SigmaBleyzer

The Role of the Private Sector in Improving Business Environments in Transition Economies

Dr. Edilberto L. Segura

Where Opportunities Emerge

World's Disparities in Performance

Today in the world, disparities in economic performance are striking: The gap between the ten richest and ten poorest countries has widened since 1960.

GDP per capita (constant 1995 USD),
Average 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

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

urce: World Bank, World Development Indic

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
- There is a clear need to replicate the Wealth Creation Capacity in developing nations

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

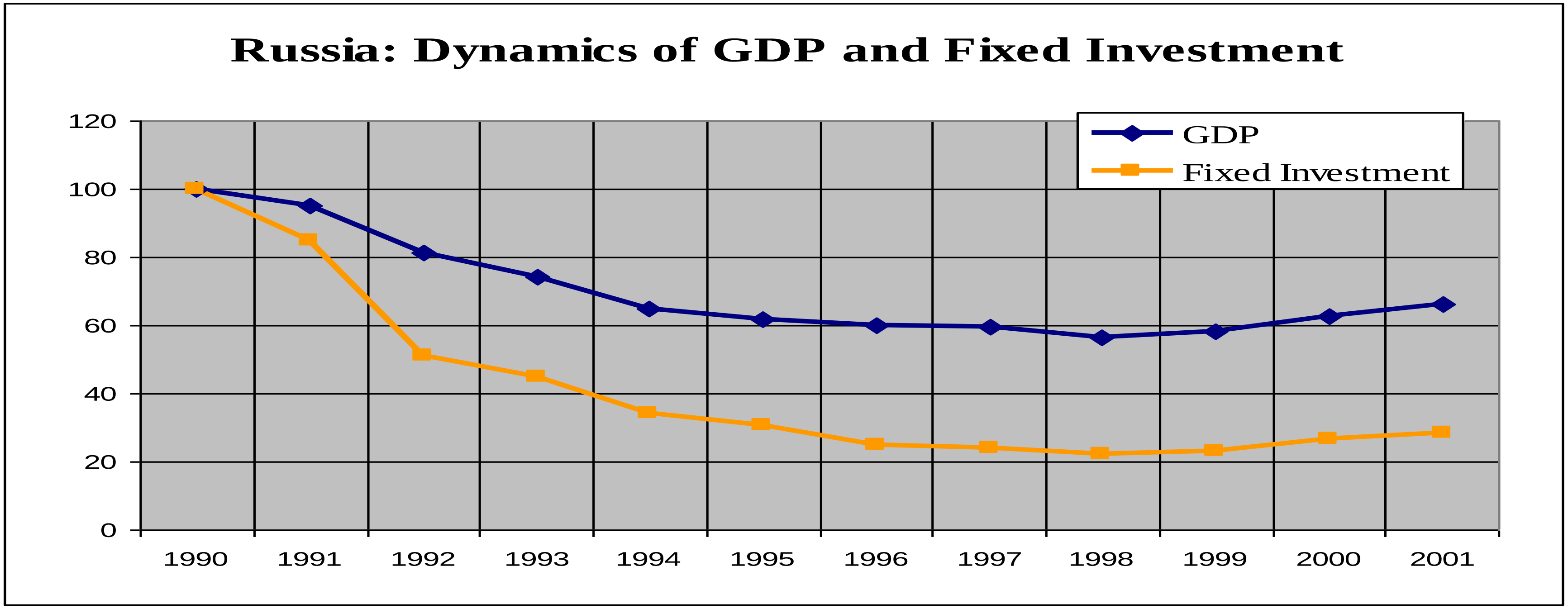
<u>I have long believed that this interdependence defines the new world we live in</u>

Tony Blair, October 2, 2001

What Explains these inequalities?

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:



FDI 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 $150B 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)*

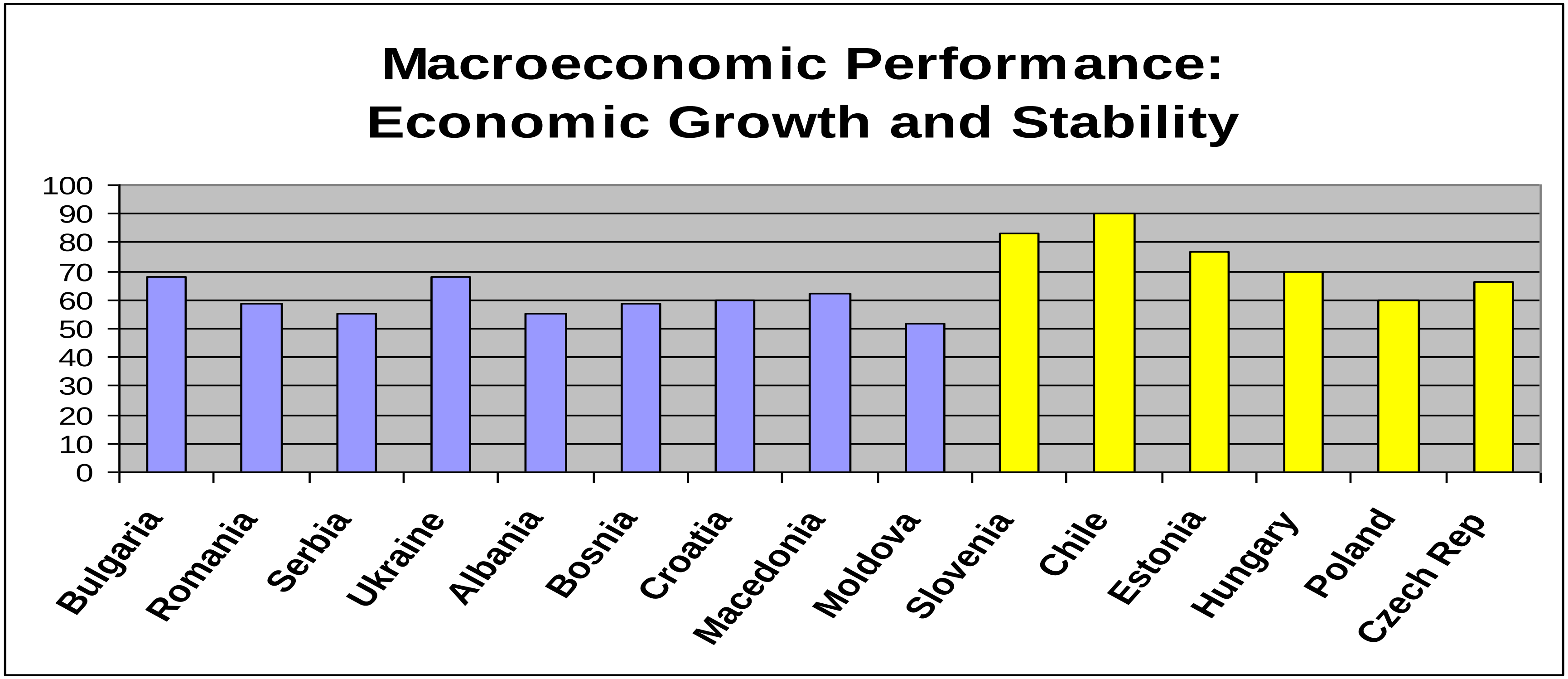
- **Unfortunately, the bulk of FDIs in concentrated in a handful of countries in Asia and Latin America.**
  - Five developing countries (China, Mexico, Brazil, Poland and Chile) have been receiving over 60% of these inflows
  - Rest of the world does not offer attractive business environments and is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

What explains the differences in flows of FDIs?
TBI Key Investment Drivers

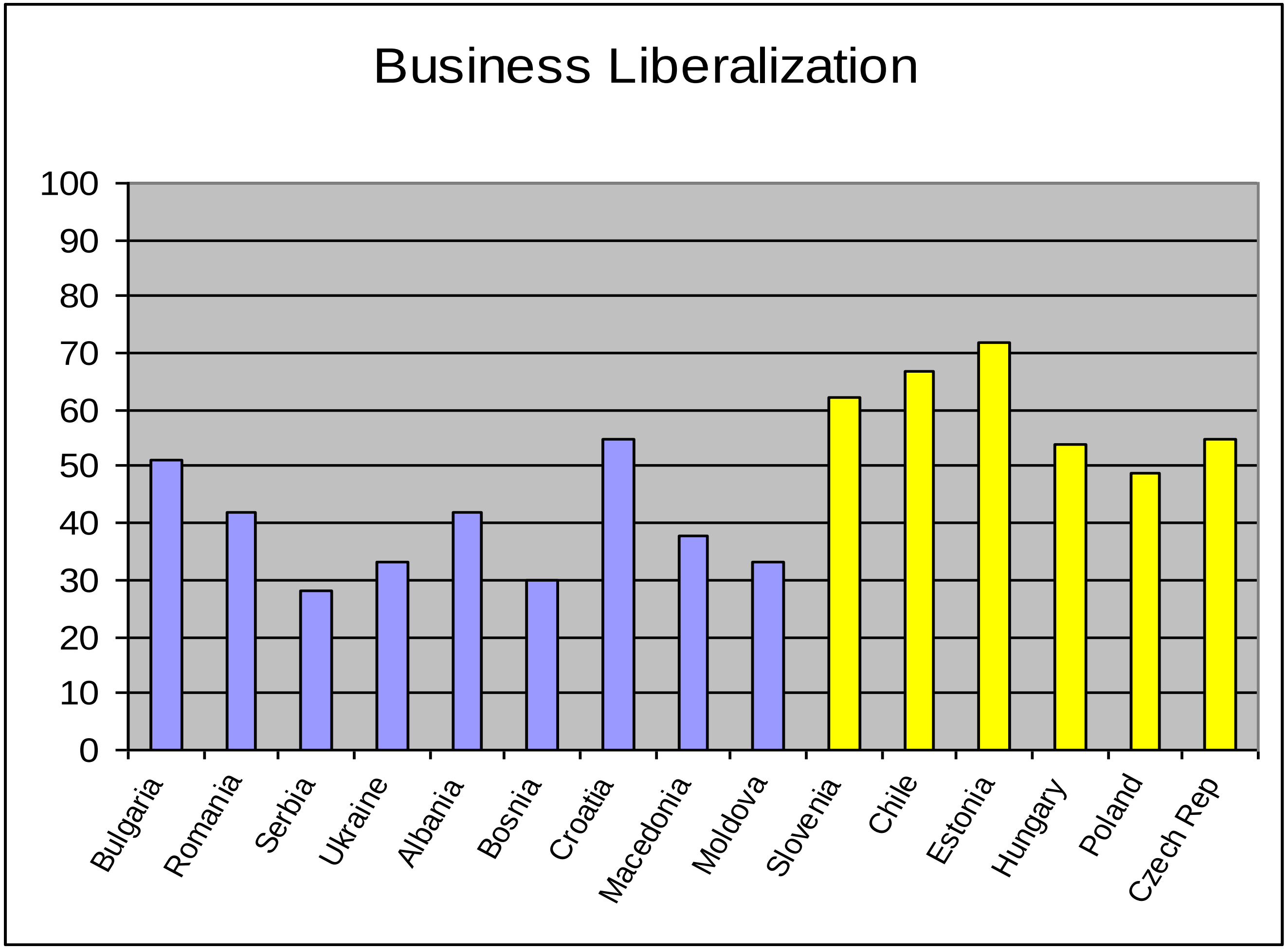
1. Macroeconomic Performance
2. Liberalization and Deregulation of Business Activities
3. Stable and Predictable Legal Environment (the Rule of Law)
4. Privatization, Public Administration reform and Corporate Governance
5. Removal of International Capital & Foreign Trade Restrictions
6. Facilitation of Business Financing by the Financial Sector
7. Reducing Corruption levels
8. Minimization of Political Risks
9. Improving Country Promotion and Image

Transition Economies: Disparities in Performance

For over a decade, the former centrally-planed economies of Europe have been undertaking economic reforms; but with very different results.



Country Ratings



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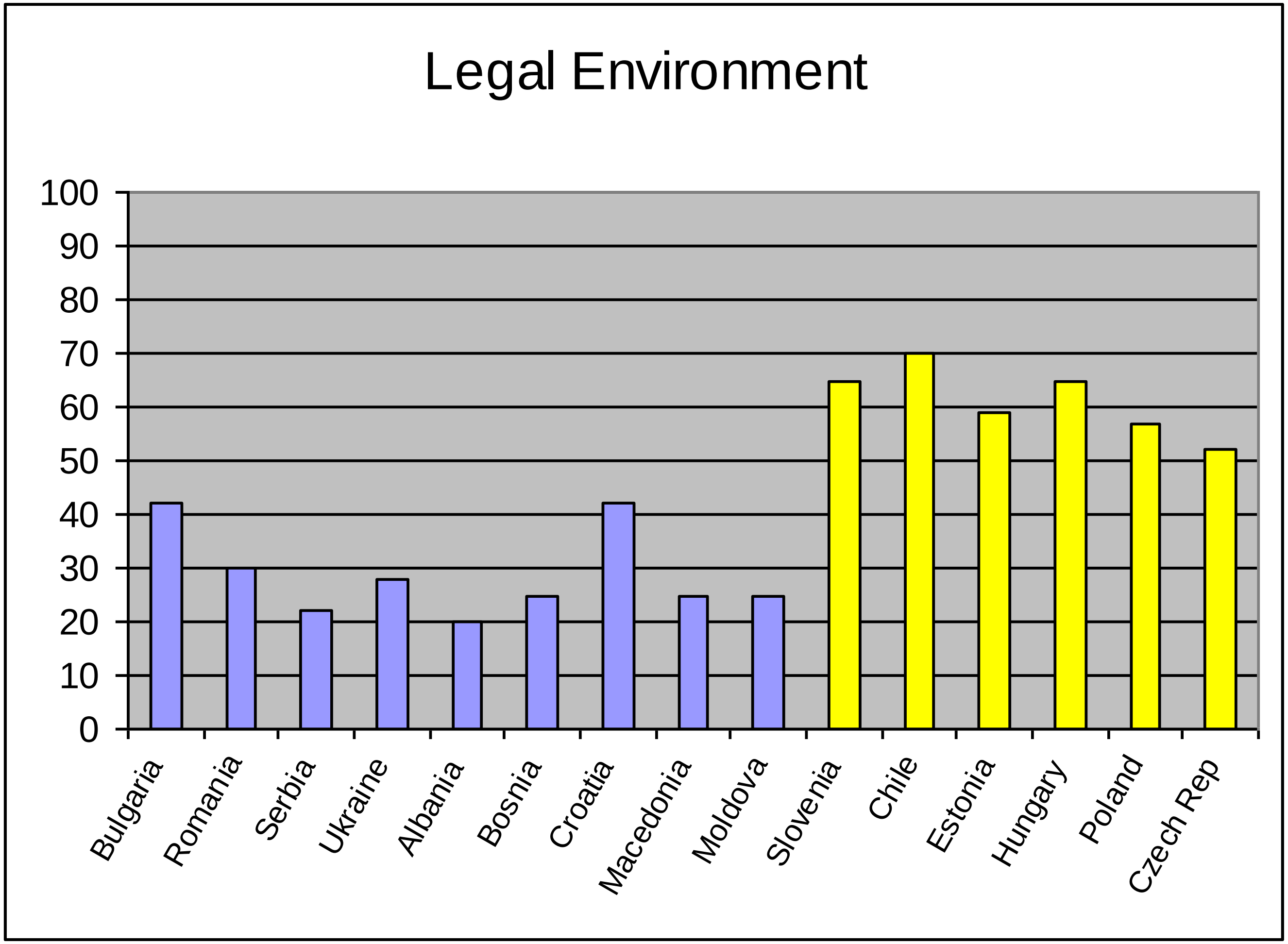

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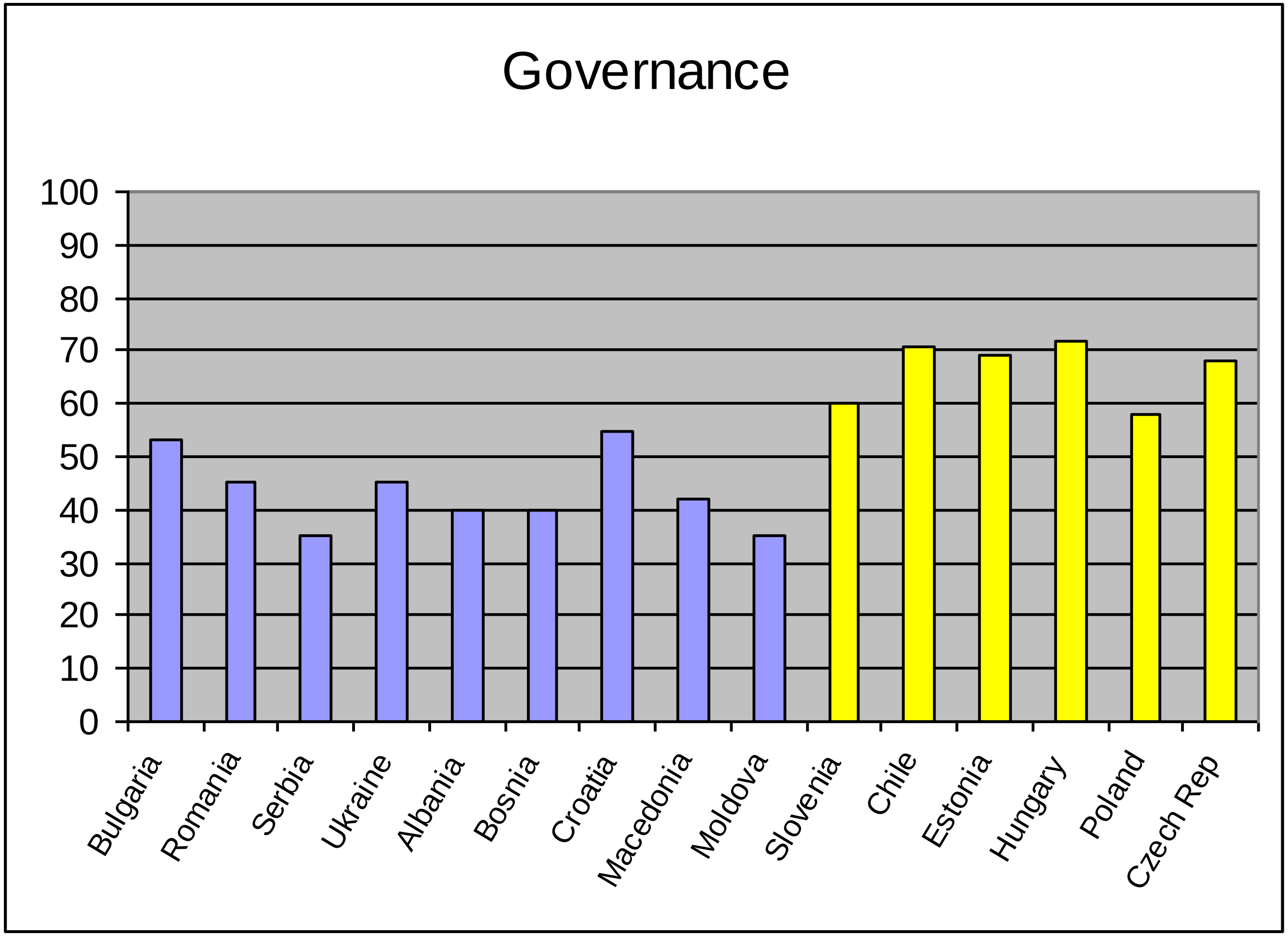

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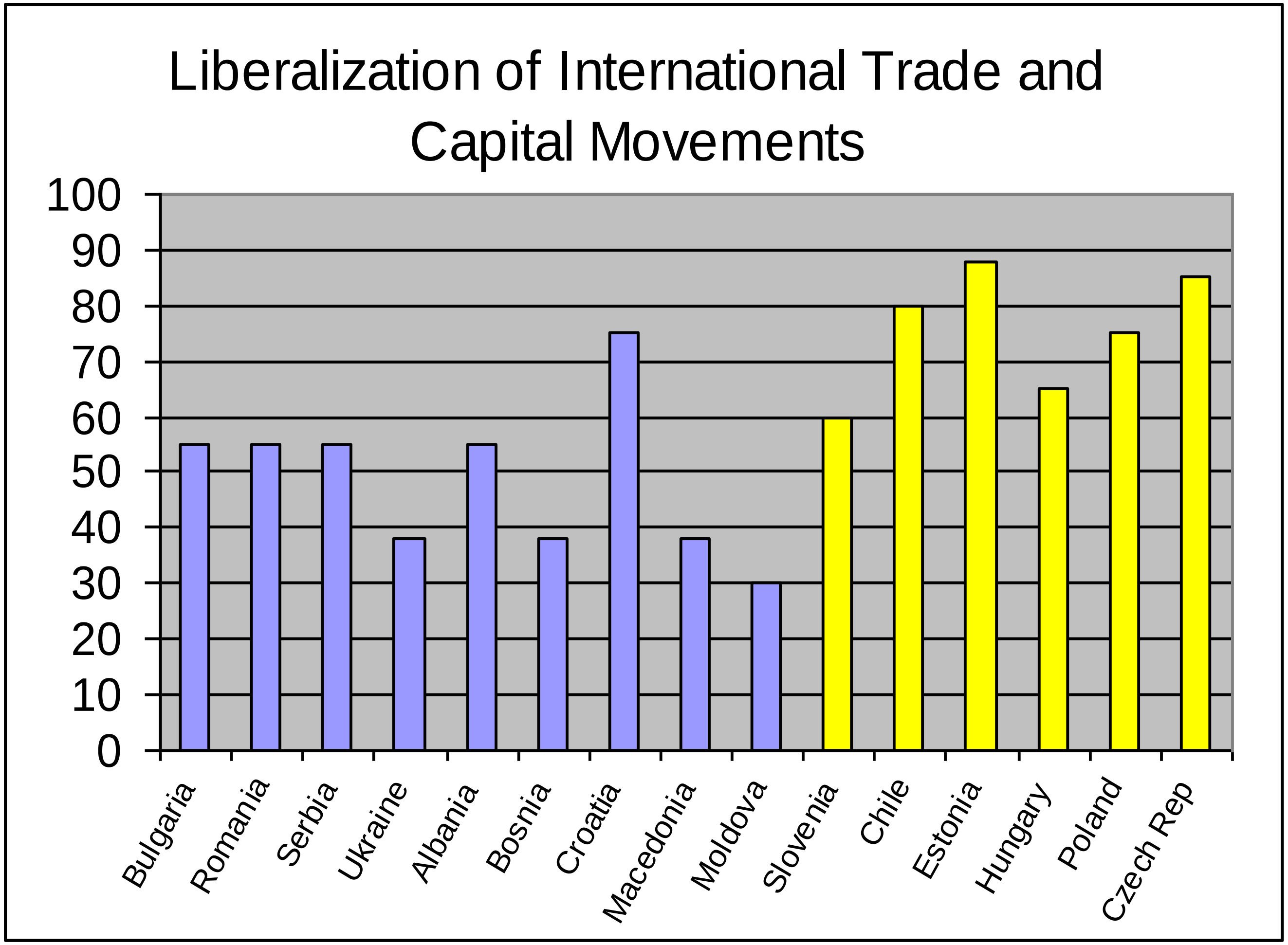

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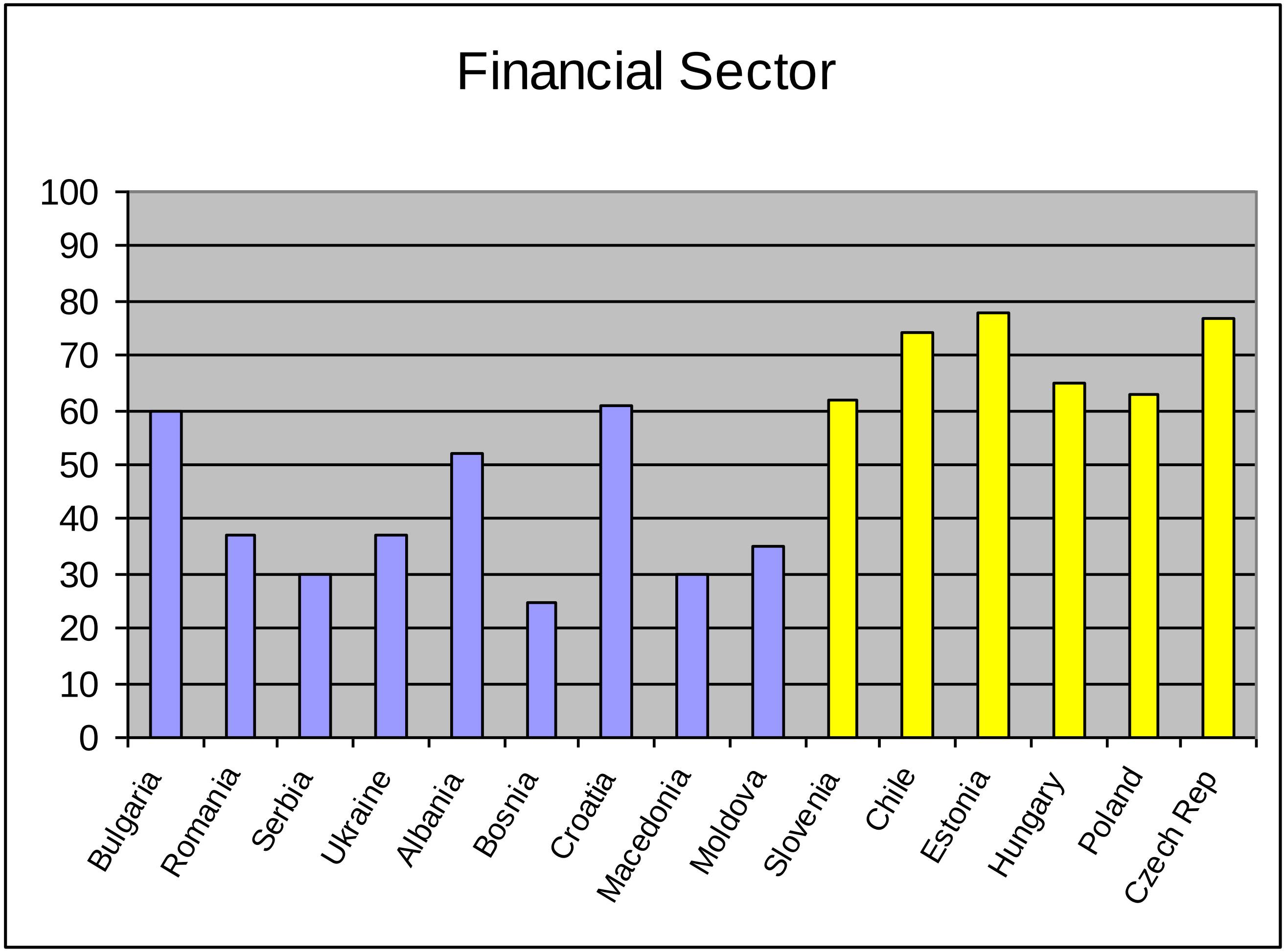

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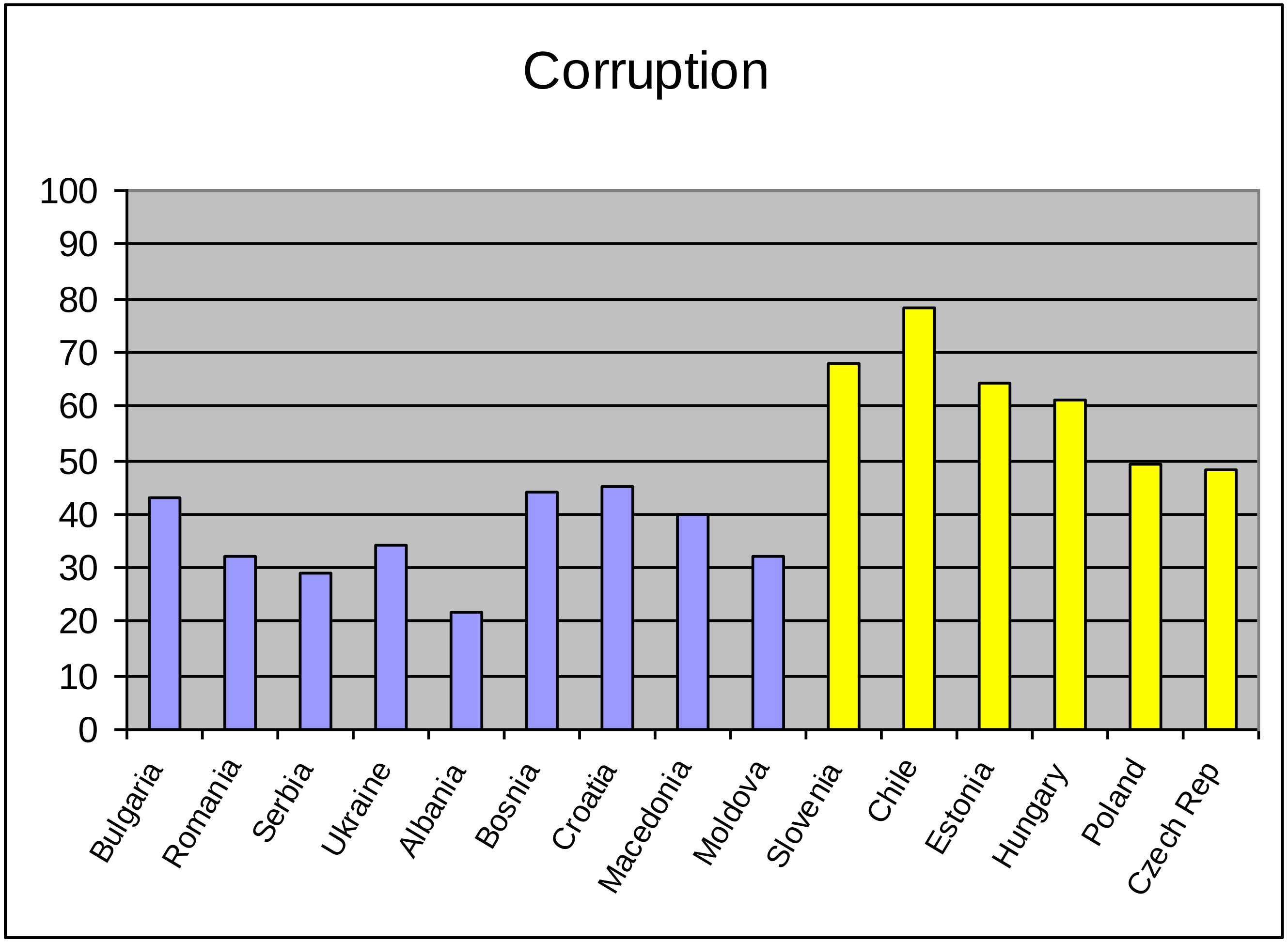

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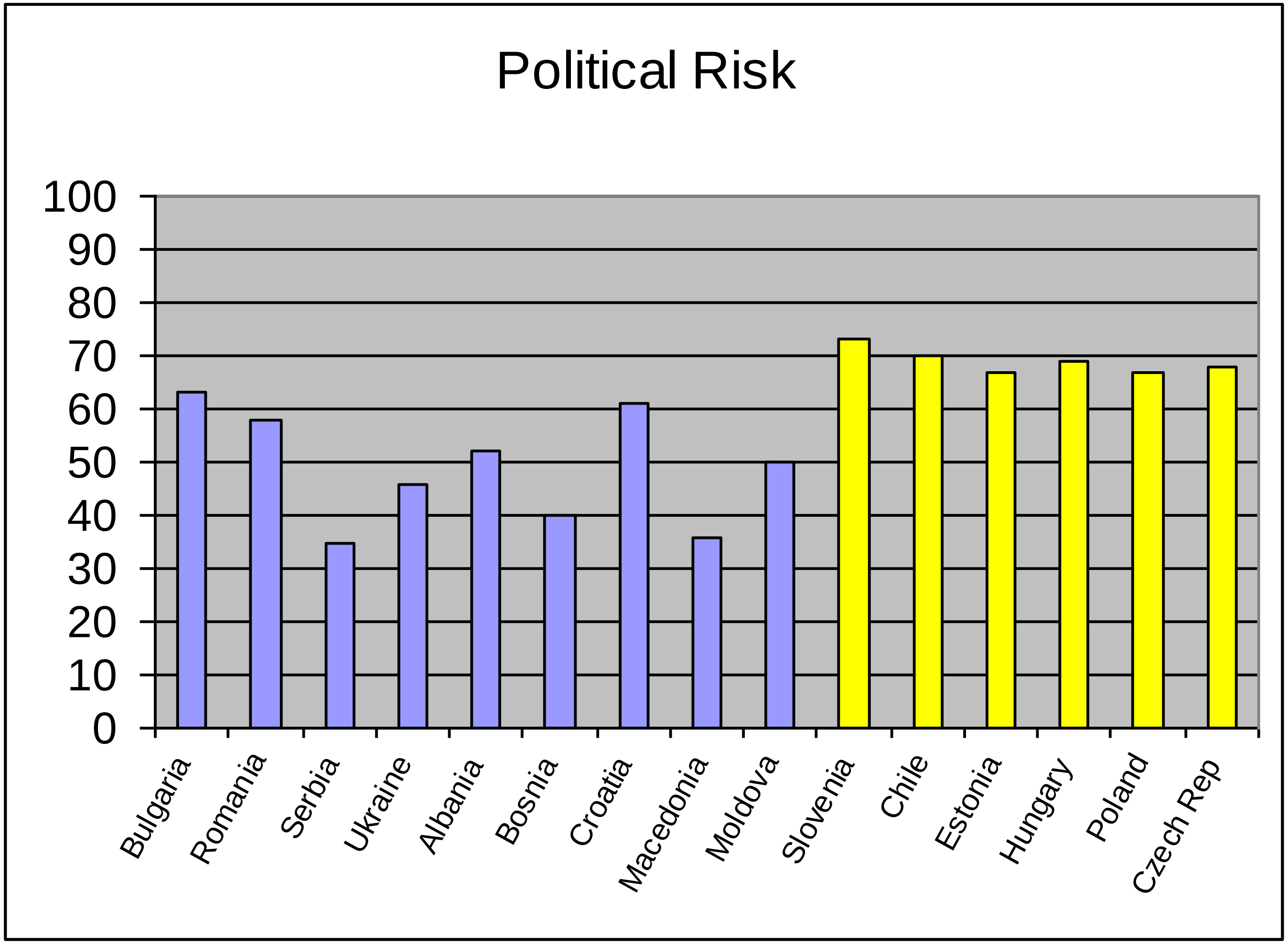

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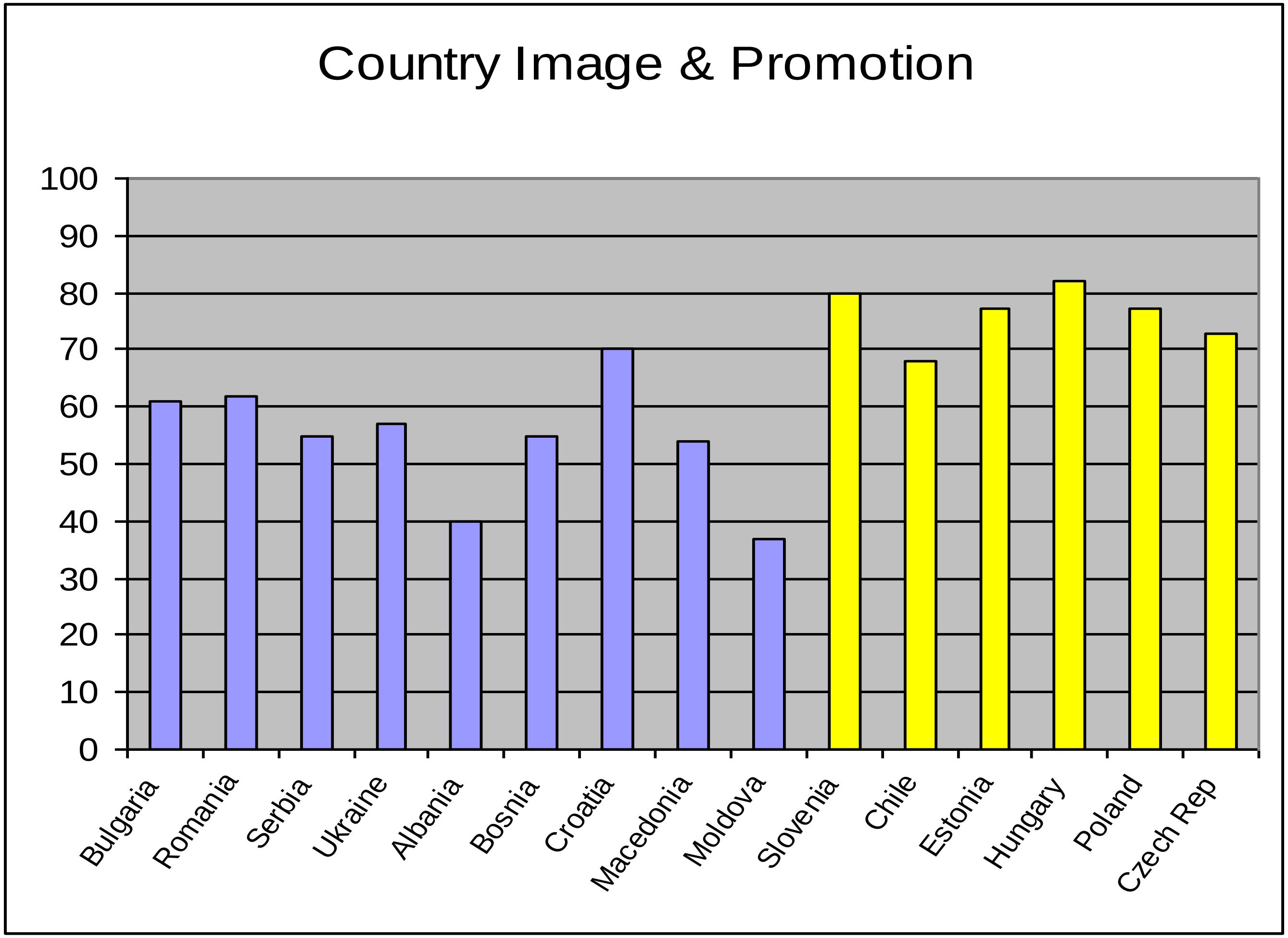
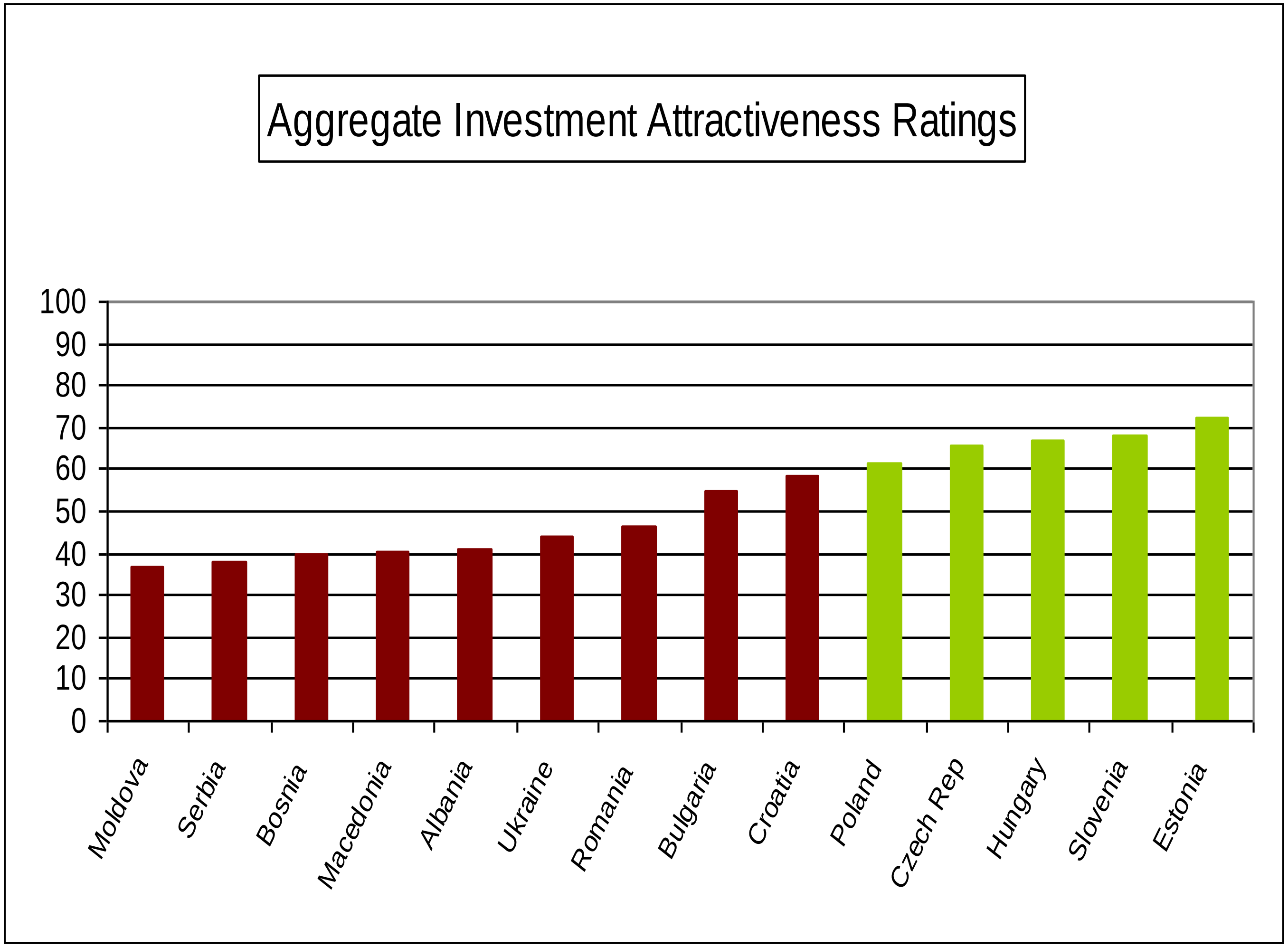


Overall Investment Drivers – Country Ratings



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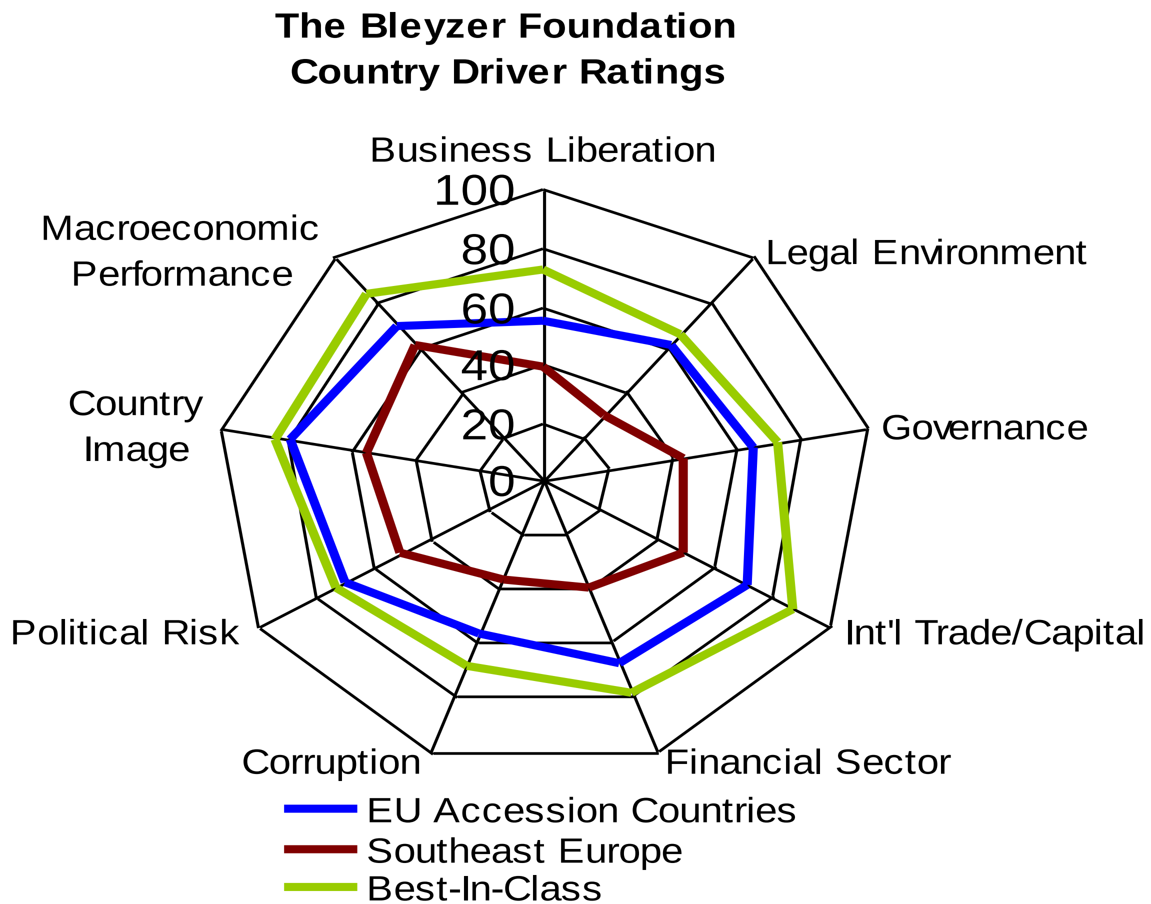


Institution Building as a constraint.

- The major problem today in 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 pursing 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

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.

Experience in Ukraine

- 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.
- The Bleyzer Foundation has carried out a number of programs to support the Ukrainian Government efforts to improve the country's investment climate.
- In the year 2000, it started a major study to identify the constraints to FDIs and the measures that should be taken to accelerate the flows of FDIs into the country.

Causes of Lower FDI Levels in Ukraine

- 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
- What was the evidence of these claims? How important were these issues in affecting FDIs? Could we quantify them?

International Private Capital Task Force (IPCTF)

- With the support of the Government, SigmaBleyzer chaired a steering committee to carry out a study on FDIs (IPCTF).
- The study was conducted by SigmaBleyzer/TBF and the Thunderbird Corporate Consulting Group, the consulting arm of one of the best international business schools in US.
- 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

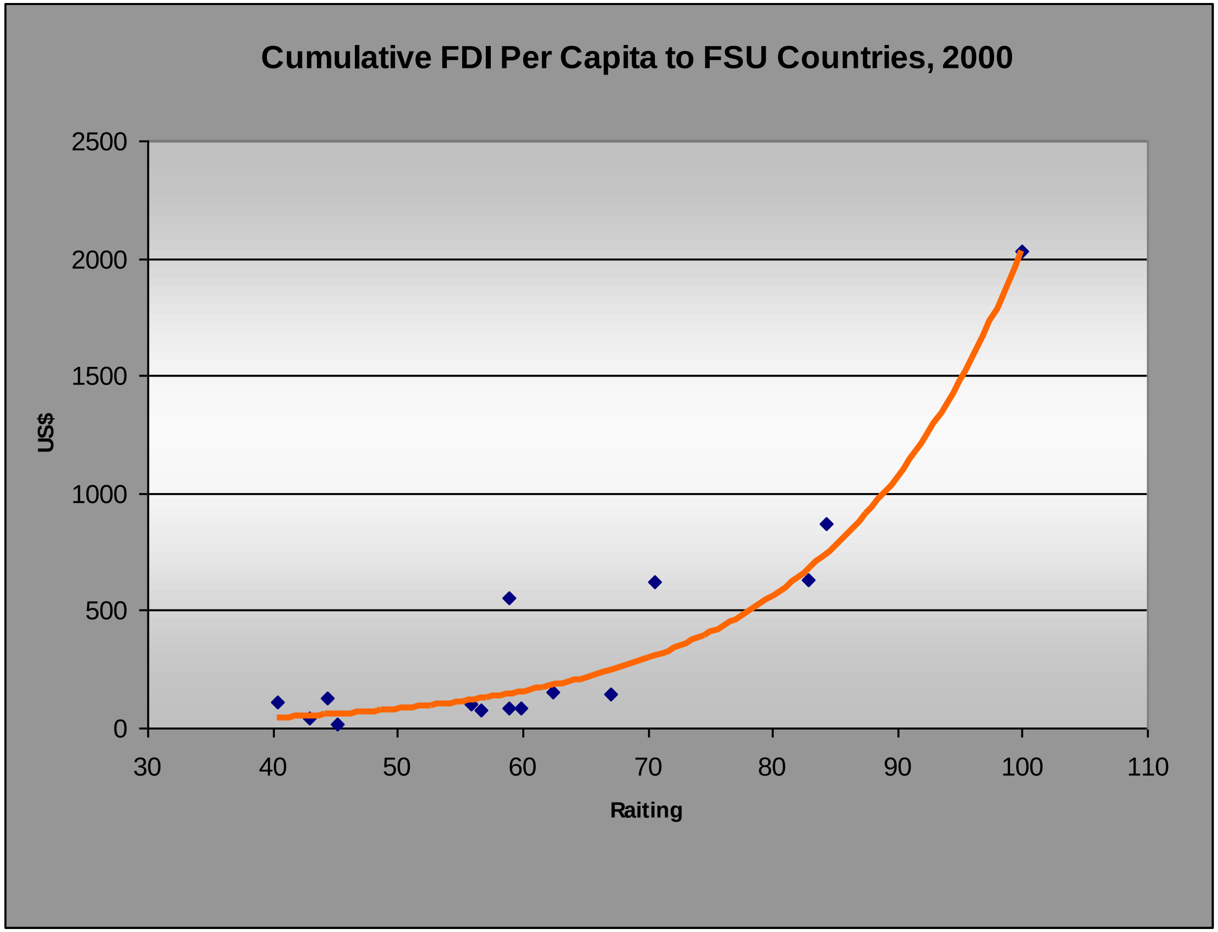
- The key determinants of a "Favorable Business Environment" were the following nine policy variables or "FDI drivers":

1. **Liberalize and De-Regulate Business Activities**
2. **Provide a Stable and Predictable Legal Environment**
3. **Enhance Governance & Reform Public Administration**
4. **Remove International Capital & Trade Restrictions**
5. **Facilitate Financing of Businesses**
6. **Eliminate Corruption**
7. **Reduce Political Risks (non-economic country risks)**
8. **Expand Country Promotion**
9. **Rationalize Investment Incentives**

Ranking of Drivers

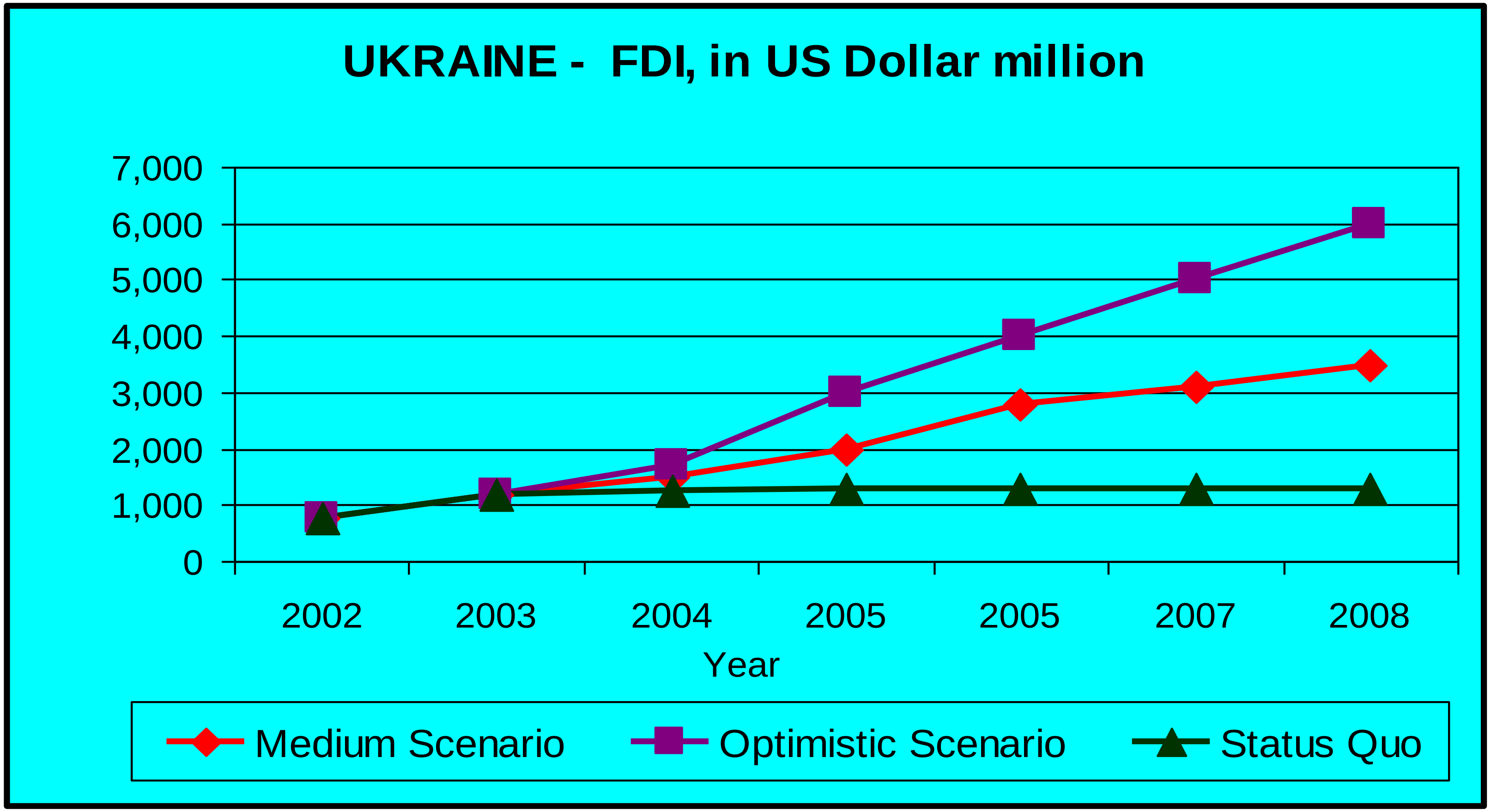
- The first three drivers had the strongest positive effects
- These policy variables explain about 60% of the variations in FDI in the sample of 50 countries
- Actions on all policy drivers were necessary to achieve sustainable results
- Investment incentives were significant, but with a negative statistical impact. This is because investment incentives is not able to compensate for poor policies

Relationship between FDI and Policy Ratings



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)

- **By 2005, 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 by 2008, 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 by 2008, FDI flows could increase to $6.4 billion per year for Ukraine.

Action Plan

- This study led to the preparation by the Government of Actions Plans to improve the country's business environment.
- This study was followed by a number of other related studies focusing on economic and policy matters.
- Many of the policy measures taken by the Government are responsible for the spectacular economic results achieved by Ukraine during the last few years.
- These improvements in the economic environment have also been important in improving the profitability of the investments undertaken by the company in Ukraine

Conclusions

- We believe that a private sector hybrid vehicle combing 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.
- We believe that this concept should be tried in other countries as a pilot project, with the participation of major international investors.
- We believe that international organizations such as OSCE could play a key role in providing support to this effort.