



SigmaBleyzer

Where Opportunities Emerge.

Accelerating Investments in Ukraine

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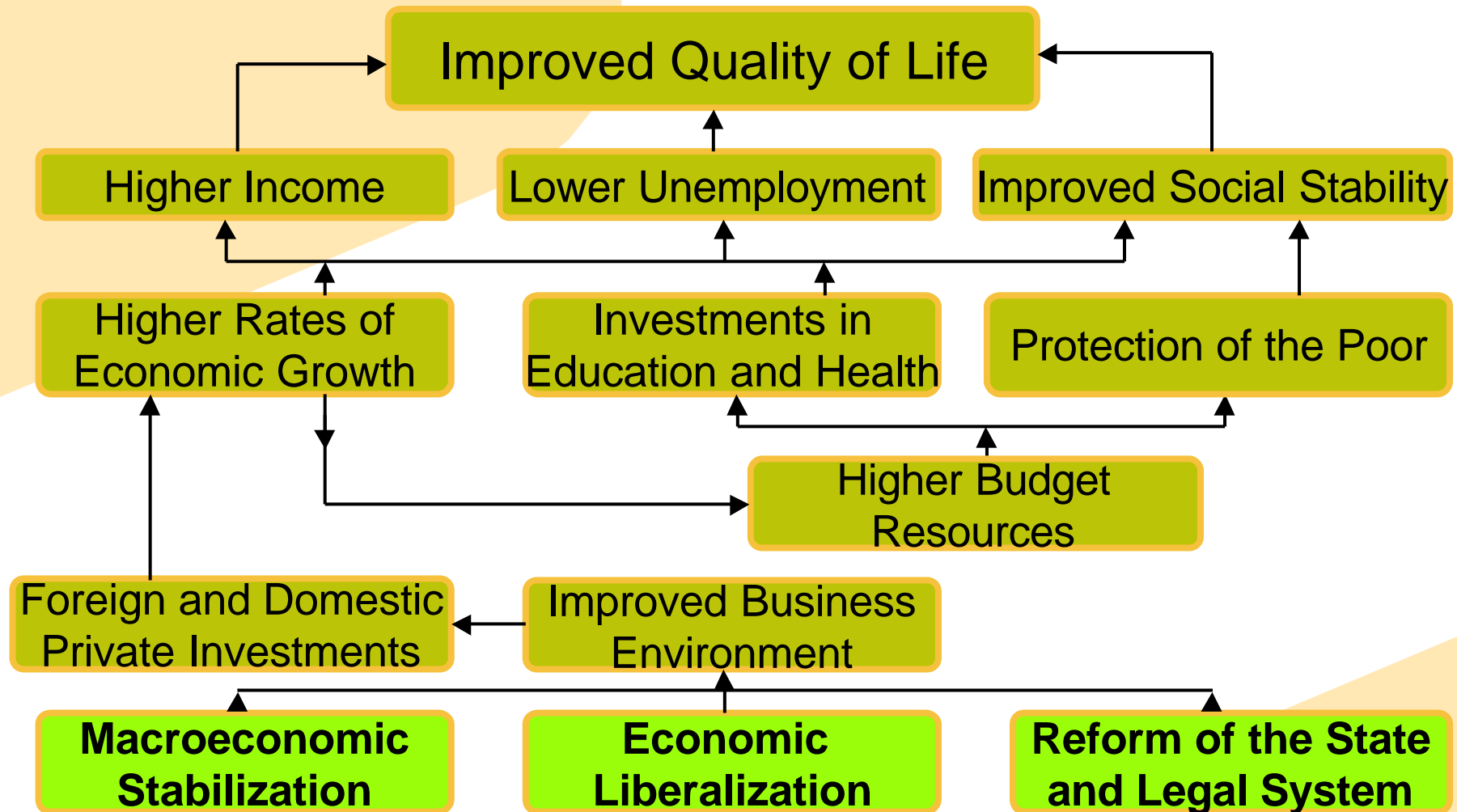
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July 11, 2002

Sustaining Economic Growth and Stability

- Ukrainian economy has performed very well in the last two years.
- But economic growth is slowing down.
- Foreign investment continues to decline.
- Major increase in investment flows is necessary to sustain long-term growth and achieve durable stability.

Investment Role



Private Equity (FDI) - the Most Stable Source of International Financing

	<u>84-89</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
Total Private	12	151	206	233	117	70	60	9	20	60
- Fgn Direct Inv	13	81	96	119	145	155	153	146	162	143
- Portfolio Flows	4	113	41	87	49	-4	31	-4	-13	14
- Bank Loans	-5	-44	68	27	-77	-82	-124	-133	-129	-96
Official Assist	26	4	27	0	63	54	5	-4	34	21
Int. Reserves <u>2/</u>	-11	-70	-117	-109	-63	-45	-88	-114	-98	-34

1/ Include Developing and Transition countries, Israel, Korea, Singapore and Taiwan.

2/ For International Reserves a minus sign indicates an increase in Reserves. For Other categories, a minus means a net outflow

SOURCE: IMF, December 2001 (2001, estimate; 2002, projection).

Identifying Best Practices to Attract FDI

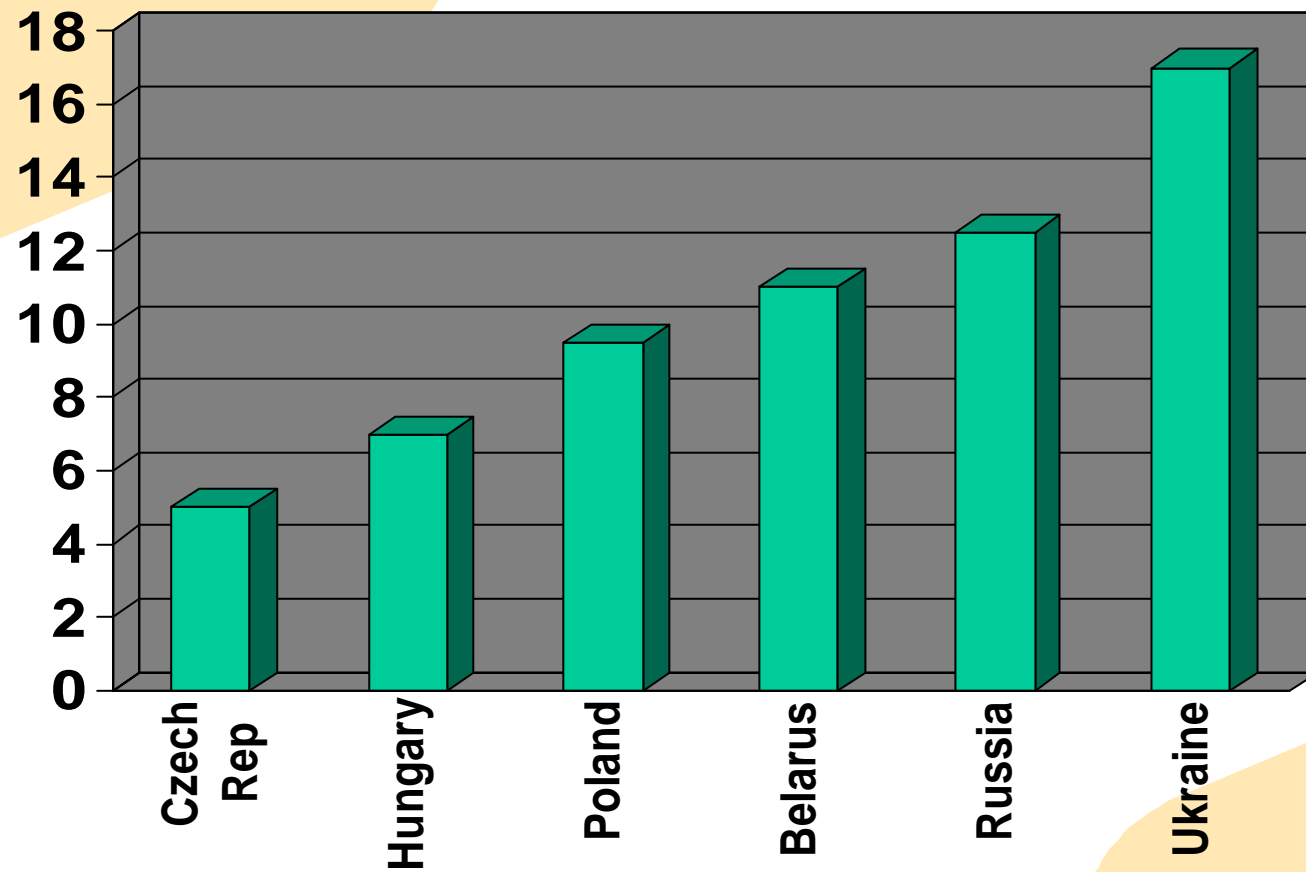
- In 1999, SigmaBleyzer launched an effort to identify best practices in government policies in transition economies to attract FDI.
- It retained the Thunderbird Corporate Consulting Group of the US to benchmark selected countries and build an econometric model of a transition economy based on the key investment drivers identified through benchmarking and statistical analysis.
- The International Private Capital Task Force (IPCTF) was launched in 1999 with the participation of a good number of private companies and agencies operating in Ukraine.
- IPCTF effort objective: Benchmark transition economies to identify best practices in government policies, which improve investment climate and attract private capital

Major Deterrents for FDI

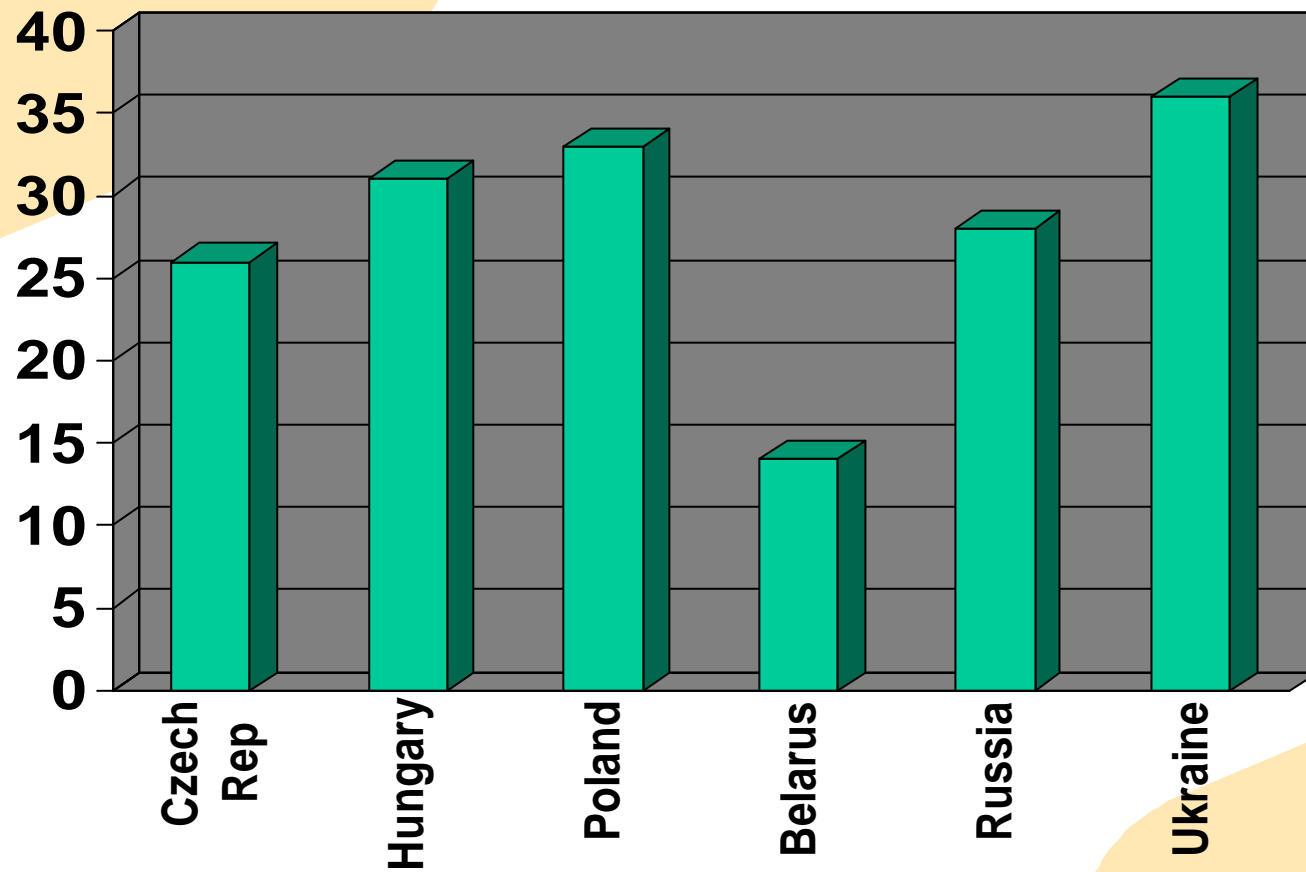
A survey of 65 large foreign firms ranked the major deterrents to FDI in Ukraine in the following order, descending in significance:

- Instability and extent of Government's regulations
- Ambiguity of the legal system
- Uncertainty of the economic environment
- Corruption
- High Tax burden
- Problems establishing clear ownership conditions
- Depressed disposable income levels
- Difficulty negotiating with Government authorities
- Volatility of the political environment
- Lack of physical infrastructure

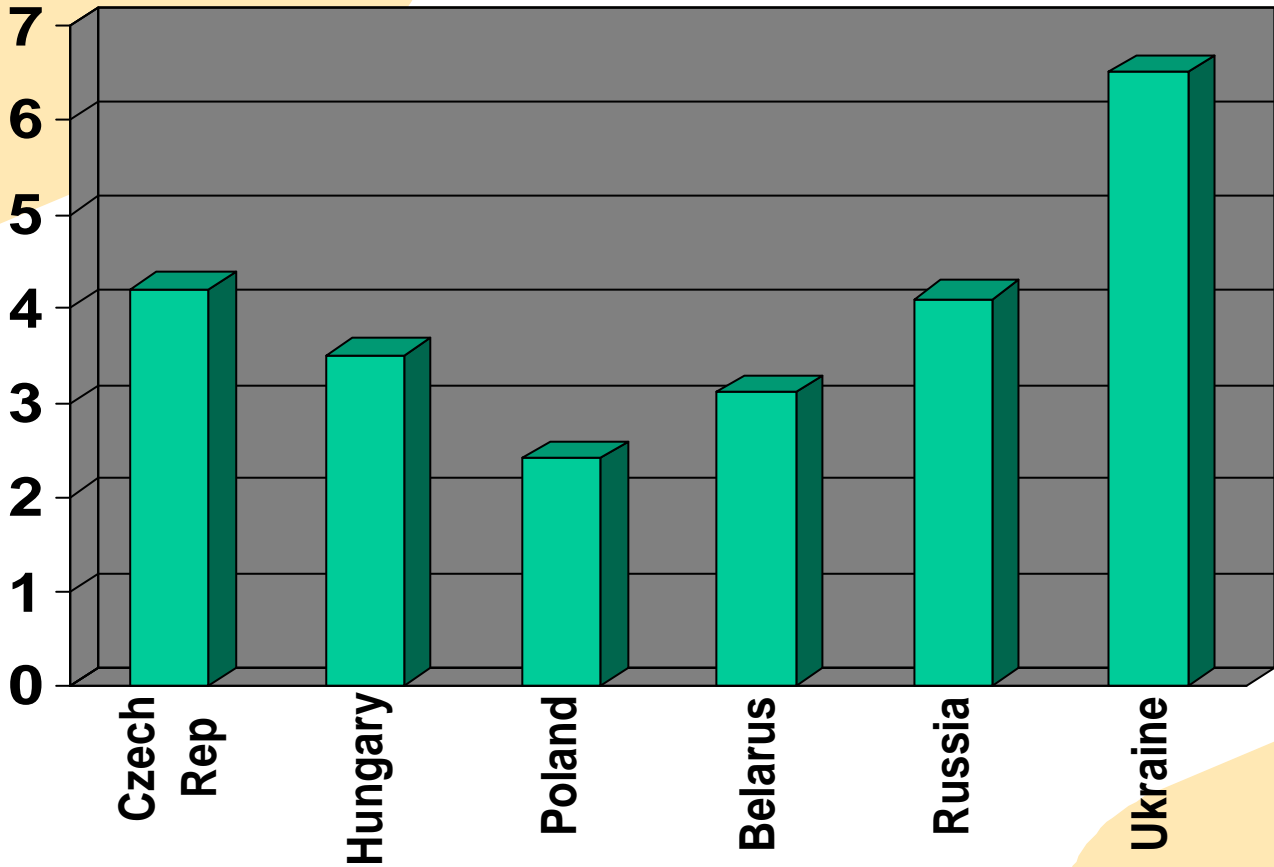
- Percentage of Management Time Spent on Regulatory Issues:



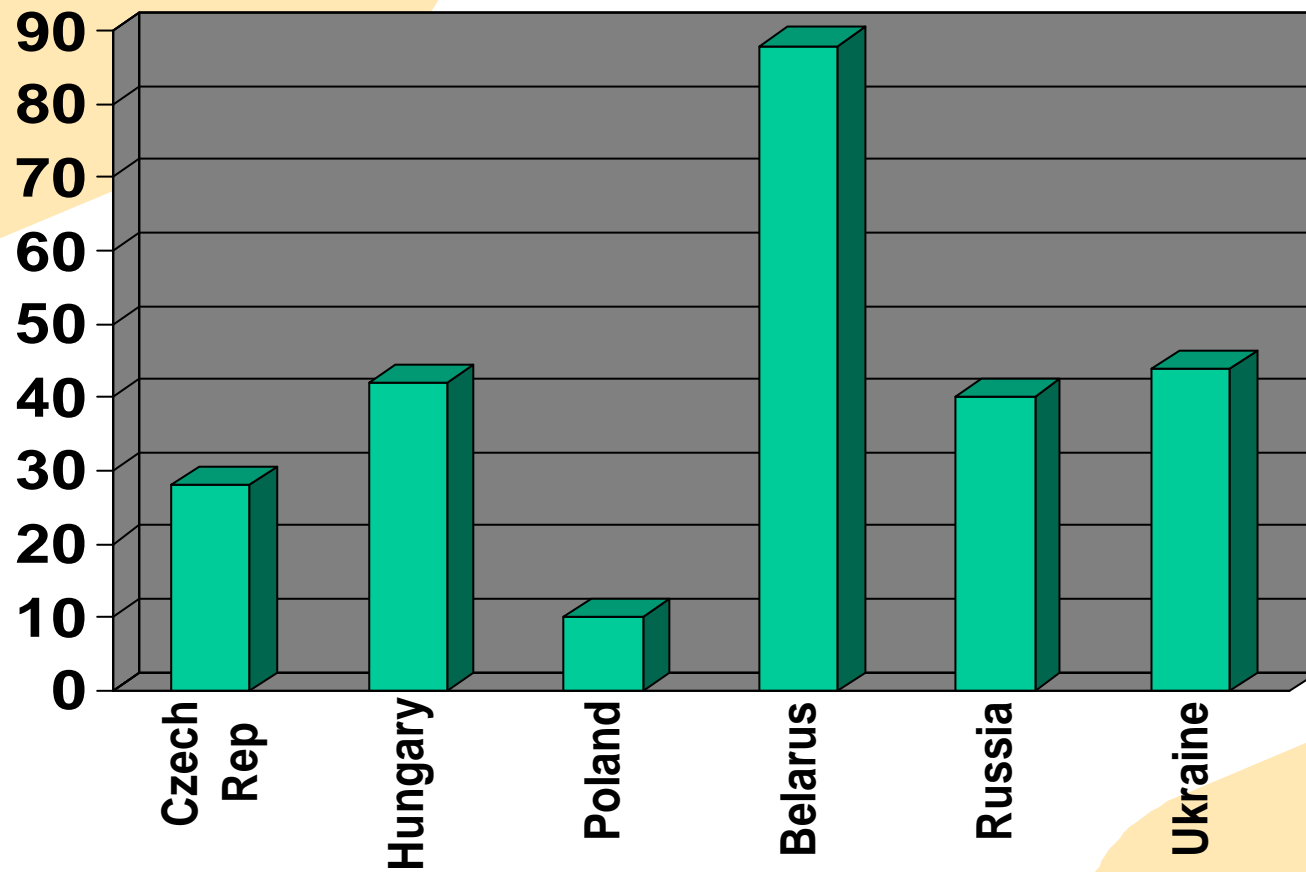
- Percentage of Firms Bribing “Frequently” or More:



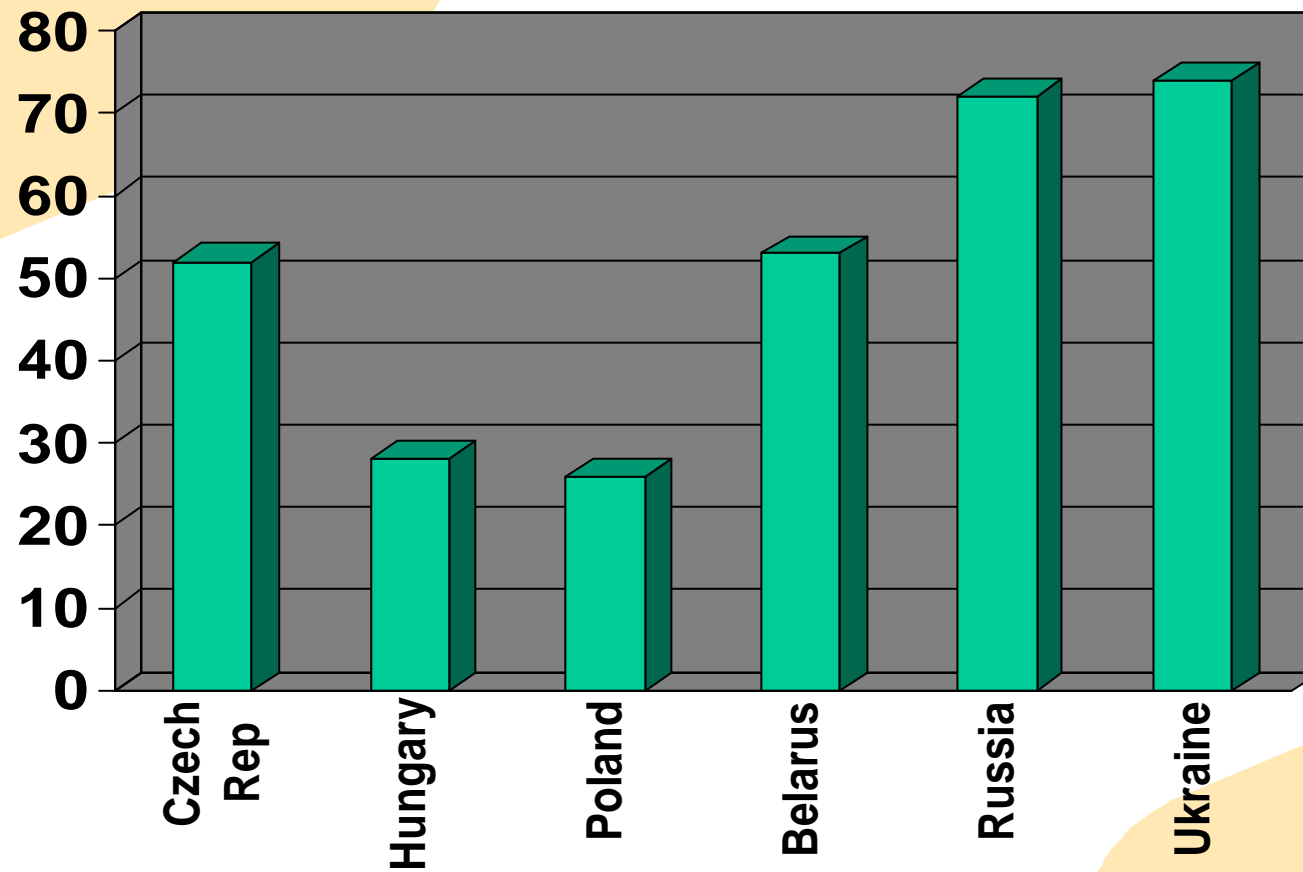
- Cost of Bribes as a Percentage of Revenues:



- Percentage of Firms Reporting State Interventions in Enterprise Pricing Decisions:



- Percentage of firms insecure in their property and contract rights:



What actions are needed to attract investors?

- Sound macroeconomic policies based on satisfactory fiscal and monetary policies are pre-conditions for FDI.
- The study carried out by the IPCTF Task Force identified the following nine key government policy actions, which stimulated foreign direct investments in successful economies.
 1. Liberalization and Deregulation of Business Activities
 2. Stability and Predictability of Legal Environment
 3. Corporate and Public Governance
 4. Liberalization of Foreign Trade and International Capital Movements.
 5. Financial Sector Development
 6. Corruption Level
 7. Political Risk
 8. Country Promotion and Image
 9. Targeted Investment Incentives

Benchmarking Results

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
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Business Liberalization Score

18	49	87	80	89	62
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Legal Environment Score

17	62	99	93	89	65
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Financial Sector Score

10	39	62	68	74	39
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Governance and Privatization Score

29	30	89	82	80	65
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Benchmarking Results

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
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Political Risk Score

65	49	83	82	71	75
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International Capital Controls & Foreign Trade Score

63	45	78	79	84	69
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Corruption Score

15	21	41	52	74	35
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Governmental Promotional Effort Score

20	30	80	100	90	75
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Tax and Investment Incentives Score

31	48	78	82	63	70
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Statistical Analysis

The study found that about 60% of the variations in the flows of Foreign Direct Investments in a group of 60 countries could be explained by the above policy actions.

Multiple Regression Analysis

	Standardized Coefficients Beta	t-values	Signif. Level	Standard Error of Beta
Business Liberalization	1,140	3,09	0,003	0,368
Legal Environment	0,646	1,99	0,053	0,325
Governance/Pub Adm	0,719	1,87	0,067	0,384
Investment Incentives	-1,863	-4,54	0,001	0,409

R	R Square	Adjusted R Square	p-value.
0,779	0,607	0,574	<0.00000

Countries Included in Statistical Analysis

Angola, Argentina, Armenia, Azerbaijan, Belarus, Bolivia, Botswana, Bulgaria, Burkina Faso, Cameroon, Chile, Colombia, Costa Rica, Croatia, the Czech Republic, Ecuador, Egypt, El Salvador, Estonia, Ethiopia, Ghana, Hungary, India, Indonesia, Jordan, Kazakhstan, Kenya, Lithuania, Malawi, Moldova, Morocco, Mozambique, Nigeria, Peru, Philippines, Poland, Romania, Russia, Senegal, Slovak Republic, South Africa, Tanzania, Tunisia, Turkey, Uganda, Ukraine, Venezuela, Vietnam, Zambia, and Zimbabwe.

FDIs- Morgan Stanley

- A USAID-funded regression study of 67 emerging economies was made by Morgan Stanley Dean Witter in July 1998 (titled “*Foreign Direct Investments and its determinants in Emerging Economies.*”)
- *This study’s* results were as follows:
 - **Finding 1:** Foreign investment inflows are influenced very little by generic variables such as:
 - locational advantage,
 - proximity to financial centers,
 - total population,
 - size of the country.

These variables show little significance throughout the regressions.

- **Finding 2:** On the other hand, foreign investments are heavily influenced by the countries’ policies and institutions.

- **Finding 3:** The above means that even though initial, country-inherent conditions may play a certain role, they can be overcome by sound policies and their thorough implementation
- **Finding 4:** Economic policies allowing for free open markets, investment and trade are key determinants of FDI inflows (Economic Openness had the highest coefficient value).
- **Finding 5:** The key determinants of “Economic Openness” were:
 - Little government interference in markets; that is, "free" markets with minimum directive regulation.
 - Open import and export regimes.
 - An exchange rate that reflects a currency's true value, with no controls on currency exchange.

Morgan Stanley Model

	Standardized Coefficients Beta	t-value
(Constant)	0.898	-2.105
Econ.Openness	0.789	3.052
Corruption	0.171	1.926
Tax on Pvt. Sector	-0.061	-3.101
Credit Availability	0.007	1.969
Adjusted R-square	0.38	

Predicting FDI in Ukraine

- Based on the statistical tests, we can construct a formula to predict the flows of FDI to Ukraine over time on the basis of the identified actionable policies :

Formula: $2(\text{Cap/FT}) + 2(\text{Polit Rk}) + 10(\text{Corru}) + 10(\text{Govt Pol}) + 4(\text{Tax/Inv In}) + 6(\text{Prom Eff})$

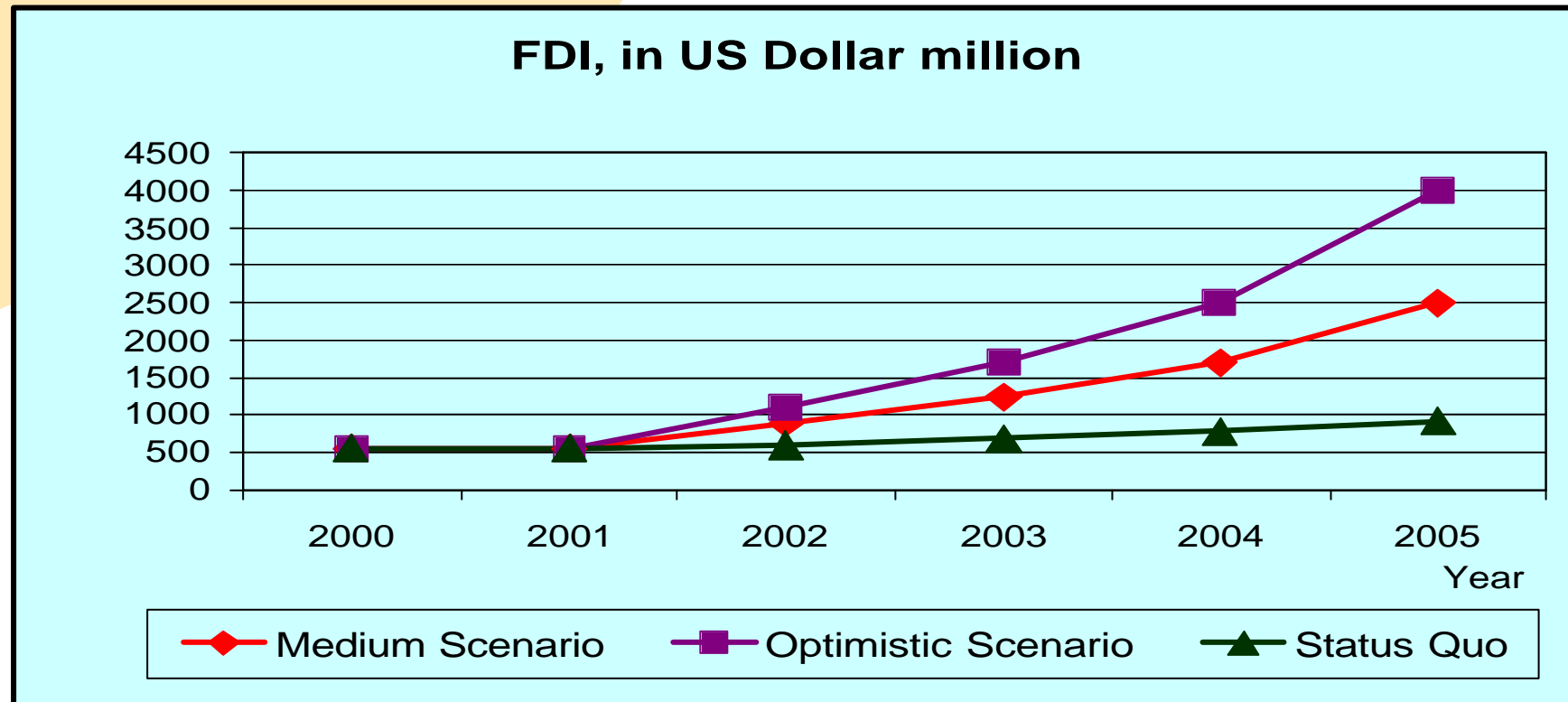
- We can then develop different scenarios for the evolution of FDI, depending on the depth of changes in the policy drivers.

Conclusions for Ukraine

- **With continuation of current policies**, FDI flows **will not increase** from its current level of under **US\$1.0 billion per year** (except for ad-hoc flows related to large privatizations)
- **Under a middle scenario**, with policy actions to **reduce in five years 50%** of the policy level differential with the Bests-in-Class, Ukraine could increase FDI to about **US\$2.5 billion per year in five years**
- **Under a more aggressive scenario**, with stronger policy actions to **reduce in five years 80%** of the policy level differential with the Bests-in-Class, the level of foreign direct investments could increase to **US\$4.0 billion per year in five years**

FDI For Ukraine- Possible Scenarios

- Ukraine's government policies will determine the FDI flows over the next 15 years (5 years shown)



- The **Middle Scenario** would generate an incremental GDP growth rate of about 4% per annum.

IPCTF Framework – A Tool for Action

- Low correlation between FDI flows and “natural characteristics” (e.g., location, size, resources, etc.)
- High correlation between government policies and FDI flows
- Measuring economic impact of government policies based on the gap between the policies of the country and the policies of the best-in-class in each of the nine government policy areas
- Econometric model of a transition economy can then predict FDI flows based on changes in government policies
- IPCTF Framework provides a **comprehensive tool** for building consensus and developing an **Action Plan** for the country.
- We are quite pleased that the Government's Action Plan has benefited from the findings of the IPCTF study.
- We would like now the Government to proceed vigorously with the implementation of the Action Plan.