



SIGMABLEYZER



The Role of the Private Sector in Improving the Business Environment

Dr. Edilberto L. Segura

Where Opportunities Emerge

World's Disparities in Performance

- The economic situation across the world shows that -- over the last few decades -- many countries have not been able to grow and improve the quality of life of their people.
- Despite billions of US dollars spent by international and bilateral institutions to help developing countries, the evidence is clear that these resources have not helped much in improving the well being of many countries in the world.
- In fact, today in the world, disparities in economic performance are striking: The gap between the ten richest and ten poorest countries has widened since 1960.
- Are there any lessons that countries like Ukraine can use??

GDP per capita (constant 1995 USD),

Average GDP per capita for Ten Richest and Ten Poorest Countries

| | 1960 | 1970 | 1980 | 1990 | 2001 | Change 2001 vs. 1960 |
|-------------------------|--------|--------|--------|--------|--------|----------------------------|
| Ten richest countries * | 13,951 | 21,629 | 27,715 | 31,965 | 38,671 | 177% |
| Ten poorest countries * | 152 | 174 | 180 | 180 | 163 | 7% |
| Gap, times | 92x | 124x | 154x | 178x | 237x | |

* by GDP per capita (constant 1995 USD)

Source: World Bank, World Development Indicators, 2003

Impact on Quality of Life: Infant Mortality

These income disparities are reflected in differences in the pace of improvement in the quality of life among countries. Higher income countries have significantly improved infant mortality rates, whereas lower income countries have not.

| (per 1,000 live births) | 1960 | 1970 | 1980 | 1990 | 2001 | Improved By |
|---------------------------------|------|------|------|------|------|-------------|
| High income | 35 | 22 | 12 | 8 | 5 | 76% |
| Middle income | 118 | 79 | 54 | 40 | 31 | 61% |
| Low income | 148 | 128 | 110 | 91 | 81 | 37% |
| Heavily indebted poor countries | 165 | 139 | 113 | 105 | 99 | 29% |
| World | 119 | 94 | 78 | 63 | 56 | 40% |

Source: World Bank, World Development Indicators, 2003

Life Expectancy at Birth By Income Group

Total (years)

| Income groups | 1960 | 1970 | 1980 | 1990 | 2001 | Improved By |
|------------------------------------|------|------|------|------|------|----------------|
| High income | 69 | 71 | 74 | 76 | 78 | 13% |
| Middle income | 46 | 61 | 66 | 68 | 70 | 52% |
| Low income | 43 | 48 | 53 | 57 | 59 | 37% |
| Heavily indebted poor countries | 41 | 45 | 49 | 52 | 51 | 25% |
| World | 50 | 59 | 63 | 65 | 67 | 33% |

Source: World Bank, World Development Indicators, 2003

*Lower income group life expectancies remaining below 60
years even today*

Illiteracy Rates By Income Group

| Adult total (% of people ages 15 and above) | 1970 | 1980 | 1990 | 2001 | Improved By |
|---|------|------|------|------|-------------|
| High income (select OECD countries*) | 13.4 | 8.7 | 5.7 | 3.4 | 75% |
| High income (select Non-OECD countries**) | 21.4 | 14.6 | 10.5 | 7.3 | 66% |
| Middle income | 34.5 | 25.6 | 18.5 | 13.1 | 62% |
| Low income | 64.0 | 55.6 | 47.0 | 38.1 | 41% |
| World | 44.1 | 36.1 | 28.9 | 22.9 | 48% |

* Selected OECD countries include: Italy, Korea, Rep., Portugal, Spain, Greece

** Selected non-OECD countries include: Barbados, Brunei, Cyprus, Hong Kong, China, Israel, Macao, China, Malta, Netherlands Antilles, Puerto Rico, Qatar, Slovenia, United Arab Emirates

These Global Inequities are now more exposed:

- Greater awareness due to the global revolution in communications
 - Exchange of information has improved tremendously
 - Poor are now better able to recognize their growing income disparity
 - Many groups of poor have become more dissatisfied leading to resentment, frustration and desire to change the current world order
- No country can isolate itself from these inequalities
 - Rise of terrorism shows that they are not immune to tensions and resentment around the world

Given these inequalities, the current New World Order is not surprising:

- Today, conflicts rarely stay within national boundaries
- Today, a tremor in one financial market is repeated in the markets of the world
- Today, confidence is global; it's presence or its absence
- Today, the threat is chaos, because for people with work to do and family life to balance and mortgages to pay and careers to further and pensions to provide, the yearning is for order and stability. And if it doesn't exist elsewhere, it's unlikely to exist here

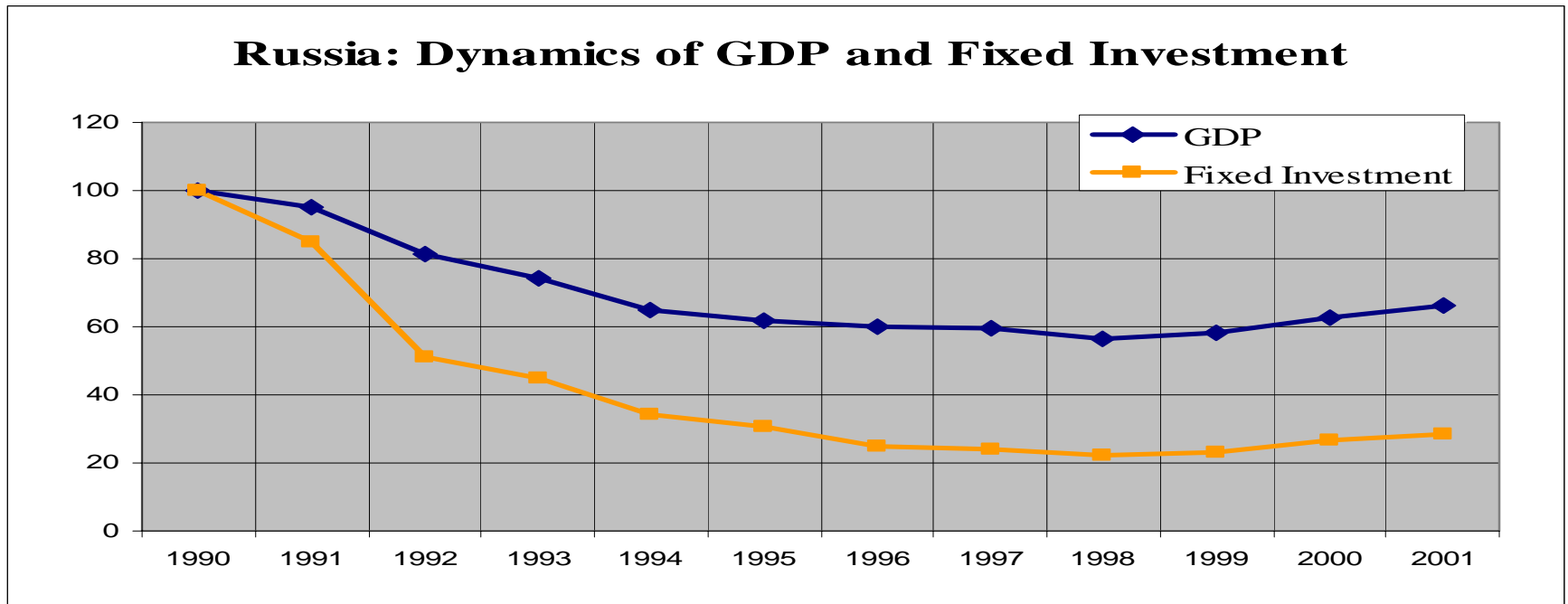
I have long believed that this interdependence defines the new world we live in

Tony Blair, October 2, 2001

What Explains these inequalities in Growth?

For most middle income economies, there is a correlation between income growth (GDP) and the level of investments.

The chart below on Russia is typical of this relationship:



Foreign Direct Investments (FDIs) is the Key that Starts the Engine of Growth

- Given low savings in most transition economies, FDIs should play a predominant role in accelerating growth.
- Countries able to attract large inflows of foreign capital are able to achieve above average levels of GDP growth
- FDI is the largest and most stable source of foreign financing for developing countries
- Emerging markets have been attracting \$150 Billion per year

Net Capital Flows to Emerging Markets

(USD, Billions)

| | 84-89 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 |
|---------------------------|-----------|------------|------------|------------|------------|-----------|-----------|------------|-----------|-----------|------------|------------|
| Total Private | 12 | 151 | 193 | 227 | 133 | 78 | 87 | 47 | 43 | 80 | 113 | 94 |
| Foreign Direct Invest | 13 | 81 | 101 | 116 | 144 | 156 | 175 | 166 | 181 | 143 | 144 | 145 |
| Portfolio Flows | 4 | 113 | 24 | 83 | 63 | 11 | 20 | -4 | -51 | -53 | -23 | -17 |
| Comm. Bank Loans | -5 | -44 | 67 | 27 | 75 | 89 | -108 | -115 | -87 | -10 | -8 | -35 |
| Net Official Loans | 26 | 4 | 50 | -2 | 42 | 58 | 8 | -13 | 21 | 7 | 10 | -16 |

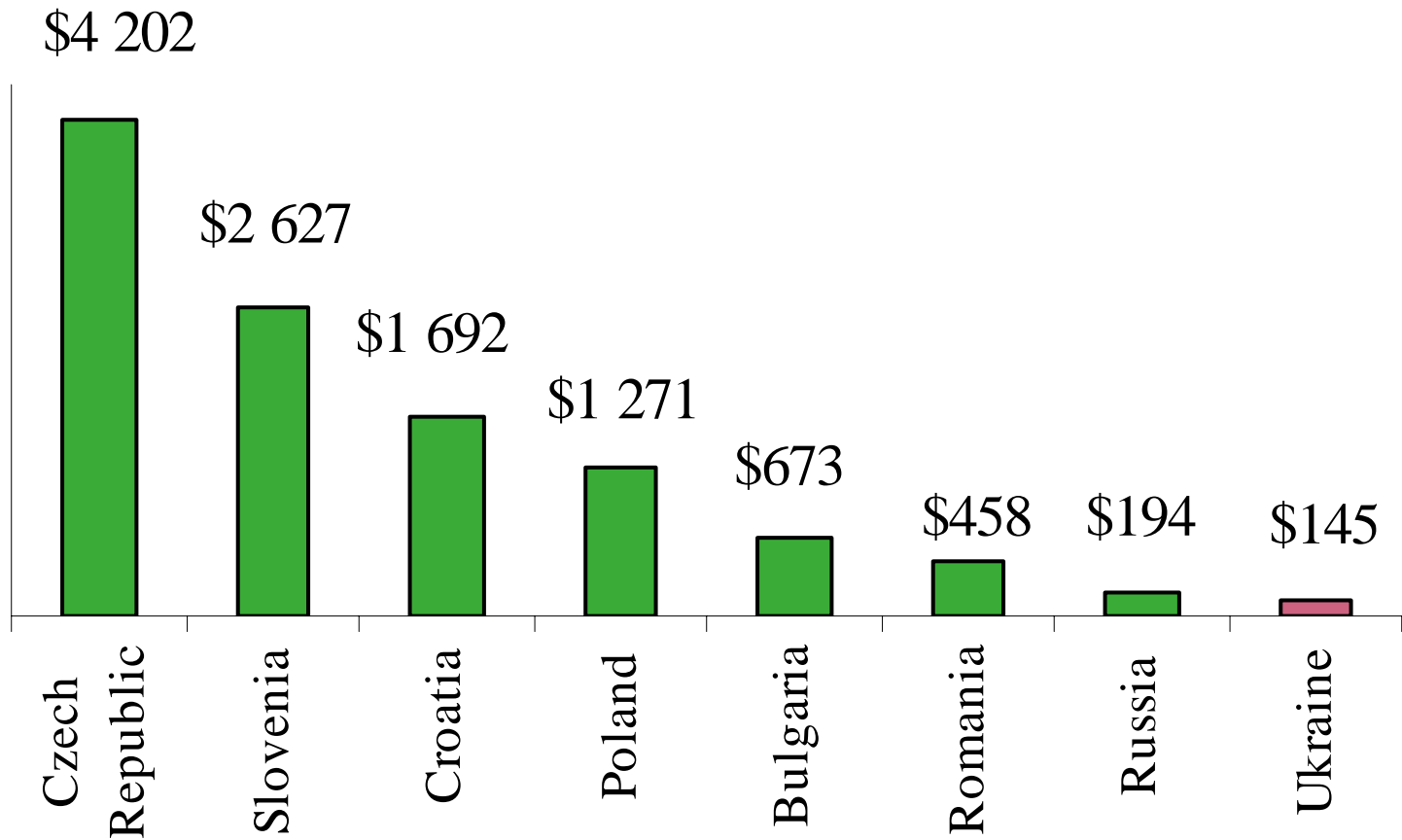
1. Includes Developing and Transition countries, Israel, Korea, Singapore, Taiwan, and Israel

2. 2001 prices

SOURCE: IMF, September 2003 (2003: projection, 2004: estimate)

- **Unfortunately, the bulk of FDI in concentrated in a handful of countries in Asia and Latin America.**
 - Five developing countries (China, Mexico, Brazil, Poland and Chile) have been receiving over 60% of these inflows
 - Rest of the world does not offer attractive business environments and is therefore left out of the loop

Cumulative FDI per capita in 2003



What Explains these differences in FDIs: Experience in Ukraine

- In the year 2000, SigmaBleyzer started a study to identify the constraints to FDIs and the measures that should be taken to accelerate the flows of FDIs into the country.
- Business surveys in Ukraine had shown that major foreign companies were worried about:
 - Uncertainty of the economic environment
 - Complexity and instability of government regulations
 - High tax burden
 - Ambiguities and unpredictability of the legal system
 - Problems establishing clear ownership rights
 - Difficulty negotiating with government authorities
 - Corruption
 - Volatility of the political environment

Causes of Lower FDI Levels in Ukraine

- What was the evidence of these claims? How important were these issues in affecting FDIs? Could we quantify them?
- With the support of the Government, SigmaBleyzer chaired a steering committee to carry out a study on FDIs (IPCTF).
- The study benchmarked Ukraine versus other economies to identify best practices in government policies, and identify their impact in attracting private capital.
- The study also included a major statistical analysis to quantify the impact of individual policy measures on FDI flows.
- On this basis, the study produced an Action Plan to improve the business environment and quantify the potential FDIs that these measures may induce.

IPCTF Steering Committee

SigmaBleyzer, AGCO, Coca Cola, Citibank, Commerzbank, Credit Lyonnais, FMI, PricewaterhouseCoopers, Leo Burnett, DuPont

World Bank, EBRD, IMF, IFC, USAID, European Commission, US Embassy, American Chamber of Commerce, International Center for Strategic Studies, Harvard Institute for International Development,

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.

Results of Statistical Analysis

- These and other consulted studies led to the following conclusions:
 - Foreign investment inflows are influenced very little by generic variables such as:
 - locational advantage
 - proximity to financial centers
 - total population
 - size of the country

Results of Statistical Analysis (con't)

- Foreign investments are heavily influenced by the countries' policies and institutions
- A policy pre-condition is macroeconomic stabilization, resulting from sound fiscal and monetary policies
- 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
- Economic policies allowing for a “Favorable Business Environment” with free open markets are key determinants of FDI inflows

Nine FDI Drivers

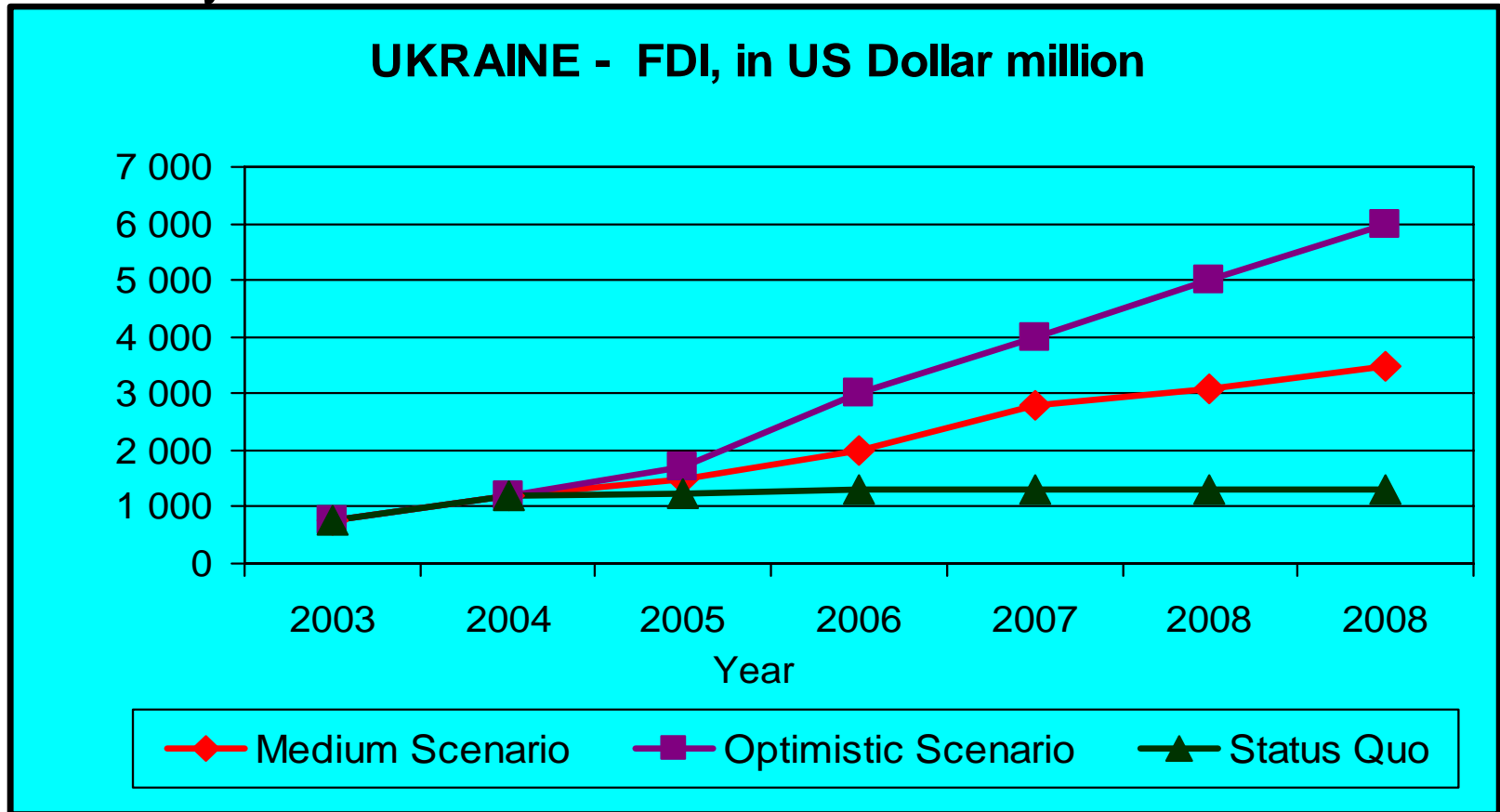
- The key determinants of a “Favorable Business Environment” were the following nine policy variables or “FDI drivers”:
 1. **Sustain Macroeconomic Stability**
 2. **Liberalize and De-Regulate Business Activities**
 3. **Provide a Stable and Predictable Legal Environment**
 4. **Enhance Governance & Reform Public Administration**
 5. **Remove International Capital & Trade Restrictions**
 6. **Facilitate Financing of Businesses by the Financial Sector**
 7. **Eliminate Corruption**
 8. **Reduce Political Risks (non-economic country risks)**
 9. **Expand Country Promotion**

Ranking of Drivers

- The first four drivers had the strongest positive effects
- These policy variables explain about 60% of the variations in FDI in the sample of 50 countries
- Actions on all policy drivers were necessary to achieve sustainable results

FDI For Ukraine- Possible FDI Scenarios

- Based on the study, we can estimate that Ukraine's government policies will determine the FDI flows over the next 5 years:

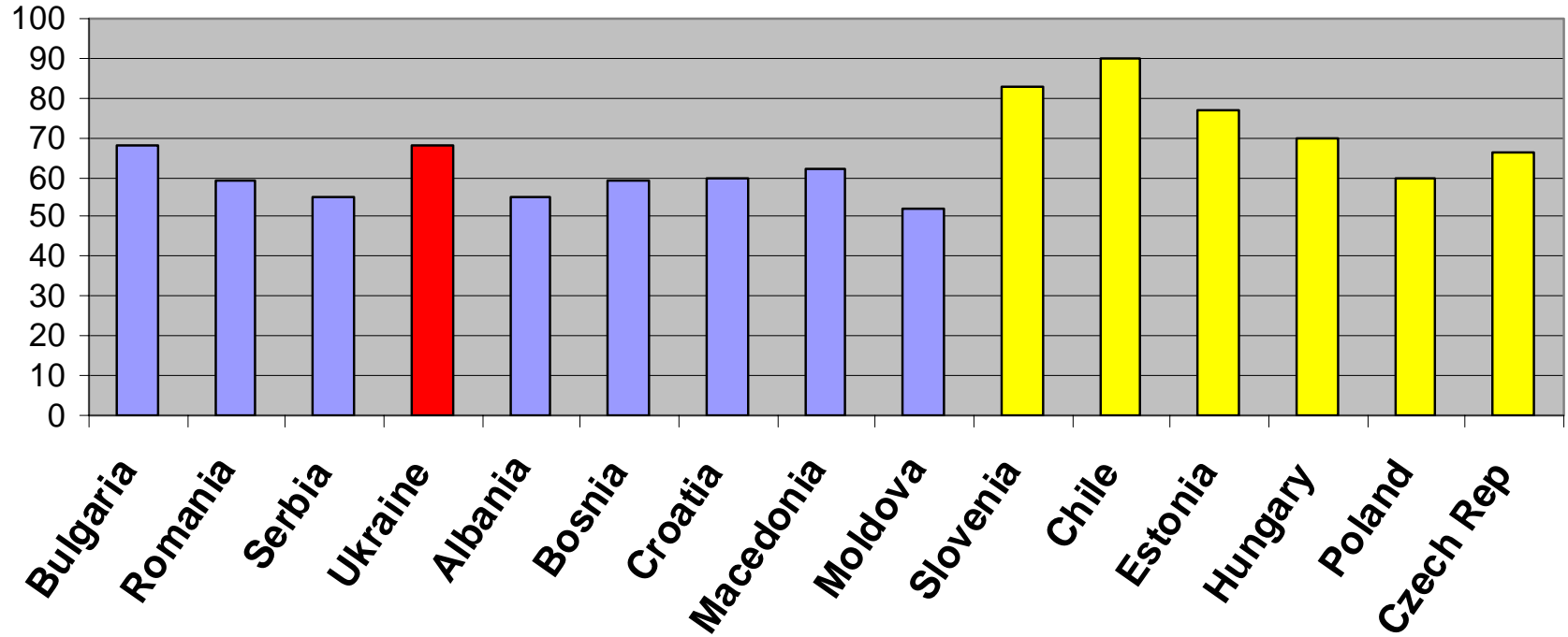


FDI For Ukraine- Possible FDI Scenarios (con't)

- **With continuation of current policies**, FDI flows will increase only slightly from its current level of about \$1.0 billion per year.
- **Under a middle scenario**, with policy actions to reduce 50% of the policy level differential with the Bests-in-Class in five years, FDI flows could reach \$3.4 billion per year for Ukraine.
- **Under a more aggressive scenario**, with stronger policy actions to reduce 80% of the policy level differential with the Bests-in-Class in five years, FDI flows could increase to \$6.4 billion per year for Ukraine.

Driver #1: Macroeconomic Stability

Economic Growth and Stability



Possible Risks to Economic Stability in Ukraine

- Inflationary pressures may emerge in 2005 as a result of:
 - Substantial fiscal loosening approved (as a result of the increase in pensions approved in late 2004)
 - Spending of huge privatization receipts for current, non-investment purposes
- Lack of exchange rate flexibility
- Rapid credit expansion and low quality of credit portfolio
- External shock (Ukrainian growth is, to a great extent, export-led; international metal prices have been key)

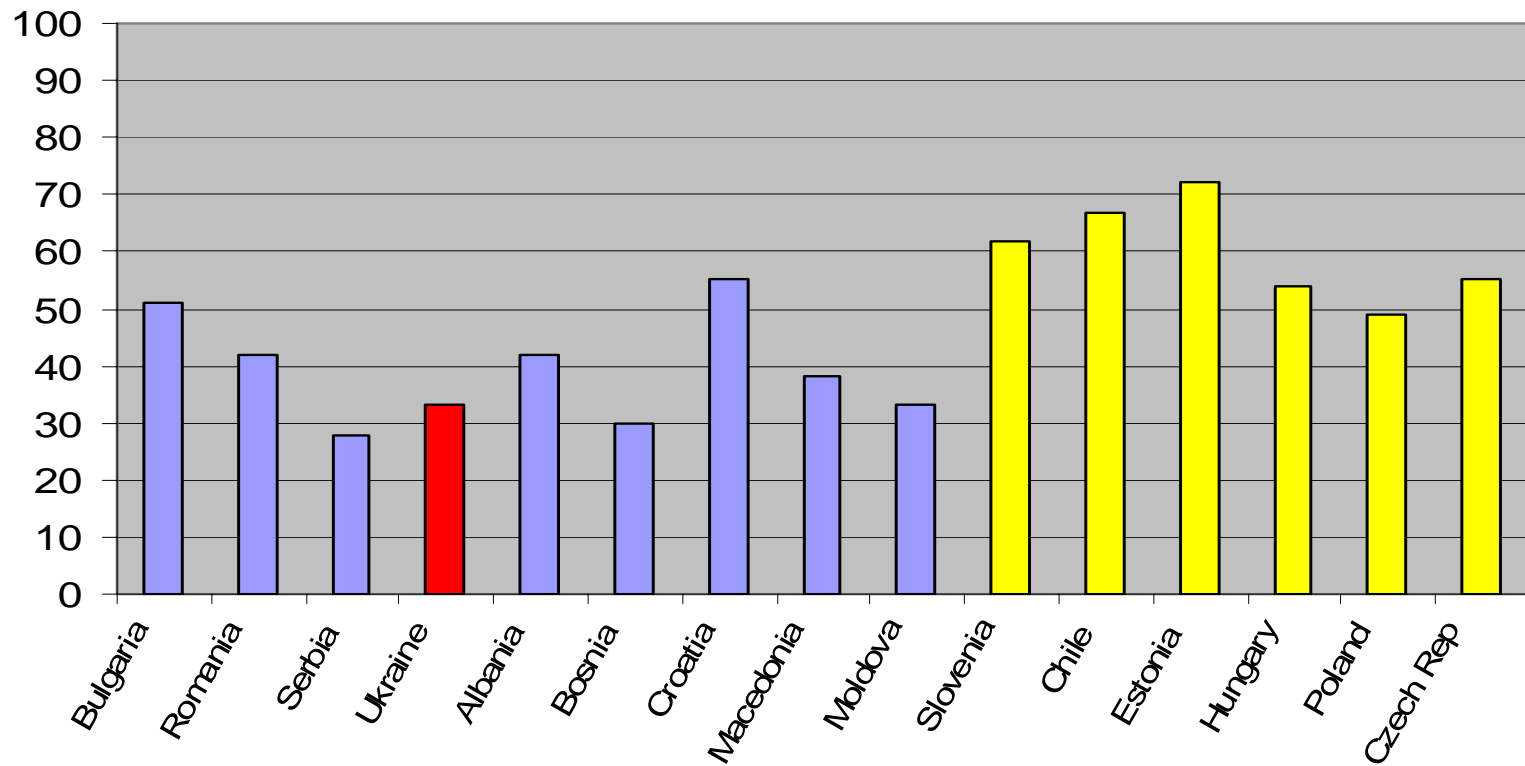
In order to sustain macroeconomic stability it is necessary to:

- (1) ensure that the fiscal deficit is sustainable by eliminating tax privileges and exemptions, and ensuring that state obligations, such as repayment of VAT arrears, are met.
- (2) gradually introduce more flexibility to foreign exchange rate policy by reducing the foreign exchange surrender requirements for exporters;

If tight fiscal and monetary policies are not implemented by the new Government, inflation may reach two digit levels in 2005.

Driver #2: Liberalization and Deregulation of Business Activity

Business Liberalization

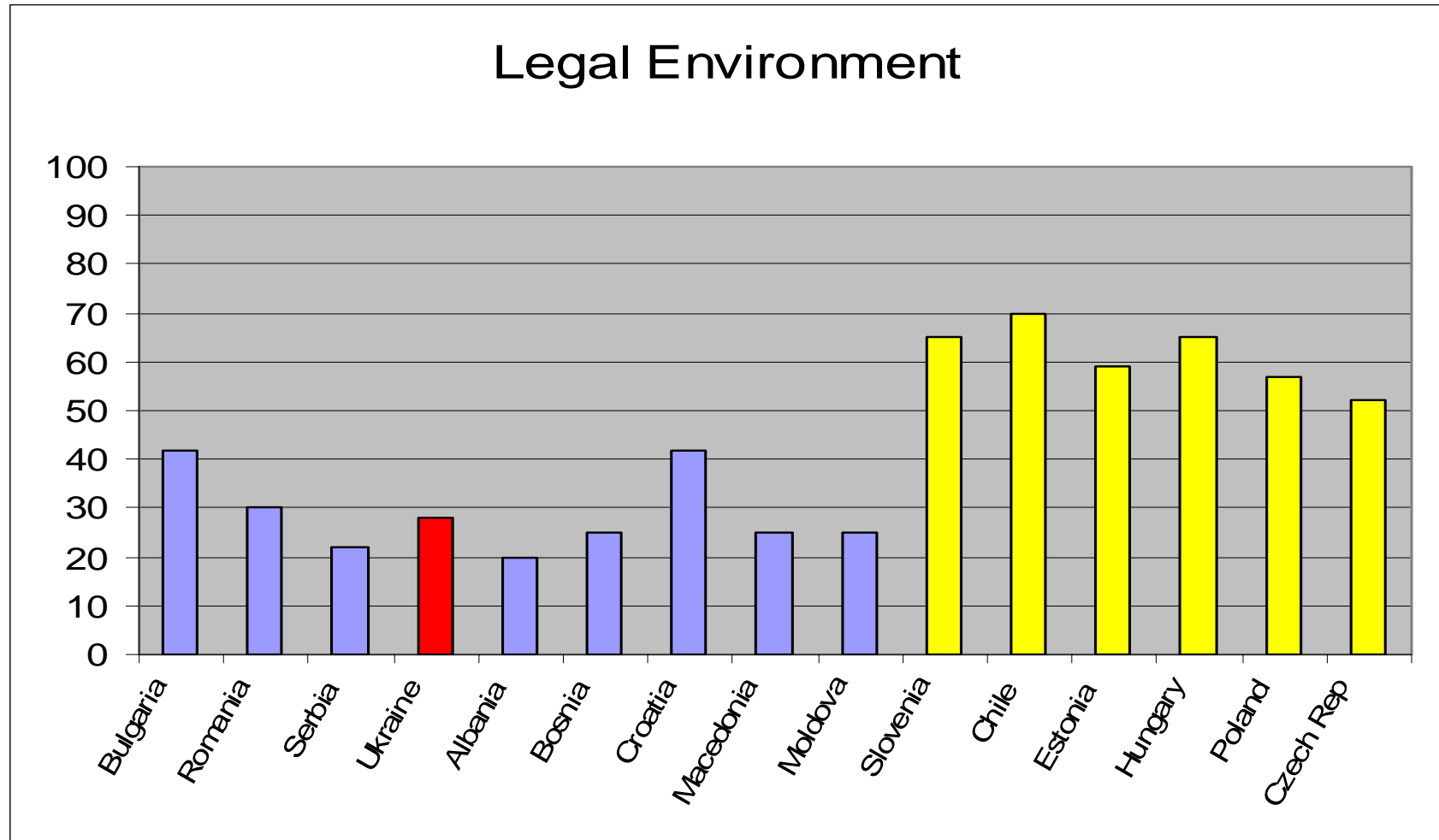


Priority actions to liberalize and deregulate business environment designed to:

(1) to eliminate excessive government intervention in businesses and abolish the incentives of state agencies to intervene in business activities;

(2) to develop transparent procedures for the liquidation of companies, including disclosure of information.

Driver #3: Stability and Predictability of Legal Environment



To create a stable and predictable legal environment with well-defined “rules of the game” for all businesses it is necessary to strengthen the Judiciary:

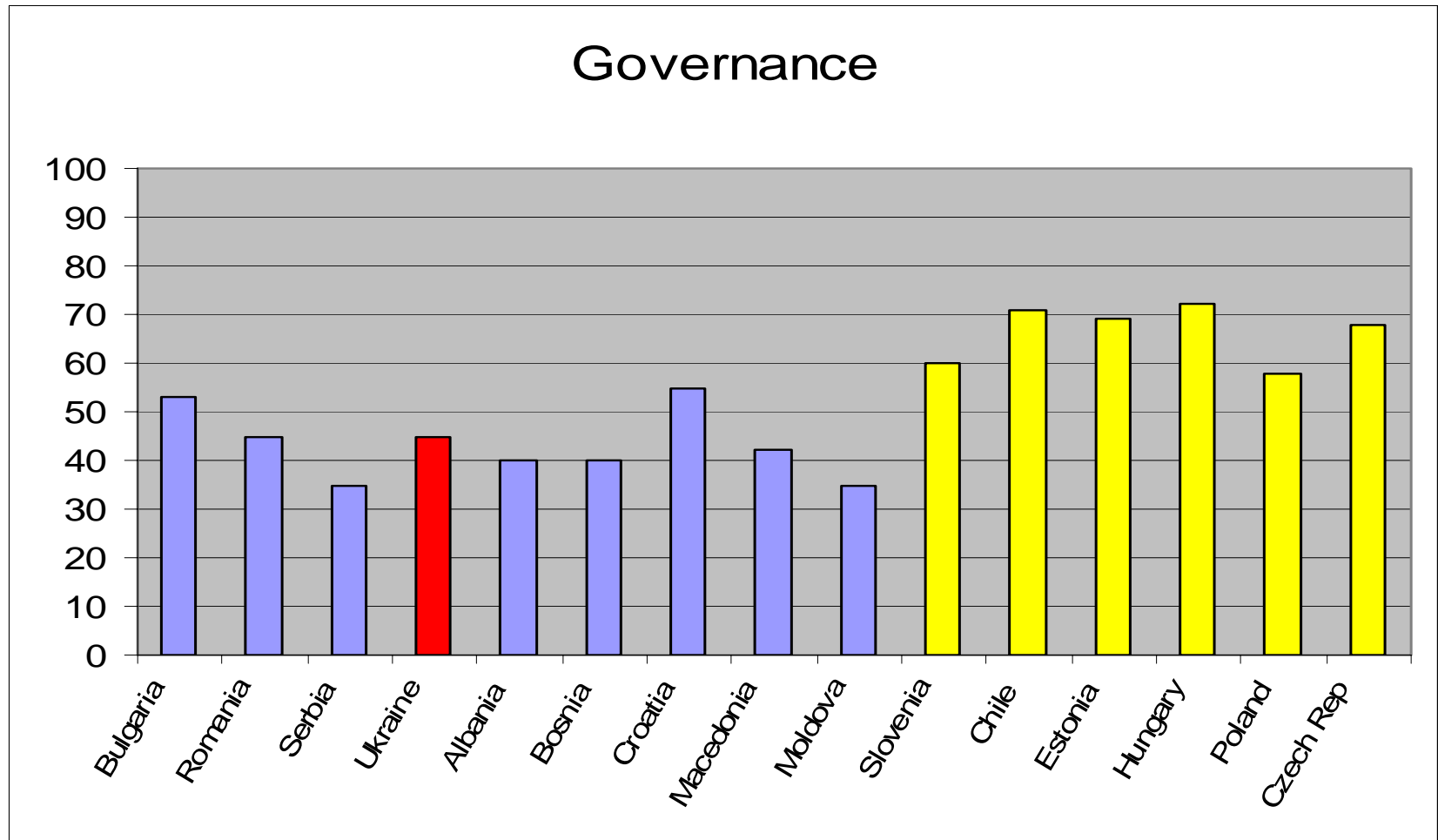
(1) Further improve financing of courts and increase salaries of judges to ensure their independence;

(2) Enhance commercial courts for settling disputes;

(3) Set the practice of thorough consideration of any kind of regulations to adopted, including their correspondence with existing legislation

Driver #4: Corporate and Public Governance

Governance

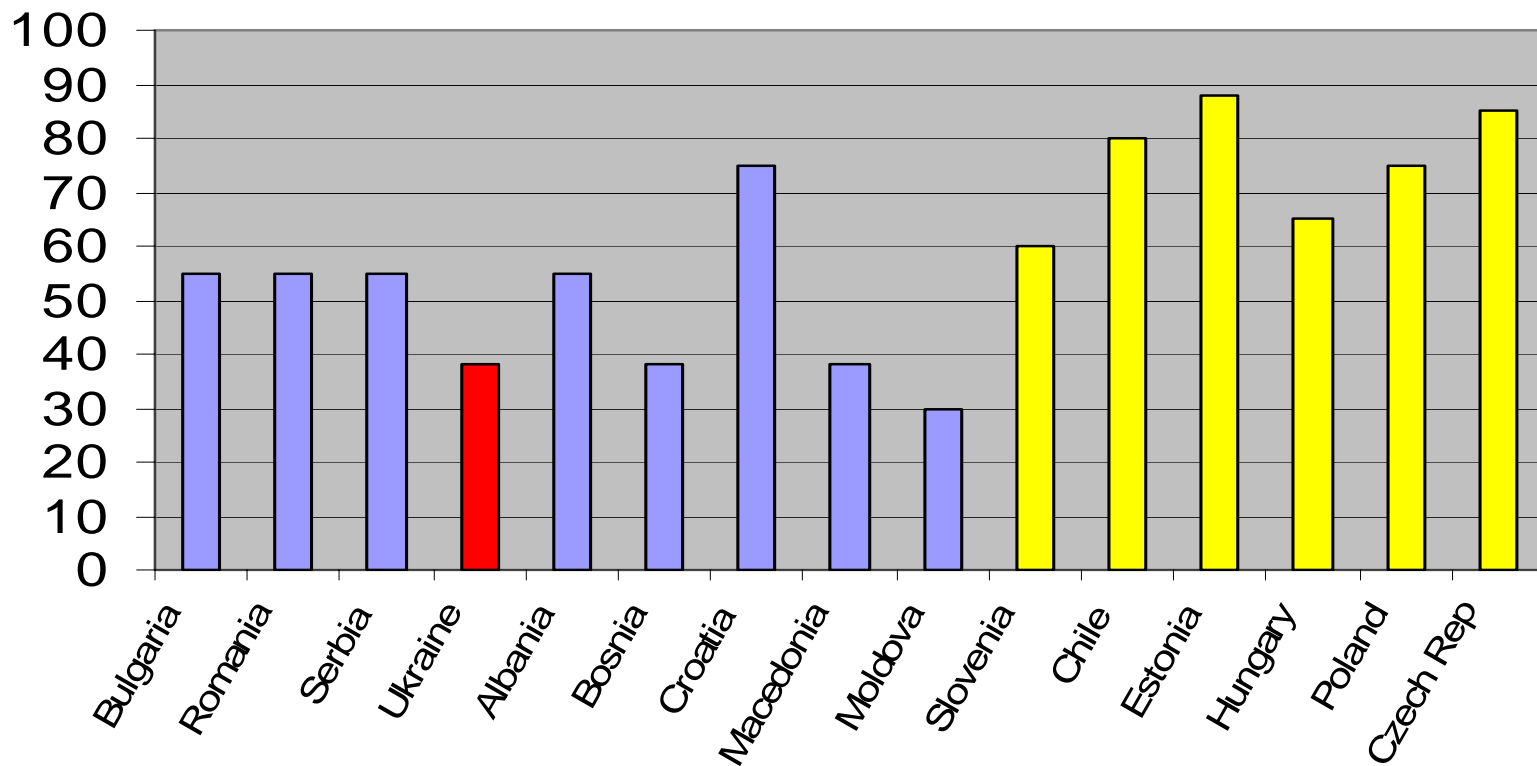


Development of sound corporate and public governance will benefit greatly from:

- (1) The adoption of the Joint Stock Company Law, according to international standards;
- (2) Functional and operational reviews of government agencies to streamline decision-making process;
- (3) Establishment of adequate procedures to ensure that privatization process is transparent and competitive

Driver #5: Liberalization of Foreign Trade and Capital Movements

Liberalization of International Trade and Capital Movements

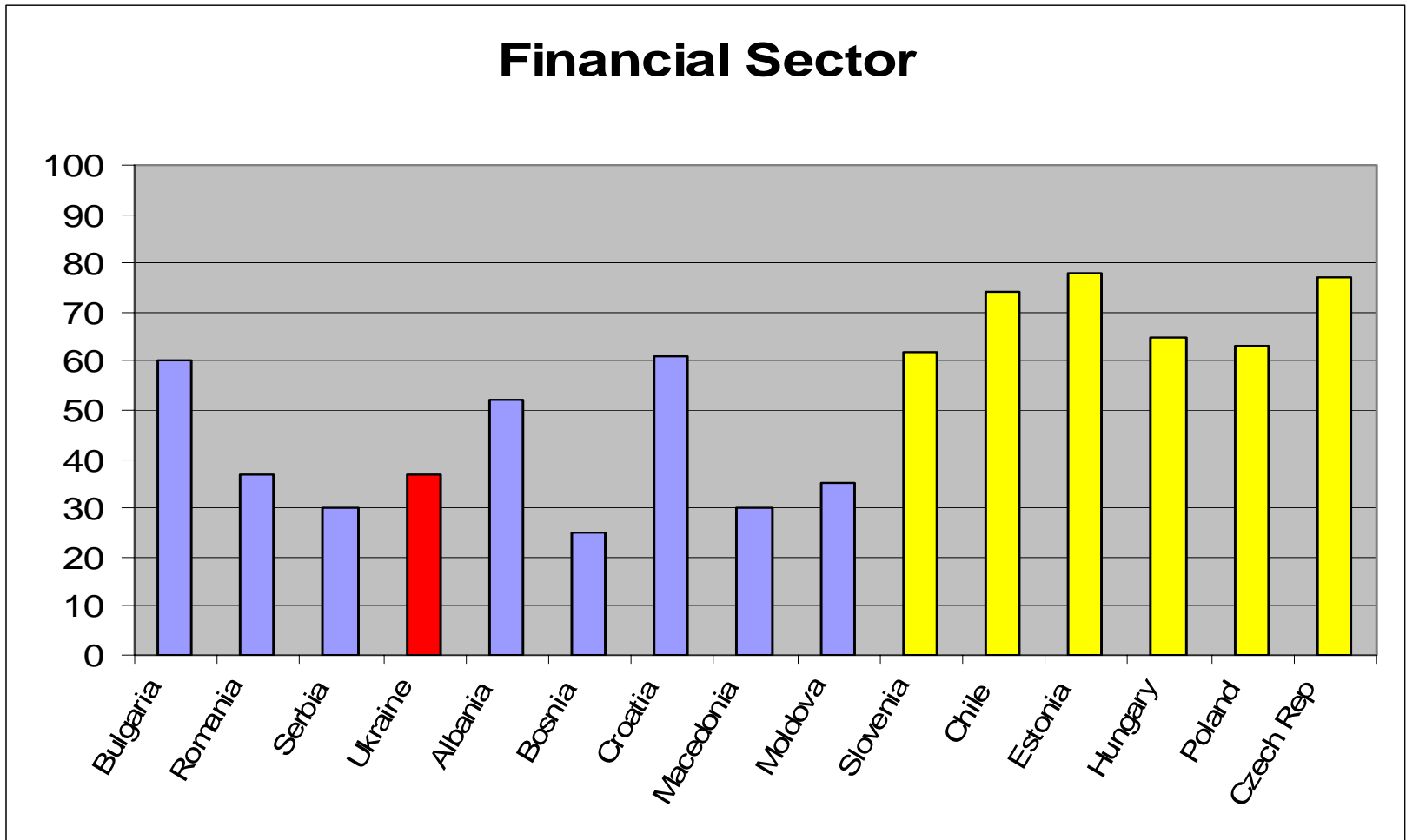


Key to further **liberalization of foreign trade** is to:

- (1) Secure market economy status from the EU and the US and entry into the WTO
- (2) Sign Free Trade Agreements with the country's main trading partners (EU, USA, CIS countries)
- (3) Streamline customs procedures and formalities to ensure prompt consideration and to reduce rent-seeking

Driver #6: Financial Sector Development

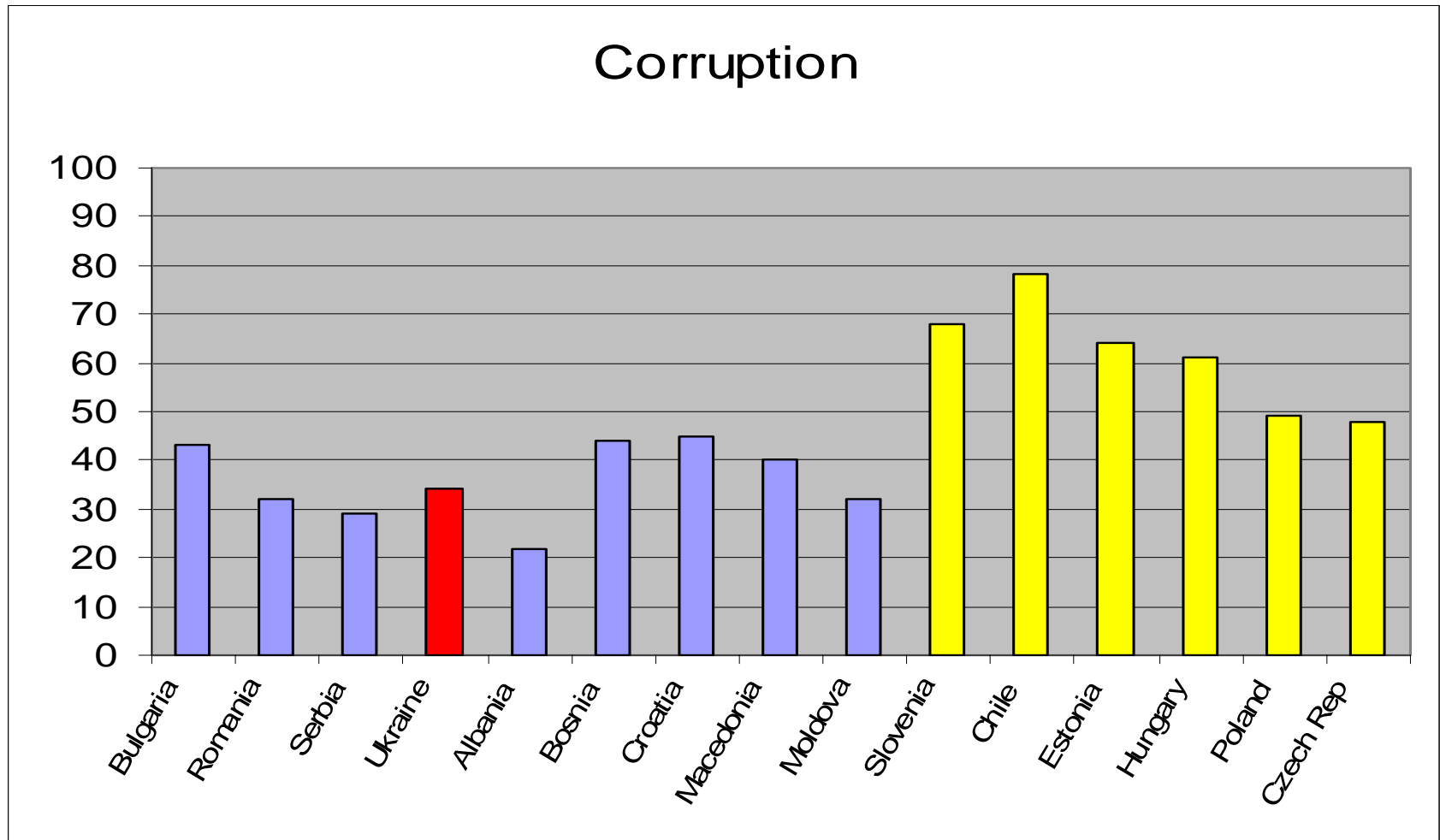
Financial Sector



In order to develop a **healthy financial sector** capable of meeting financial needs of growing businesses it is necessary:

- (1) To further improve banking supervision, including stronger prudential regulations (capital adequacy, lending to related companies, etc.);
- (2) Encourage stock market transactions to be made on the organized market;
- (3) To facilitate the development of private pension funds.

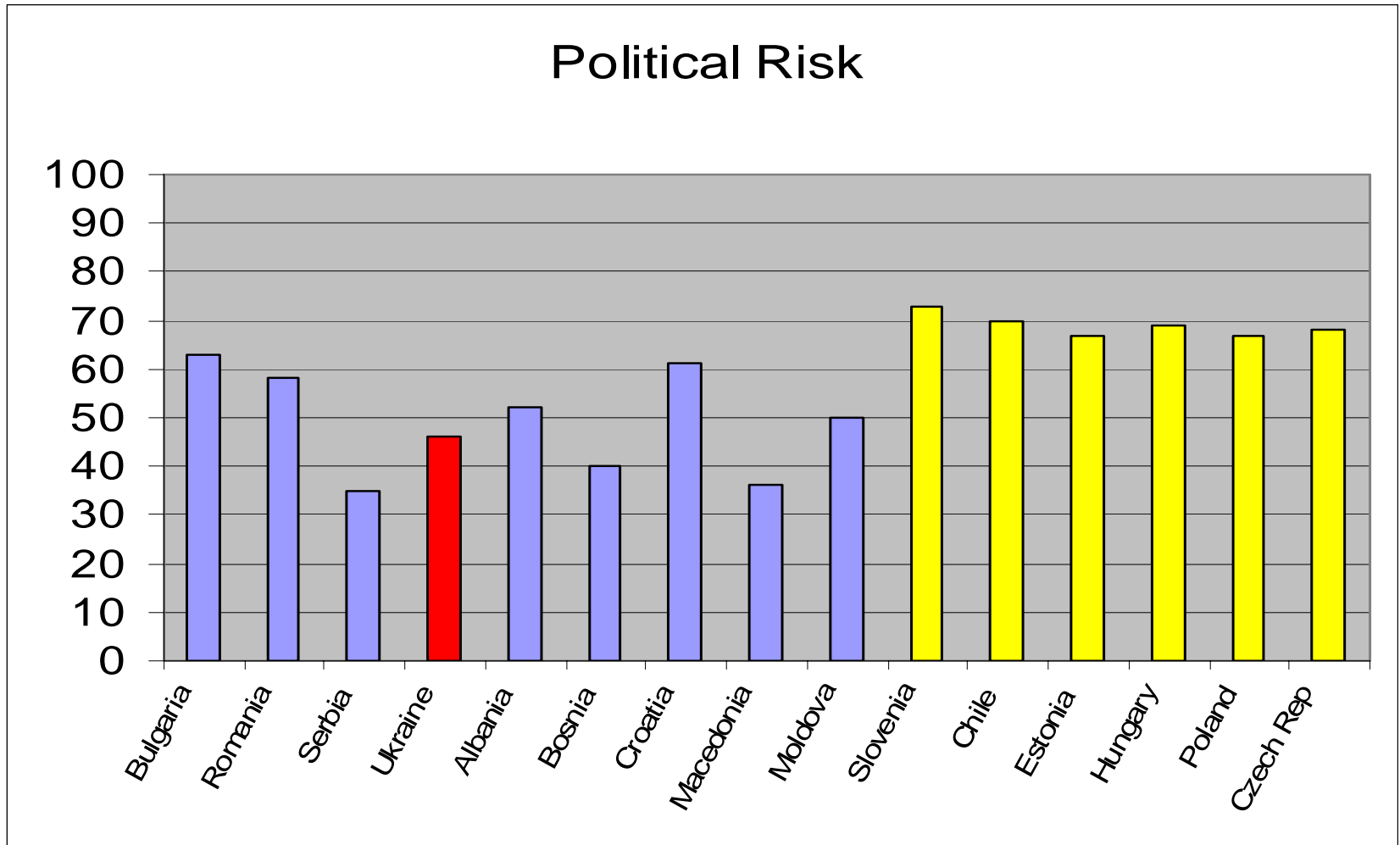
Driver #7: Corruption



Important measures to prevent **corruption** are:

- (1) to continue with the public administration reform to improve transparency of decision-making process;
- (2) to reduce the ambiguity of government regulations and raise accountability of the public servants for their decisions;
- (3) strengthen the internal audit office.

Driver 8: Political Risks



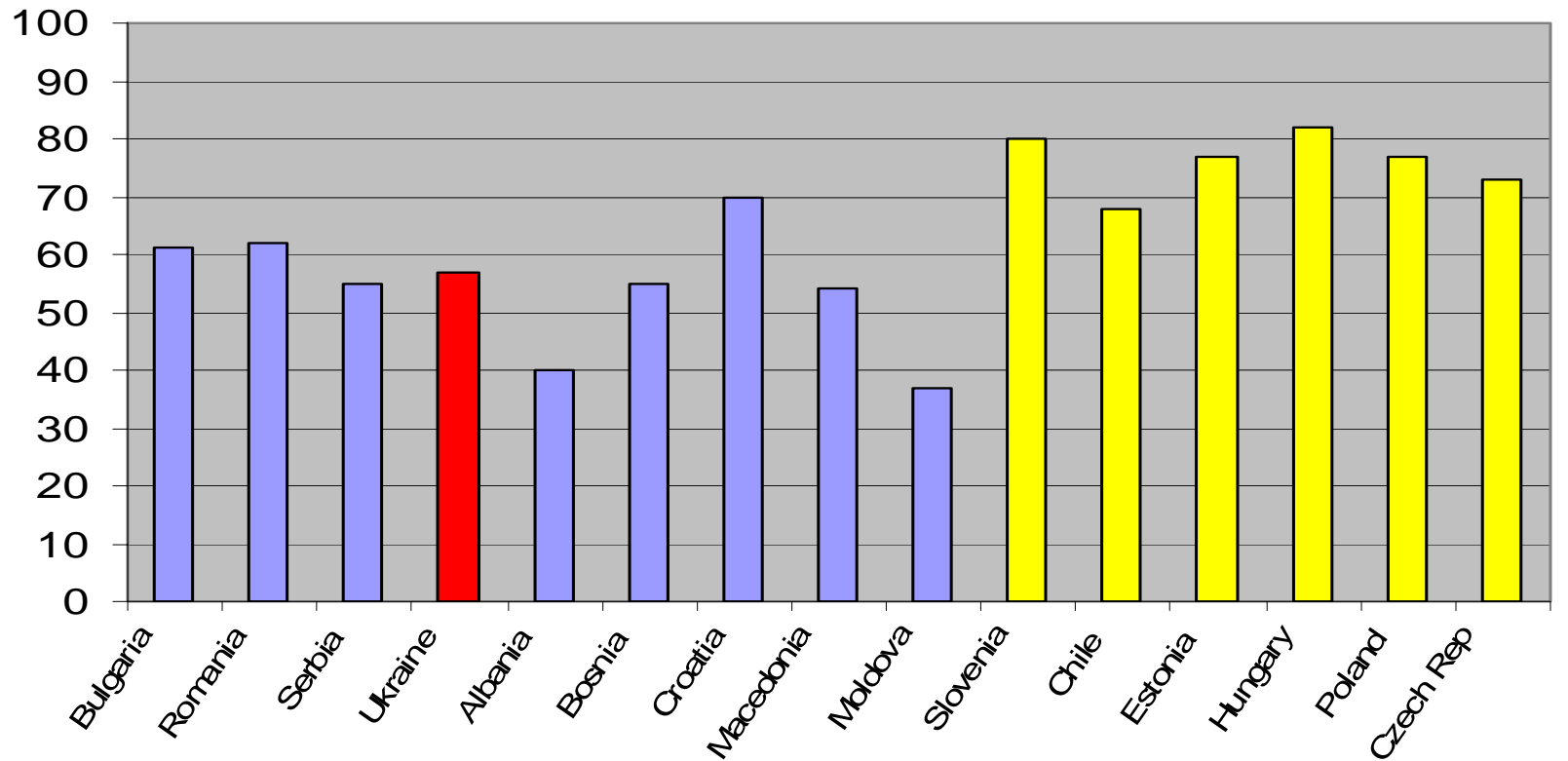
In order to minimize the **political risks** for business activities it is important:

(1) to strive for governmental stability, including longevity of key officials;

(2) to take measures to eliminate power abuses at different levels of the authorities.

Driver 9: Country Promotion and Image

Country Image & Promotion

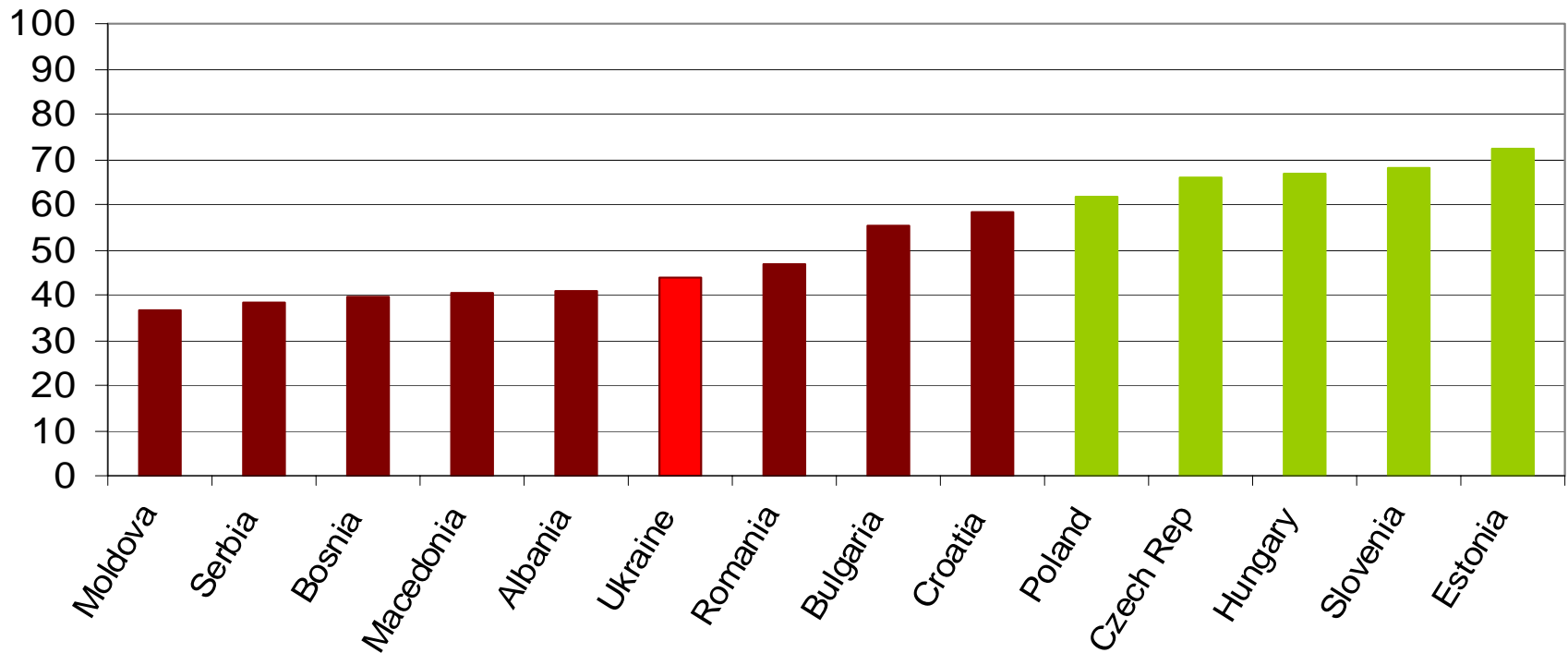


Among priority actions to **promote and inform investors about business opportunities in the country** are:

- (1) To ensure effective functioning of the investment promotion agency;
- (2) Continuously interact with representatives of the private sector in Ukraine to learn the problems they are facing and provide feedback on dealing with those problems.

Overall Investment Drivers – Country Ratings

Aggregate Investment Attractiveness Ratings



Why Countries like Ukraine has been slow in improving its investment drivers?

- The major problem today in Ukraine and many transition economies is the **low institutional capacity of their public administrations** to design and implement the required reform agenda.
- Institution-building aimed at strengthening this Government's capacity is the most desirable route to change this situation and should be pursued vigorously.
- But experience in many countries has shown that this is a slow process: It will take years for many transition countries to achieve the capacity of public administration to implement effectively reforms.
- There are two parallel avenues to overcome the constraint of policy design and implementation imposed by a weak institutional capacity in public administration:

The Private Sector and Investment Promotion Agencies.

- The first avenue is to encourage the international Private Sector to be more involved in a collective manner in supporting the design and implementation of policy reforms. The proposed Private World Fund can be such a mechanism.
- The second avenue is for the Government to create an Investment Promotion Agency (IPA) with a clear role of supporting and coordinating the design and implementation of policies that affect the business environment for investments. This agency would work closely with the Private World Fund.
- These two institutional mechanisms would complement each other. In fact, one should work with the other as its counterpart in pursuing the same objectives.

Investment Promotion Agency

- Several studies (by FIAS, UNCTAD) have reviewed the international experience with IPAs to identify best practices.
- These studies have shown that indeed IPAs have played an effective role in encouraging FDIs - Over the last few years about 30% of FDIs into Hungary and the Czech Republic were identified with work of their IPAs .
- But studies have also shown that the success of an IPA depends heavily on:
 - its degree of autonomy (Independence from line ministries), based on clear objectives and investors' trust,
 - the level of political support it enjoys (reporting to a PM),
 - the private sector experience of its staff and salary, and
 - its functions.

Investment Promotion Agency - Functions

These agencies typically have four functions:

1. **Economic Policy Advocacy** (help improving the business climate by being the link between the private sector and Government agencies, including undertaking surveys of private sector concerns, making policy and legal proposals to authorities, lobbying, etc.)
2. **Country Image-Building** (advertising, PR events, mass media campaigns abroad, investor forums, maintaining relationships with journalists and business partners, etc).
3. **Provision of Investment Services** (facilitate entry through provision of information, "one-stop-shop" registration and approval service; sectoral analyses; various assistance in obtaining sites, suppliers, legal or other advisory support, assistance in dealing with bureaucracy, etc.)
4. **Investment Targeting and Generation** (create leads to target investments into specific sector, identification of potential investors, matchmaking, direct mailing, telephone campaigns, etc.) .

Investment Promotion Agency (Con't)

- A recent study by IFC measured the effectiveness of the various functions of a Foreign inn IPA in attracting FDI.
- The study concluded that policy advocacy was the most effective activity to attract FDI.
- Image-building and investor services were also important.
- On the other hand, the study showed that investment generation was not associated with higher FDI flows, even though it absorbed the greatest share of most IPA budgets.
- The report recommended that most IPAs should dedicate a larger portion of their budget to policy advocacy, particularly to improve the country's business environment

Increased Role of the International Private Sector

- Traditionally, bilateral and Multilateral Institutions have played major roles in assisting countries in the design and implementation of economic reforms.
- However, experience have shown that this assistance, though necessary, has not been sufficient to achieve results.
- This may be due to a number of factors, similar to those faced by Government-owned institutions elsewhere:
 - Multiplicity of goals and objectives, often in conflict
 - Political considerations in foreign aid allocations.
 - Lack of ownership of assistance projects and programs by recipients.
 - Lack of coordination among donors in their aid activities.
 - The practice of aid tying by donors.
 - Inefficient terms of aid use.

The Private World Fund

- Given that the International private sector should be a major beneficiary of improvements in business environments in developing countries, the time may have come for their greater involvement in this effort.
- One reason for the limited involvement of the private sector so far is the fact that such assistance is a "public good": it is expensive to offer but it benefits not only the provider by everybody else.
- This difficulty can be overcome by the development of a "collective" private sector mechanism for the provision of support to developing countries in improving their business environments.
- This mechanism is what we call the Private World Fund

The Private World Fund (con't)

- To be viable, this collective mechanism -- the Private World Fund -- should be an hybrid vehicle:
- It would combine private equity investments with developmental assistance.
- It would demand business environment improvement as a condition for investments and would provide financing to make this happen.
- But it would also be prepared to walk away if promises are not fulfilled.
- It is expected that this combination of activities would enhance the profitability of investments, making the proposition financially viable.

- To a great extent this idea of an hybrid vehicle has been operating in Ukraine through the combination of the private equity investments of SigmaBleyzer (the manager of three private equity funds) and the developmental assistance provided by The Bleyzer Foundation, the NGO supported by the Bleyzer family.
- We believe that a private sector hybrid vehicle combining equity investments with policy advice has the potential to accelerate improvements in business environments in transition economies.
- It would also provide superior returns to investors.

Conclusions

- Experience across many transition economies show that sustainable growth requires a favorable economic environment in which small, medium and large business are free to pursue profitable activities without undue interference of Government agencies.
- This policy could be accompanied by more concrete efforts to attract large foreign investors to the country.
- But without a liberalized business environment, stable legal system and good public and corporate government, these efforts will not yield results.
- The success of the new Government will be measured by the extent to which these policy measures are implemented.