign investors, it does not act as a major deterrent of FDI inflows. The most serious problem influencing the performance of FDI firms were found to be not enough skilled and educated local labor force, economic and political uncertainty. In general, however, it was found that foreign investors have been satisfied with their performance largely due to the relatively smooth competition and the availability of several market niches in country market.

საინვესტიციო კლიმატი საქართველოში. უცხოური პირდაპირი ინვესტიციების მოზიდვა

ფარუკ გურსოი
შავი ზღვის საერთაშორისო უნივერსიტეტი

ნაშრომი იკვლევს უცხოური პირდაპირი ინვესტიციების შემოსვლის პირობებს საქართველოში. მთავარი საკითხებია: საქართველოს ეკონომიკაში საინვესტიციო კლიმატის შექმნა და შესაძლო უცხოური პირდაპირი ინვესტიციების (FDI) შემოსვლის მხარდაჭერა საქართველოს ეკონომიკაში. ნაშრომის მიზანია ხელი შეუწყოს უცხოური პირდაპირი ინვესტიციების კვლევას. შედარებითი ანალიზის საფუძველზე, უცხოური პირდაპირი ინვესტიციების (FDI) მნიშვნელობა განხილულია იმ გამოცდილებაზე დაყრდნობით, რომელიც ინვესტორებმა მიიღეს და იმ სირთულეების ანალიზის საფუძველზე, რომელთა წინაშეც დგანან FDI ფირმები საქართველოში. კვლევის შედეგებით ნათელი ხდება, რომ ქვეყანაში ინვესტიციების შემოსვლას განაპირობებს გეოპოლიტიკური მდგომარეობა, თავისუფალი ბაზრის პირობები და სტიმულები: სახელმწიფო გარანტიები, გადასახადები, პოლიტიკური სტაბილურობა, ინფრასტრუქტურის განვითარება და რეკლამა. კვლევის შედეგების მიხედვით საქართველოს მთავრობა მხარს უჭერს თავისუფალი ბაზრის პირობების შექმნას და არ ერევა ქვეყნის ეკონომიკაში. ერთ-ერთ ყველაზე მნიშვნელოვან საკითხს ინვესტორებისათვის უსაფრთხოება წარმოადგენს. ფირმებისათვის მთავარ წინააღმდეგობად კი არასაკმარისად კვალიფიციური და განათლებული სამუშაო ძალა რჩება, ამას ეკონომიკური და პოლიტიკური სიტუაციის გაურკვევლობაც ემატება. სირთულეების მიუხედავად უცხოური ინვესტიციების შემოსვლას ხელს უწყობს შედარებით მსუბუქი კონკურენცია და ქვეყნის ბაზარზე არსებული რამდენიმე ნიშა.

Foreign direct investment (FDI) can play an important role given the inability of developing or emerging countries to modernize their industries and support their socio-economic development on their own. FDI by multinational companies in emerging market economies of Central Asia and Caucasus region is a controversial issue. There are both critics and defenders of FDI. It was confirmed by Farrell et al (2004) that FDI unambiguously helped the receiving economy as it raises productivity and output, thereby raising productivity and production capacity, thereby raising national income and standards of living of society. Georgia is newly independent country of the former Soviet Union (FSU). Since the early 1990s, the country has received the attention of foreign investors and has started to become the subject of FDI inflows. Georgia has relatively small markets and do not have rich natural resources (e.g. oil, natural gas and rich minerals) compared to other countries in the region, such as Azerbaijan, Turkmenistan, Kazakhstan and Uzbekistan. A majority of the foreign investment flows toward the region is in the form of FDI (Garibaldi et al. 2001). Foreign investors have been active in the region with different motives (Kaynak E., 2006).

After gaining its independence, Georgia encountered problems such as ethnic conflicts and civil war. During the 1992-1995 periods, Georgian economy was in a very poor situation. Severe economic problems coupled with grave criminal situation hindered FDI inflows to the country (Economist, 1993). Starting from 1995 Georgian economy began to show development signs. But the remarkable increases in the economy occurred after the rose revaluation with new government, mostly due to the introduction of a political and economic stabilization program, which involved the strengthening of central authority, decline of crime rates and acceleration of privatization. These efforts had a positive impact on the economy and led to an increase in the value of FDI.

This paper focuses on the levels of foreign direct investments coming to Georgia. The main areas addressed by this study include: how to create a favorable investment climate in Georgia and on the possible means of encouragement of FDI inflows in the Georgian economy.

Many Georgian and foreign organizations have performed research on the barriers to the attraction and operation of FDI in Georgia, with recommendations on how to deal with the issue provided to Georgian government.

However, it is becoming increasingly obvious that some barriers have not been discussed, and the recommendations provided have been difficult to implement.

Moreover, the existing studies have not acknowledged the priorities of the Georgian economy with few highlighting the positive features of the Georgian business climate of which, there must be some.

By conducting this study we aim to find answers to the following questions:

“What barriers mostly affect foreign businesses in Georgia that are not generally addressed in the existing studies?

“What has assisted foreign businesses, which are still operating in Georgia, to survive and resist or overcome the obstacles, which has caused the withdrawal of other businesses?

< The fact that many companies are operating in Georgia, makes it clear that, along with strong will and motivation, there must be some other positive features about Georgia and doing business in Georgia that help investors to resist and overcome multiple obstacles.

< What are these positive features? Are they significant enough to encourage foreign investors to continue their operations and start new businesses?

Therefore, the main purposes of my research are:

< Identify problems foreign businesses encounter in Georgia

< Identify positive features involved in doing business in Georgia

It is obvious that any company is taking certain risks by deciding to invest in the economy of a foreign, especially less developed, country. Accordingly, in order to attract the necessary investment the recipient country must minimize these risks for a foreign investor, i.e. create the most favorable investment climate possible. This paper will discuss what needs to be done in Georgia to achieve this purpose, through the elimination or minimization of existing barriers and the development of the country's positive features; this thus enabling the country to benefit from the economic development facilitated by the flow of foreign investments into the country.

Data collection and the respondents

The study was conducted among 64 companies, from Tbilisi in September, October, November and December of 2006. Out of 64 companies, 52 are foreign and 12 are domestic ones. Sectoral breakdown of the companies as follow: manufacturing (31), services (18), transport (7), energy (5), and banking (3). Most of them were large

companies (38), medium size (17) and small ones (8). I personally visited 55 companies, remaining part distributed by my outstanding students. Respondents selected through convenience sampling. 75 questionnaires were distributed and 64 of them returned and response rate was 85 percent. The high response rate was very reasonable, because of my previous work, I had good relations with companies and it helped me a lot in getting the questionnaires filled. Overall a "typical" response rate is about 50 percent; a "good" one is 60 percent to 70 percent (Kervin, 1992).

Therefore, a "drop-off, pick-up" method of survey administration was found very suitable for the purpose of this study and it was adopted. Before the survey administration, a pre-test of the questionnaire was conducted with a small group of respondents, and the result was satisfactory. The most important the reason of not returning some papers is the behavior altitude of the firm's owner.

The statistical package for social sciences (SPSS) is used for the following calculations.

Survey was conducted by Firm's owner; general managers or representatives of the firms who were generally marketing or sales managers. They took part in the survey and get the questionnaires filled.

The Questionnaire

Data were collected by means of self-administered questionnaires, each lasting for approximately 30 minutes. The questionnaire was first developed in English and then translated into Georgian for Georgian firms. Then, a business professor and a Georgian language professor who are also fluent in English checked the Georgian translation. Finally, Georgian translations of the questionnaire were retranslated back to English by four students in order to ascertain that it was conveying the exact meaning as originally designed. Surveys were based on a questionnaire consisting of three parts: the first asked a series of questions focusing on the company information; the second comprised some questions about the investment climate of Georgia. The third part was about the existing attractive futures of Georgian investment climate and what should be done to have a favorable investment climate. A special effort was made to keep the questionnaire as simple as possible in terms of structure, wording, and scaling.

The data collected were analyzed and used to identify; the positive features and the perceived existing barriers of doing business in Georgia, potential areas of development and growth, and the changes desirable to the foreign investors - the respondents to our survey.

Table 1
Mean Scores for Investment Climate in Georgia

<u>Factors</u>	<u>Mean Scores</u>
Skills and Education of available workers	2.3
Crime, theft and disorder	1.97
Economic and Regulatory Policy Uncertainty	1.92
Cost of Finance (interest rate)	1.66
Electricity	1.53
Anti-competitive or informal practices	1.44
Customs and Trade regulations	1.36
Tax administrations	1.35
Macroeconomic instability(inflation, exchange rate)	1.34
Tax rates	1.32
Corruption	1.20
Access to Finance	1.04
Transportation	0.97
Labor Regulations	0.79
Business Licensing and Operating Permits	0.68
Access to Land	0.64
Telecommunication	0.45
Overall Avarage	1.29

Mean scores are based on a five-point scale ranging from 0= No Obstacle to 4=Very Severe Obstacle.

Table 1 displays the results of mean scores for each environmental impact statements used in the study. The statements in Table 1 have been arranged in order of the magnitude of the mean score. The highest mean score (2.3) was for the statement that the biggest obstacle for investing in Georgia is skills and education of available workers. This is the major obstacle for the investor to operate and

grow their business. Specially, firm's managers indicated that they have lack of skillful worker in technical jobs. When Georgian roads and building were adjudicated, there were only foreign companies ready to compete. This is a good indicator that in Georgia there is lack of skillful worker, mostly in technical jobs. Although crime, theft and disorder levels decrease recently, investors still do not feel safety (1.97). They think that economic and regulatory policy uncertainty is moderate obstacle (1.92). It is a great success of the new government that this issue was before among severe obstacle.

Cost of finance (interest rate) is another difficulty to operate and grow business (1.66). Some respondents argue that interest rate is reasonable when we compare it with the risk factor. Some of international investors even stated that because of high interest rates, they get credits from banks in Europe. Electricity is no longer a major problem (1.53). Most of the investors who indicated electricity as an obstacle have branches in different regions of Georgia. That is to say, it is mostly a regional problem. An anti-competitive or informal practice seems to be a problem that we have to fight with (1.44).

Another issue for foreign investor for importation or production of different goods in the country is the problem of poor performance of the official at the customs (1.36), which also corresponds to the findings of the other researches. Some investors suffer from the officials who are not experienced enough at their fields and they waste time at the borders. Tax administrations (1.35) another serious issue stays on the table, especially finance police makes it difficult to operate business.

Most of the comments made by our respondents' show that macroeconomic instability (inflation, exchange rate) are a minor obstacle (1.34), they are stable. Tax rates (1.32) are reasonable after the enacted new tax code in 2005 that significantly reduced tax types and rates.

Previous studies showed that corruption used to be the number one problem of Georgia (1.20). Thanks to new government's considerable efforts against corrupted officials, it is no more very severe obstacle.

Investors do not think that it is difficult to “access to finance” (1.04). But some of them stated that it is difficult to get the amount of money that they demand. That is why; they have to work with several banks to get the amount that they want. As we see from the numbers, transportation (0.97), and labor regulations (0.79) are not serious issues for the country anymore.

The number of business activities subject to licensing and permitting regimes was reduced by 84%. Due to successful reforms in “business licensing and operating permits” (0.68), Georgia has favorable investment climate for doing business.

Access to land (0.64) and telecommunication (0.45) values, according to our corresponds, are very close to no obstacle. But I should indicate that some investors have problems of telecommunication in the regions, to contact head quarters with offices in the region.

Table 2
Factor Analysis
Factor Analysis of Investment Climate

Factors	Factor Loadings		
	1	2	3
Factor 1: Macro environmental concerns			
Macroeconomic instability (inflation, exchange rate)	.791	.146	.004
Economic and Regulatory Policy Uncertainty	.732	.000	.048
Tax administrations	.704	.079	.020
Tax rates	.671	.204	.259
Labour Regulations	.584	.066	.418
Business Licensing and Operating Permits	.416	.323	.103
Factor 2: Dissatisfaction with illegal practices			
Corruption	.378	.681	.059
Skills and Education of available workers	.021	.643	.059
Electricity	-.051	.638	.380
Anti-competitive or informal practices	.275	.583	.113
Customs and Trade regulations	.118	.568	-.111
Factor 3: infrastructure and financial issues			
Telecommunication	-.161	-.148	.641
Transportation	.208	.246	.576
Cost of Finance (interest rate)	.329	.198	.559
Access to Finance	.208	.321	.503
Access to Land	.187	-.319	.492
Crime,theft and disorder	.008	.415	.467

Note: Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization.

Companies responses were then factor analyzed to determine the salient factors underlying Georgian Investment Climate and the surrounding environmental factors. Factor analysis produces hypothetical constructs, called factors, which represent sets of variables (Harman, 1967). The principal component method of factor analysis was used with a varimax rotation. The resultant Varimax rotation factors are given in Table 2. The analysis produced three factors which explained 46.68 percent of the total variance.

The first factor in Table 2 consists of: “Macroeconomic instability (inflation, exchange rate) (0.791)”, “Economic and Regulatory Policy Uncertainty (0.732)”, “Tax administrations (0.704)”, “Tax rates (0.671)”, “Labor Regulations (0.584)”, “Business Licensing and Operating Permits (0.416)”. This factor accounts for 18.31 percent of the total variance.

The second factor accounts for 15.43 percent of the total variance and “Dissatisfaction with illegal practices” is shown here, “Corruption (0.681)”, “Skills and Education of available workers (0.643)”, “Electricity (0.638)”, “Anti-competitive or informal practices (0.583)”, “Customs and Trade regulations (0.568)” are loaded on this factor. This factor may be labeled as care for foreign investors.

The third factor in Table 2 delineates a cluster of “Telecommunication (0.641)”, “Transportation (0.576)”, “Cost of Finance (interest rate) (0.559)”, “Access to Finance (0.503)”, “Access to Land (0.492)”, “Crime, theft and disorder (0.467)”, This factor accounts for 12.93 percent of the total variance. This factor may be labeled as foreign investor's dissatisfaction with infrastructure and financial issues.

Table 3
Factor analysis results- Consumer Environmental

Factors	Eigenvalues	% of Variance	Cumulative variance%
Factor 1:			
Macro environmental concerns	3.113	18.312	18.312
Factor 2:			
Dissatisfaction with illegal practices	2.624	15.435	33.748
Factor 3:			
Infrastructure and financial issues	2.200	12.939	46.687

Notes: aRotation Sums of Squared Loadings of Total Variance Explained

Reliability Analysis

Cronbach's coefficient alpha was used in this study to assess the reliability of the measures. Nunnally (1976) suggests a reliability coefficient of 0.60 or larger as a basis for acceptance of the measure. A Cronbach alpha coefficient of 1 would indicate perfect uni-dimensionality within a scale. When Cronbach alpha was computed for all the seventeen scale items this was found to be 0.893. This indicated the possibility that the entire scale was uni-dimensional. Cronbach alpha coefficient of 0.893 can be considered a reasonably very high reliability coefficient. Based on this, it can be assumed that all 17 items used are measuring the same construct (FDI and Investment Obstacles in Georgia) and, therefore, a summative measure can be used to represent the Importance of Investment Climate and Obstacles in Georgia score of the respondents (see Table 4).

Table 4
Reliability statistics

	Cronbach's Alpha	N of Items
All	.893	17
Factor 1	.823	6
Factor 2	.741	5
Factor 3	.672	6

Factor 1 had six items and reliability of 0.823; factor 2 had five items and reliability of 0.741; factor 3 consists of six items with reliability of 0.672. Even though reliability of factor 3 is relatively low, the factor coefficients of the items are highly polarized (see Table 4).

Table 5
Mean Scores for Government Intervene in the Economy

Factors	Mean Scores
Sales	0.35
Employment	0.34
Wages	0.29
Pricing	0.27
Investment	0.23
Mergers	0.21
Dividends	0.15
Overall Average	0.27

Mean scores are based on a five-point scale ranging from 0= Strongly disagree to 4=Strongly agree.

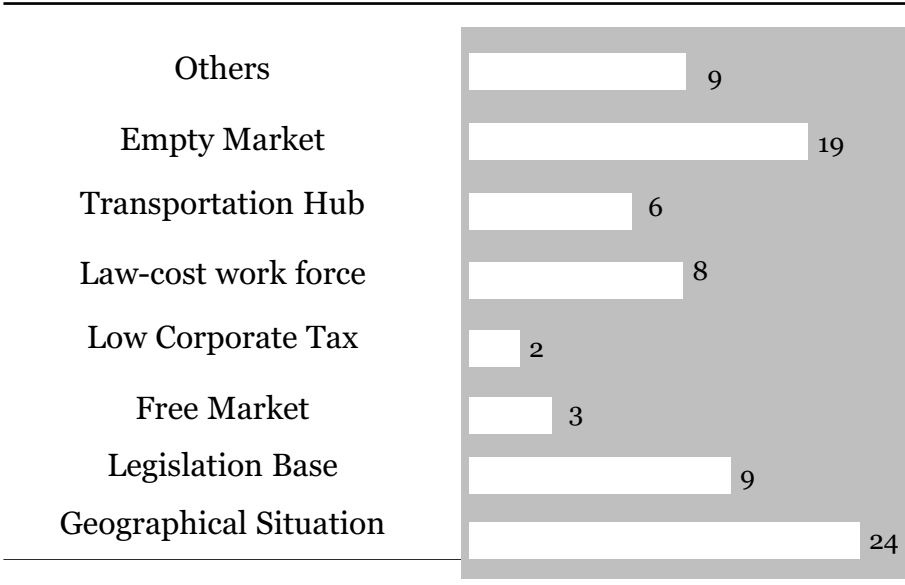
Table 5 displays the results of mean scores for each environmental impact statements used in the study. The statements in Table 5 have been arranged in order of the magnitude of the mean score. As we can see from the numbers that Georgian Government does not intervene to the economy. The highest mean score (0.35) was for the statement for sales. Employment means score is 0.34, wage is 0.29, pricing is 0.27, investment is 0.23, merger is 0.21 and the last value is dividends (0.15).

The values are parallel with the aim of the government. The aim is to establish the free market economic conditions in Georgia as it was stated by the minister of the Economic Development of Georgia. The respond of the 64 companies shows that Georgia is on the right way in order to have free market economy.

Decision on Investing in Georgia

As the survey results showed, most of the respondent companies have selected Georgia because of the geopolitical situation (24 out of 64 responses). The next most important incentive for starting business in Georgia was empty market (19), followed by: free market legislative base (9), low-cost employment (8) and transportation hub between Europe and Asia (6). WTO Membership and low cooperate cost were other named important incentives for investing in Georgia. Most of the companies indicated more than one reason for the following evaluations.

Fig. 1 *Reasons of investment in Georgia*



As table 6 shows us, the geopolitical situation is obviously the biggest asset of Georgia. Despite several problems, including having Chechnya in its neighborhood and the rebel regions of Abkhazia and South Ossetia, Georgia still seems to be attractive due to its location. It is the geopolitical situation, which Georgia has above other countries in being chosen.

This is particularly important when we take into consideration that 40 % of the respondent companies have invested and are continuing to invest in other CIS countries. For Georgia it means competition from other CIS countries for foreign investments in the region, is becoming extremely difficult in view of significant development achievements of the other countries in the region.

One interesting and recurring remark was that most of the respondents did not have high expectations for the rate of return. 70 % of the respondent companies stated that expectations were moderate and the actual results did not differ greatly from them. So forecasts made based on information collected and analysis made prior to investing in Georgia, in most cases turned out to be valid. Of course there were some unpleasant surprises for foreign companies, but generally they were manageable. Generally, we may conclude that in spite of the lack of available data investors were quite well informed about the problems that exist in Georgia and despite this they still decided to invest in the country.

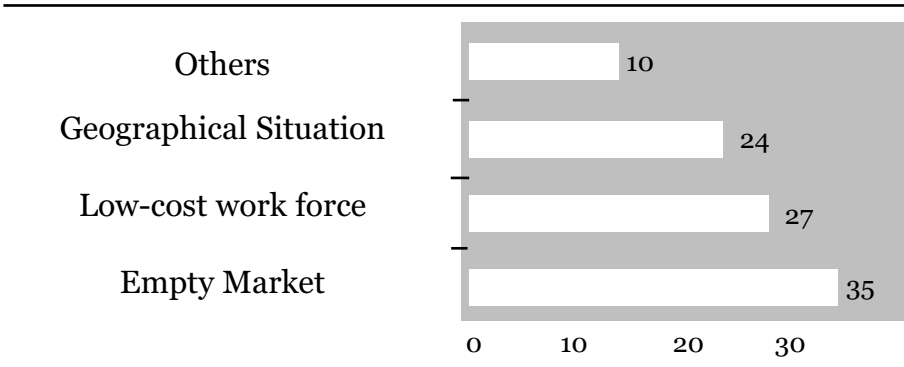
It is noteworthy that 55 % of the respondent got credit from the Georgian banks. This shows that banking system of Georgia received favorable comments from the overwhelming majority of the respondents. Most of the respondents said it is meeting their requirements, although others admitted that they thought it needed further development, but were impressed over the significant progress that had been made and the rate of development. Several respondents disapproved of high interest rates, though; some underlined that for Georgia it is normal rate because of the risk factor. Some indicated that Georgian banks are not big enough to finance the amount that they want. Some said that they take the credits from European banks where the interest rate is very low comparing to Georgia.

Answering the question of whether they consider their investment successful, 57 out of 64 respondents answered positively. Amongst the negative responses, the main reasons provided for continuing operations in Georgia despite of the unsuccessfulness of investments were: "we will wait and see". They have great hope to make money in the future. Although, more positively 53 of the respondents reported of plans to expand their businesses in Georgia. In view

of a general negative impression of business climate in Georgia, it is unexpected to find out that 85 % of the respondents would recommend their partners and colleagues to invest in Georgia. They insistently underlined that high positive respond to questions “expand their business and recommend their partners to invest in Georgia” is because of the new government successful reforms.

According to the responses, one of the biggest obstacle that they have is about the judicial system. 24 % of the total response said that they do not trust in Georgian judicial system at all, and it is noteworthy that almost all of them are foreigners. 19 % do not trust in most cases and another 19 % tend to not trust. So, totally 62 % do not trust in judicial system to some degree. 38 % trust in the judicial system, just 7 % trust Georgian judicial system fully.

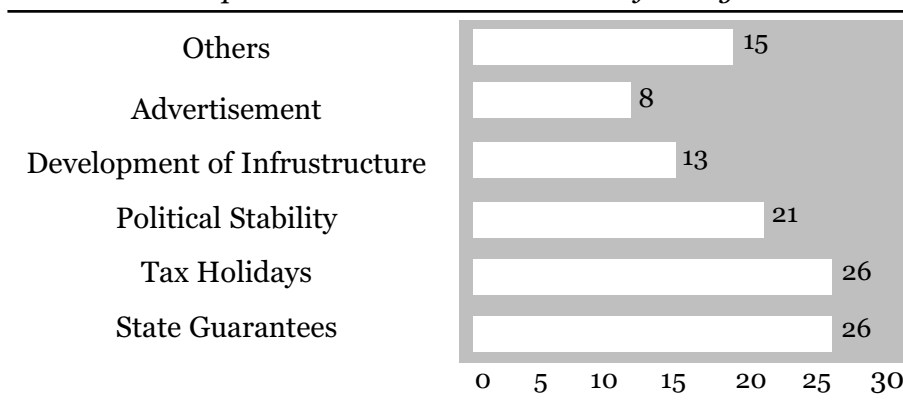
Table 7
Attractive Features of Business Climate of Georgia



Moreover, it was very interesting that some companies trust in judicial system when they have conflicts with private sectors but they do not when they have it with government.

According to our respondents, currently the best attractive feature of business climate of Georgia is empty market (see table 7). They believe that today it is easy to invest in Georgia but later there will be huge competition to find sector to invest. They think that to exist in the market today will give them great advantage in the future. Second important attractive feature of business climate of Georgia is the low-cost work force. Comparing to other countries in the region, they believe that this is a reason to invest in Georgia. Another important feature is the geopolitical situation. Georgia will always be attractive to the foreigner for its geopolitical position.

Table 8
Incentives to Improve the Investment Climate of Georgia



Thanks to new economic reforms and incentives, FDI flow to Georgia dramatically increased in the last two years. Most of our respondents believe that with the promotion of the positive features Georgia currently possesses more FDI will be attracted into the Georgian economy. The suggestions on what measures can be taken to encourage investment in Georgia included: state guaranties, tax holidays, political stability, improvement of infrastructure and advertisement of the country (see table 8).

The world market for FDI is becoming increasingly competitive. To be seen as an attractive place for investors seeking to do business, Georgia must expand on its progress to date and begin to think more creatively about attracting FDI. Starting from 1995 Georgian economy began to show development signs. But the remarkable increases in the economy occurred after the rose revaluation with the new government, mostly due to the introduction of a political and economic stabilization program, which involved the strengthening of central authority, decline of crime rates and acceleration of privatization. These efforts had a positive impact on the economy and led to an increase in the value of FDI.

According to survey results, although increase in FDI in the country recently, there is much to do to attract more investors. These can include business climate reforms that reduce the costs of doing business, offering a variety of incentives such as tax preferences or government financed infrastructure develop-

ment to serve particular investors, and targeting and recruiting investors from particular sectors believed to be especially suitable. Another important issue is that investors in Georgia can not find good enough skilled and educated workers. This shows that we should pay attention more for technical training schools or courses and educate people that are needed. It is another danger for us to be considered very seriously that foreign investors still do not feel safety and they still do not trust much in Georgian judicial system. The suggestions on what measures can be taken to encourage investment in Georgia included: state guaranties, tax holidays, political stability, and improvement of infrastructure and advertisement of the country. It is obvious that Georgia's population, estimated at about 4.2 million, is too small to be attractive to many foreign investors. However, its unique geographic location and its trade agreements with neighboring countries make it attractive as a platform from which to serve other markets, particularly the EU and Turkey. Longer term, if relations with Russia improve, Georgia could also become an important platform to serve that market. Besides lucky location, empty market is another attractive feature of business climate of Georgia.

While this study has tried to fill the existing knowledge gap with regard to FDI issues in this relatively under-researched part of the world, further research is definitely called for in order to gain deeper understanding of the issues confronting both foreign investors and domestic firms when forming strategic business alliances and partnerships. Another line of research would be to investigate the factors influencing foreign investors' choice of alternative modes of investment when operating in these regions. As the survey utilized in this study was undertaken solely from the perspective of foreign investor, a survey utilizing the perspectives of both foreign and indigenous firms would be a valuable contribution to the extant literature. As the degree and level of FDI is directly related to a country's level of economic development, an additional study which looks at the relationship between FDI and level of economic development of countries will be illuminating.

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