International Business Review 24 (2015) 1009–1024

Contents lists available at ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

The legends of the Caucasus: Economic transformation of Armenia and Georgia

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ARTICLE INFO

Article history:
Available online 24 December 2014

Keywords:
Armenia
Comparative economics
Diaspora vs. dispersion
External exposure risks
Georgia
Regional vs. standalone market strategies
Post-socialist transformation
Transitional business models

ABSTRACT

Considered peripheral in economic terms the structurally fragile Armenia and Georgia with obvious limitations are open to international business. This article constructs a compact analytical synthesis of the duo's potential across macroeconomic, industrial, external exposure risk, institutional, and the Diaspora (dispersion) effects within the five forces model of the social and economic transformation. Post-Great Recession dynamic analysis, sketching sectoral and business trends, tackles issues of market entry and foreign investor strategy. Armenia's impressive pre-crisis pattern has yet to be recovered, while Georgia's post-crisis record has been more consistent with earlier years. Armenia's entrepreneurial and innovative capacity, vital to new business accommodation, ranks above Georgia's, where traditional sectors are dominant. All in all there is a need for an individual, not "bulk", analysis of the post-socialist periphery. Foreign firms' managers are suited to gain if acquire local context and local (or Diaspora-) based partner (public or private) prior to regional or standalone entry. Despite multiple headwinds, both economies retain strong international business potential and hope for an economic and social resurrection.

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1. Introduction

The Caucasus is a land of ancient snow-capped peaks, age-old traditions of hospitality, and tremendous human potential. The legendary Argonauts sailed to Colchis in the southern Caucasus in search of the Golden Fleece, and in the biblical tale Noah's ark came to rest on Mount Ararat. Although as a whole, the Caucasus is still a land of promise, the individual nation-states that comprise it are in dire need of robust and inclusive development in the political, social, economic, business, institutional, and cultural domains.

A contribution to this journal's colloquium on transitional periphery, this article draws unified analytical insights on recent macroeconomic, business, and institutional trends in the Caucasus duo—the Republic of Armenia and the Republic of Georgia—in the context of a larger post-socialist transformation. Despite their peripheral status the structurally fragile duo seeking multilateral integration with global marketplace with obvious limitations may in fact be open to larger international business. However, for international firms' managers knowledge of local content dynamics and partnering with local or Diaspora-based counterparts would serve equally as critical requirements and competitive advantage for any new local market entrants in either country case. Hence, this article's multifaceted focus on various aspects of international business modalities in Armenia and Georgia. Of those aspects, legacy systems visible in the duo's market structures and trade patterns, as well as institutional make up seem to be the most critical.

Both countries, neither of which is well endowed in resources, are unique post-socialist economies, with domestic and dispersed (Diaspora) human capital as one of the core factors. Armenia, which is largely mountainous, is landlocked, with its western and eastern borders (those with Turkey and Azerbaijan respectively) blockaded. Georgia has a larger landmass, with access to the Black Sea and its commercial port infrastructure and open borders, despite politically strained relations with Russia.

Plunged into macroeconomic "shock therapy" reforms during the early 1990s, the Caucasus duo went from one extreme to another. Both spiraled through a decade of lost output and deteriorating capacities, as military conflicts of the time intermixed with skyrocketing unemployment, poverty, and out-migration before the modest macroeconomic recovery of the early 2000s. The latest global crisis (the Great Recession) delivered yet another structurally challenging macroeconomic, social, and institutional blow to both countries. The sustainability of any successes, despite, albeit episodic, double-digit economic growth, remains uncertain, while domestic (and geo-) politics, social, and business development problems remain complicated. From international business point of view, a forward-looking analysis suggests that legacy circumstances are important as new

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http://dx.doi.org/10.1016/j.ibusrev.2014.12.002
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institutional structures gradually replace the old. International firms' managers eyeing either of the two markets as potential standalone or regional entry points would benefit from stronger appreciation for the local context, in particular vis-à-vis hierarchical and segmented market structures. In fact, a strategic entry in industrial or emerging (e.g. recycling, financial services, or IT, etc.) sectors, despite new opportunity risks, may help establish sustainable profitable presence than random attempts into some of the existing sectors. Local partnership (public or private), informed of domestic policy nuances, may be necessary. A viable alternative is to partner with a Diaspora business or investor already familiar with the local market and established business and administrative connections.

Consequently, the duo's complex political economy, may be hindering potentially greater business gains and foreign business entry. The growth in domestic credit and large import-oriented enterprises seem to have partially stalled industrial development. At the same time, foreign multinational corporations (MNC) and some firms led by nationals living abroad are gradually penetrating the durable, travel, mining, financial, information technology, and telecommunications sectors, where foreign direct investment (FDI) has been the highest. Yet risks from external exposure are real, due to currency pressures from high dollarization, mainly by way of migrant workers' remittances, and excessive reliance on dominant trade patterns. It is important, then, as is this article's effort, to interpret core business and institutional dynamics in the larger macroeconomic context with insights to international firms' executives seeking or considering access in these peripheral markets.

Following this introduction, Section 2 presents a brief macroeconomic analysis of Armenia and Georgia and some of their political peers in the Former Soviet Union (FSU) (excluding the Baltics, due to their structurally different dynamics). Section 3 analyzes some of the key trends in FDI, sectoral growth, and exposure to external risks. Problems of institutional change in the overall post-socialist dynamic as well as the Diaspora (dispersion) effect are explored in Section 4. The concluding section synthesizes macroeconomic and institutional transformation in a conceptual model, which is at the core of business environment evolution in the two markets. A simplifying averaging-out "bulk" analysis is inadequate because the post-socialist economies are not alike, despite perceived commonalities. As shown by the example of the two Caucasus states explored here, a nuanced, local content-informed, individual approach is needed, which perhaps is the most critical advice to foreign firms' managers seeking regional entry points.

2. Transformative macroeconomics or some stylized facts

A dramatic (and well-documented) collapse of output, distortion of regional markets, and immense precipitous declines in human welfare became the hallmarks of the early liberalization reforms in Eastern Europe (EE) and the FSU throughout the 1990s. The intensity of deterioration varied by country, partly a function of the pre-existing institutional framework, and Armenia and Georgia bore the brunt of the worst effects. There, structural economic deficiencies were compounded by disastrous military conflicts, with a devastating earthquake in 1988 adding to Armenia's woes before the transition had even started.

Despite economic collapse and massive brain drain, the Caucasus duo benefited from the late 1990s' macroeconomic consolidation aided by a modest pickup in domestic production—primarily in agriculture and raw materials exports—as the political situation calmed and trade slowly expanded. Some other factors, such as a construction boom (e.g., Manookian & Tolosa, 2011), foreign aid, significant financial involvement by the Diaspora, remittance transfers from the migrant workers abroad, and burgeoning consumer spending helped elevate growth in the years that preceded the global economic crisis.

As early as 2006, the World Bank, commenting on Armenia's progress, coined the term *Caucasian Tiger* to describe the economy's impressive growth in the first half of the 2000s (World Bank, 2006). According to a World Bank study, by 2005 Armenia's gross domestic product (GDP) reached an unprecedented 120 percent of pre-transition levels in real terms. Georgia, too, saw significant improvement in its growth record during the same period. Double-digit growth and productivity gains continued through 2007, with Armenia achieving GDP growth of 14 percent in 2005 and Georgia 12 percent in 2007 (in real 2005 terms), according to the International Monetary Fund (2013a).

In terms of per capita income, Armenia and Georgia are classified in the World Bank's (WB) lower-middle-income group (Fig. 1). The real change has been stronger in Armenia than in Georgia, as the former exceeded its pre-transition (1990) level by 2005 while the latter is still significantly behind its starting point. Certainly, relative price levels, demographic changes, FDI flows, productive capacities, entrepreneurial activity, and other indexes (reviewed below) in part explain Armenia's lead.

However, in the context of the systemic post-socialist collapse, higher pre-transition levels require significantly stronger efforts for recovery and to rebuild sufficient capital in the catchup process, which may partly explain Georgia's predicament. Popov (2007) shows empirically that in such cases macroeconomic distortions across transition samples have been more severe and extensive. For context, as of 1993 in Armenia losses accounted for up to 42 percent of output growth and in Georgia, up to 45 percent.

In the context of the post-socialist economic transformation, the duo are in the *net importers* group (Gevorkyan, 2011), where imports have generally exceeded exports in the two decades of independent macroeconomics. As detailed in the next section, the duo characteristically have significant shares of manufactured imports (e.g., consumer goods and equipment) and fuel. Those are balanced mostly by raw materials and agricultural exports, yet with a growing technical, tourism, and services sectors (WITS, 2014).

The growth record reveals Armenia's and Georgia's structural weaknesses despite recent per capita gains (Fig. 2). While outperforming their FSU peers in the pre-crisis years and despite relative isolation from the world's major financial centers, they collapsed yet again as the full force of the crisis reached them, albeit with a lag. The recent global crisis impacts, though short term, were akin to those of the market liberalization shocks of the 1990s, due in part to institutional resistance (Section 4).

This time, Armenia's GDP declined from a pre-crisis USD 13.2 billion (in 2012 terms) to a post-crisis height of USD 9.9 billion by 2012. In contrast, Georgia recovered its pre-crisis (USD 15.1 billion in 2012 terms) national income levels by 2012, achieving an estimated USD 15.8 billion (IMF, 2013a). Both economies expanded more rapidly in the pre-crisis years, benefiting from a combination of the macro factors mentioned above. Overall, Armenia's economy grew CAGR 9.6 percent and Georgia's 7.3 percent in the 2000–2012 period.

It must be said that the term "peers" is applied here rather loosely. Clearly, aside from a shared political and transitional legacy, neither Armenia nor Georgia would find either Kazakhstan or Russia its peer in macroeconomic terms. However, the net importer group, consisting of Armenia, Georgia, Moldova, the Kyrgyz Republic, and Tajikistan, offers more grounds for contrast. This group is shaped by reliance on consumer imports and long standing labor out-migration, with subsequent massive inflows of remittances—both of which relate to deeper structural distortions in each economy (on recent migration, see ECA, 2014).

Two relevant observations are needed for full comprehension of the Great Recession's impact on economies and business of

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