SigmaBleyzer

*Where Opportunities Emerge.*

# Government Policies and Private Capital in Transition Economies

**THIRD ANNUAL LEONTIEF CONFERENCE**

**«The Russian Economy: Current Reform Issues»**

**Saint-Petersburg, February 8 to 9, 2002**

Michael Bleyzer
The Bleyzer Foundation

# SigmaBleyzer, IPCTF and The Bleyzer Foundation

- US company managing one of the premier Ukrainian Investment Banking groups
- Three Private Equity Funds in FSU, with focus on Ukraine
- Ten years experience in Ukraine
- Investors include: International Investors, Institutions, and high net worth individuals / families
- Ukrainian Growth Funds (UGF) – over $100 million under management
- Investments in over 70 Ukrainian companies
- Substantial experience in managing and restructuring companies
- Significant number of successful exits
- Significant Ukrainian infrastructure
- Leadership in International Private Capital Task Force (IPCTF)
- The Bleyzer Foundation – Ukrainian / International NGO

# New World Order

- 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

# Developed and Developing Countries – Assured Interdependence

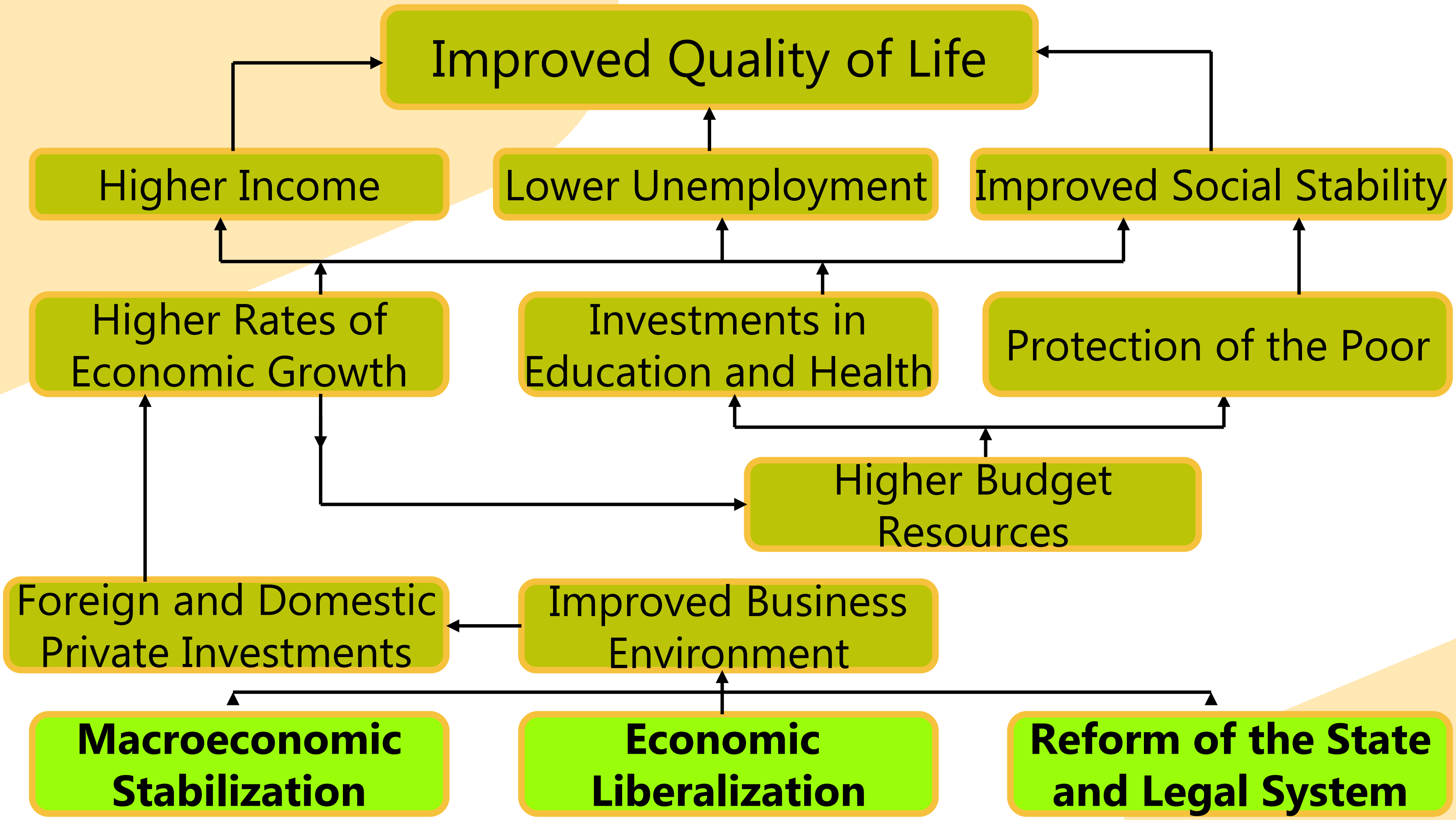
- A large portion of the world is in a state of transition, therefore unstable
- The main goal is to successfully complete transitions and achieve stable economic growth, based on market economy and democracy
- The developed countries hold the keys to this transition and must lead the effort
- Benchmarking and statistical analysis of the transition economies help identify the best practices, which must be used in other countries, with some adjustments for local culture

# Transition to Market Economy

| | Centrally Planned Economy | Transition Economy | Market Economy |
|---|---|---|---|
| **Decision Making** | Centralized | Chaotically Decentralized | Mainly Decentralized |
| **Sources of Savings for Investments** | The State | Initially, without domestic savings, source is principally foreign capital, and primarily debt. | Savings of Individuals and Corporations (Retained Earnings) |
| **Coordination** | Compulsory Plans, Overly Restricted | Weak State and Inefficient Markets | Primarily Market, but with some State Regulation |
| **Ownership** | The State | State, Legally Private, Semi-Private, and Shadow | Primarily Private |
| **Incentives:** | None, Collective Success | Money | Individual Success |

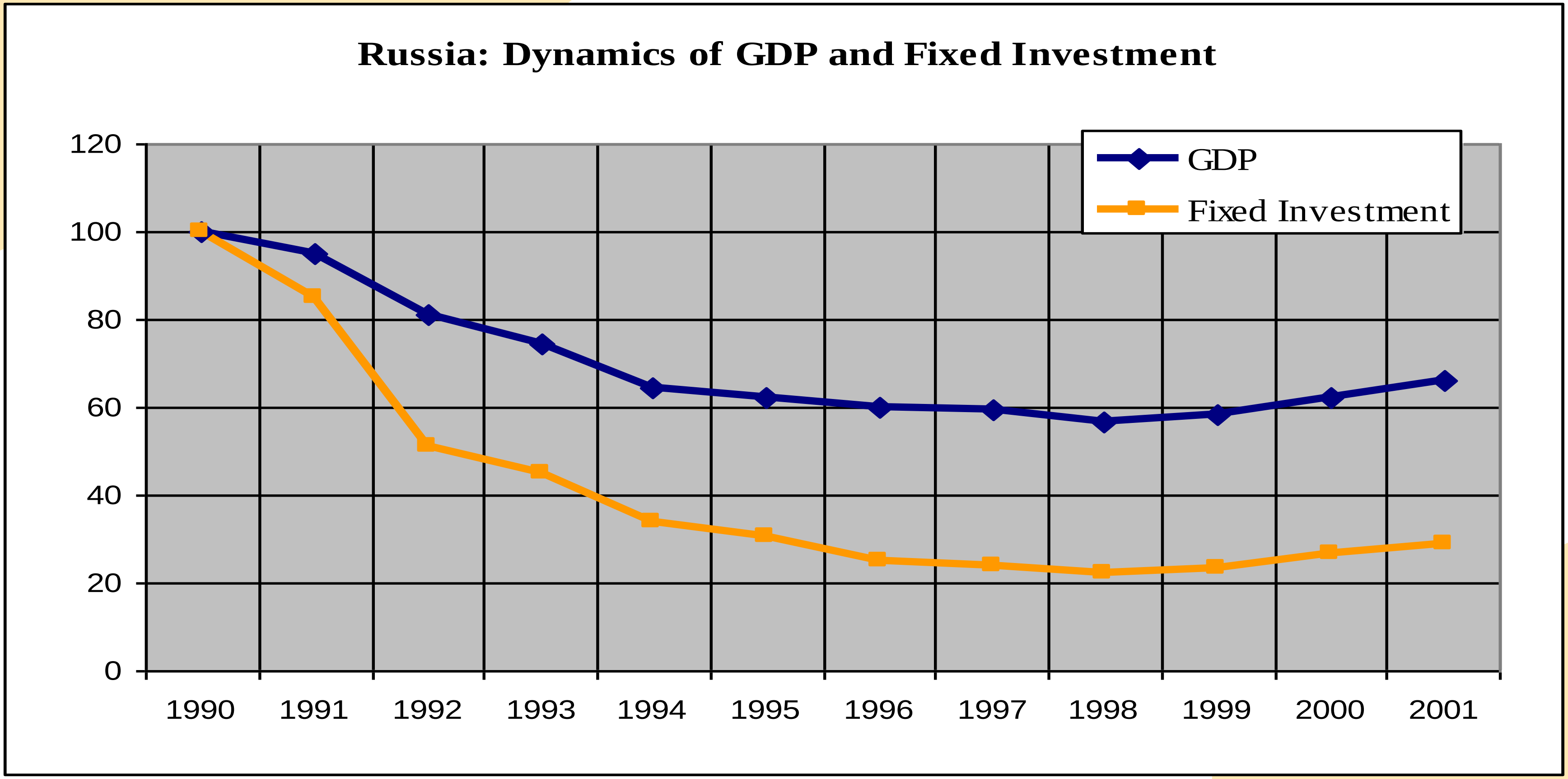
***Every Transition Economy has to start being a capital importer. With successful reforms it hopes to become a capital exporter.***

# Why Transition?



# Importance of Sustainable Growth

- Sustainable GDP and fixed investment growth are among the key factors to achieve improved Quality of Life
- Still a challenge for the FSU countries, including Russia



# Russia's Performance Since 1998 Crisis

- Russia has performed relatively well since 1998
- However, without major increases in investment, growth will not be sustainable over the long term

| | **1999** | **2000** | **2001** |
|---|---|---|---|
| Real GDP Growth, % | 5.4% | 8.3% | 5.3% |
| Fiscal Balance (%GDP) | -1.4% | 2.3% | 2.4% |
| Inflation Rate, end-year | 36.8% | 20.2% | 18.6% |
| Goods Exports ($bn) | 75.3 | 105.6 | 103.5 e |
| Goods Imports ($bn) | 39.5 | 44.9 | 52.4 e |
| Trade Balance ($bn) | 35.8 | 60.7 | 51.1 e |
| Current Acc. Balance ($bn) | 25.0 | 46.3 | 34.0 e |
| Foreign Direct Investments ($bn) | 3.31 | 2.71 | 2.9 e |
| Gross Reserves ($bn) | 8.46 | 27.97 | 36.62 |
| External Debt Stock ($bn) | 154.6 | 142.198 | 156.8 e |

*Source: EBRD Transition Report 2001, EIU Country Report*

# Identifying the Best Practices

- SigmaBleyzer launched its first effort to identify best practices in government policies in transition economies in 1999
- Thunderbird Corporate Consulting Group led by Professor Krishna Kumar was retained to benchmark selected countries and build an econometric model of a transition economy based on the key drivers identified through benchmarking and statistical analysis
- The International Private Capital Task Force (IPCTF) was launched in 1999
- In 2000 SigmaBleyzer continued developing IPCTF framework and in 2001 hired a group of graduating Oxford MBAs to expand IPCTF framework to all FSU countries

# International Private Capital Task Force (IPCTF) Ukraine, 2000 - 2001

- Ukrainian economy has performed very well in the last two years
- But foreign investment continues to decline
- The country remains unstable
- Major increase in investment flows is necessary to sustain long-term growth and achieve stability
- IPCTF effort objective: Benchmark transition economies to identify best practices in government policies, which improve investment climate and attract private capital

# IPCTF Steering Committee

***Private Companies:*** ***AGCO, SigmaBleyzer, Coca Cola, Citibank, Commerzbank, Credit Lyonnais, FMI, PricewaterhouseCoopers, Leo Burnett, DuPont.***

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

# Benchmarked Countries

- Argentina
- Chile
- Hungary
- Poland
- Russia
- Ukraine

# 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.*

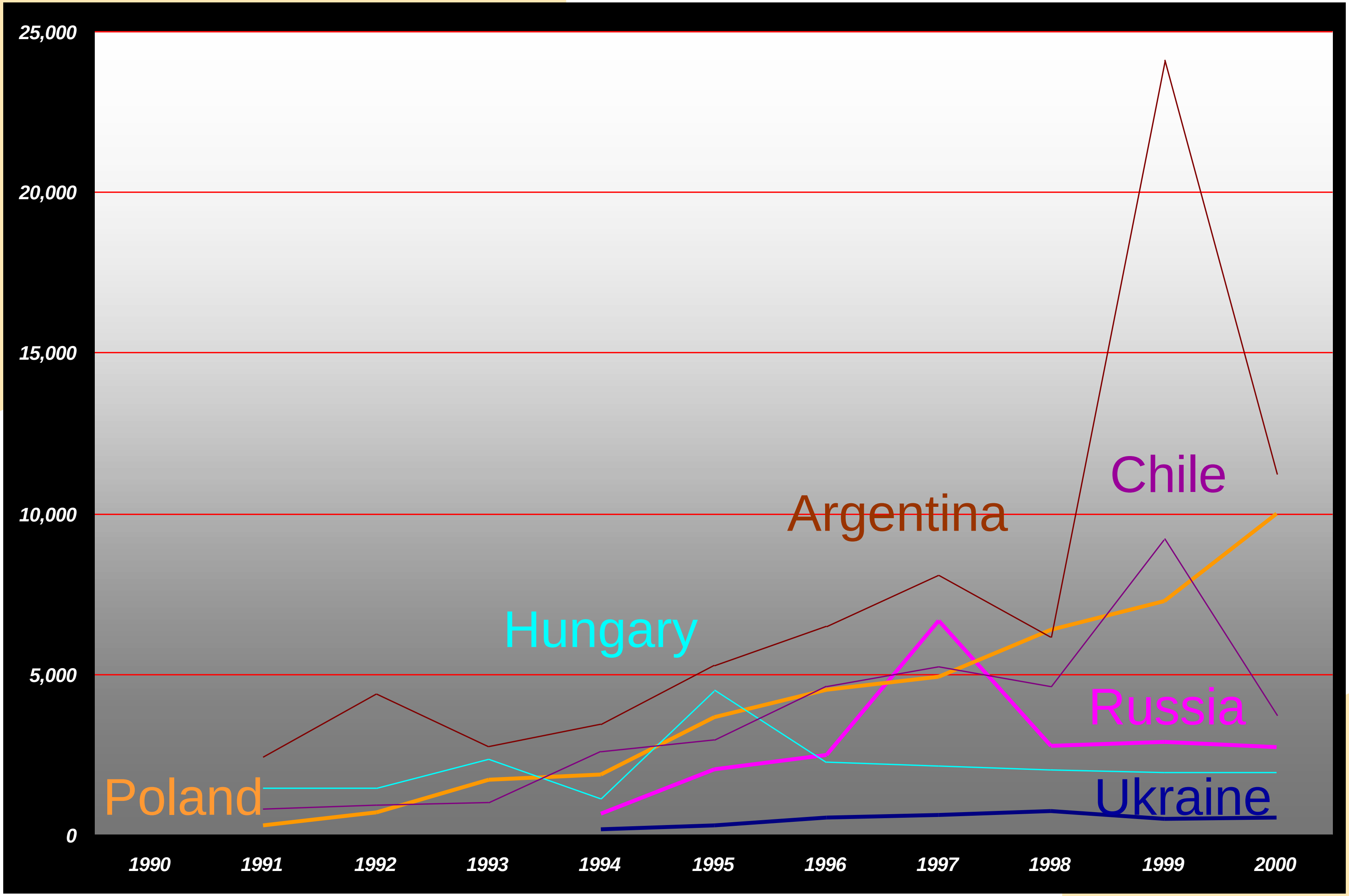
# Private Equity (FDI) - the Most Stable Source of International Financing

## Net Capital Flows to Emerging Markets (in US Dollar billions)

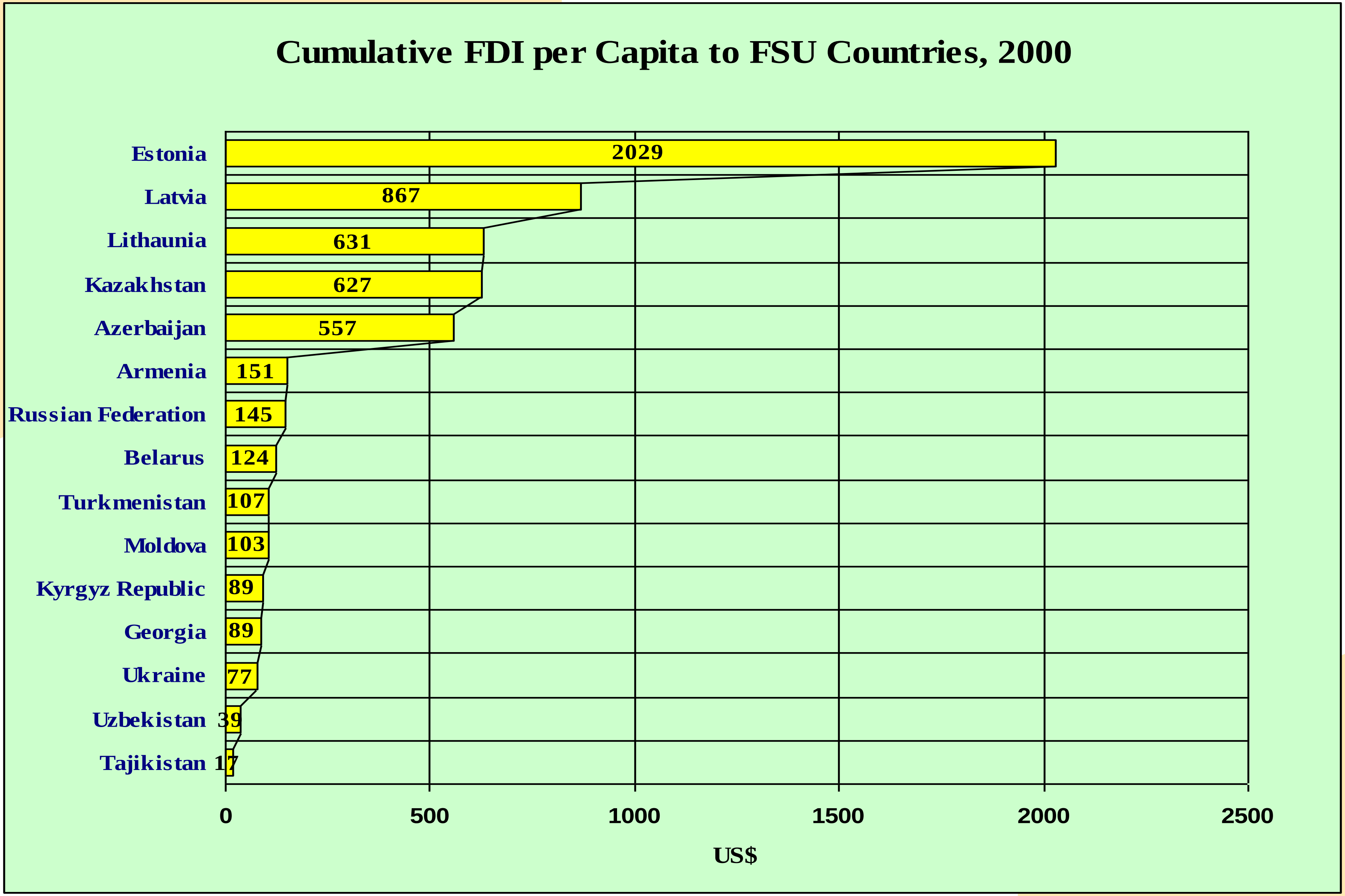
| | 1984-89 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|
| Total Net Int'l Private Capital | 12 | 141 | 189 | 224 | 126 | 45 | 71 | 32 |
| - Foreign Direct Investment | 13 | 81 | 97 | 120 | 145 | 149 | 153 | 146 |
| - Portfolio Flows | 4 | 110 | 43 | 85 | 43 | 24 | 54 | 58 |
| - Commercial Bank Loans | -5 | -50 | 50 | 19 | -62 | -127 | -136 | -172 |
| | | | | | | | | |
| Official Assistance | 26 | 4 | 12 | 1 | 23 | 45 | 3 | 1 |

Source: IMF, August 2001

# Foreign Direct Investments – Selected Countries (in millions of US Dollars)



# Cumulative FDI per Capita



# Key Drivers / Policy Action Groups

- ***The study pre-condition is macroeconomic stabilization, resulting from sound fiscal and monetary policies.***
- Study identified the following key government policy actions, which stimulated foreign direct investments in successful transition economies:

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**

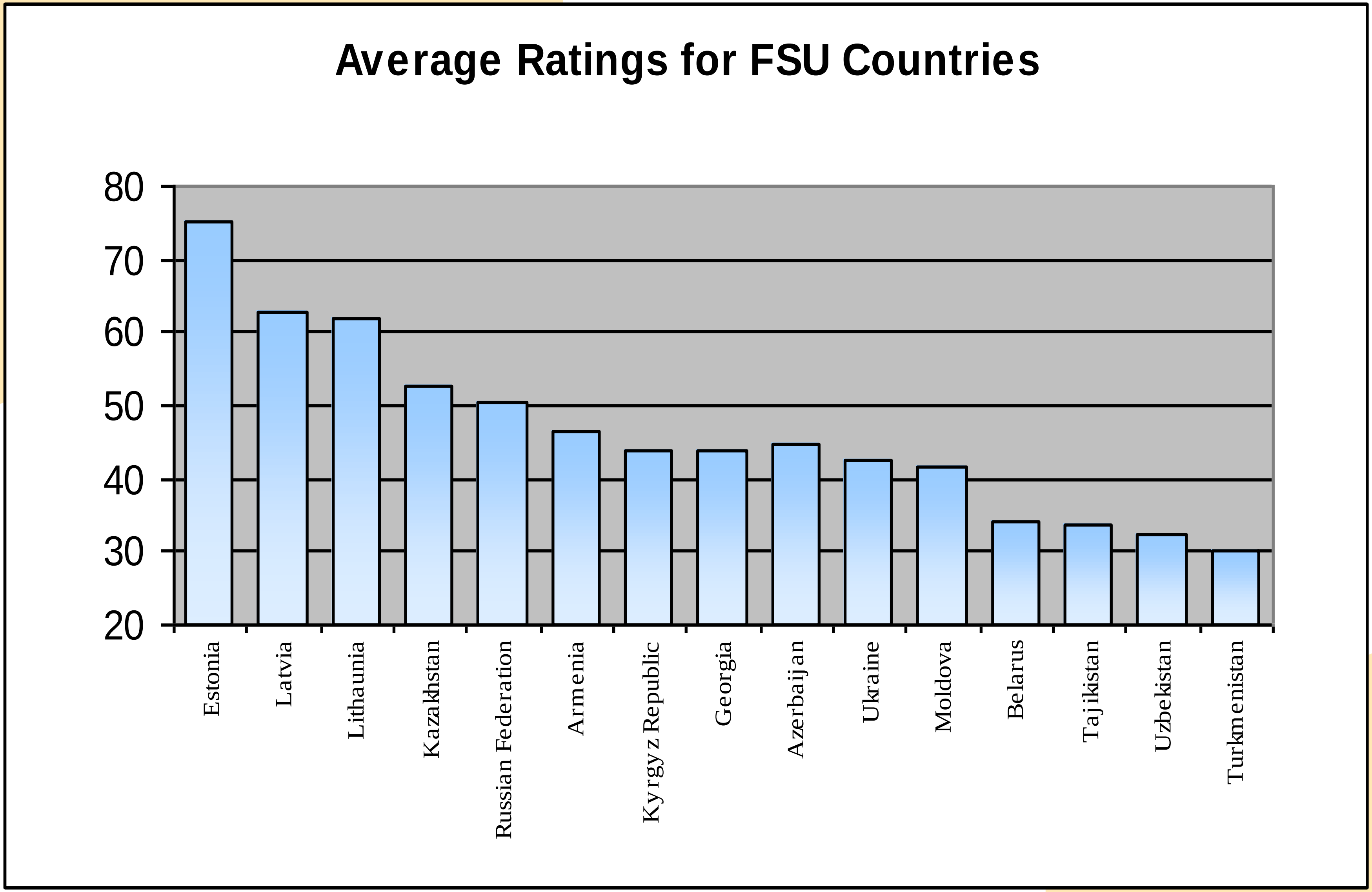
# Benchmarking Results

| UKRAINE | RUSSIA | POLAND | HUNGARY | CHILE | ARGENTINA |
|---|---|---|---|---|---|
| **Business Liberalization Score** | | | | | |
| 18 | 49 | 87 | 80 | 89 | 62 |
| **Legal Environment Score** | | | | | |
| 17 | 62 | 99 | 93 | 89 | 65 |
| **Financial Sector Score** | | | | | |
| 10 | 39 | 62 | 68 | 74 | 39 |
| **Governance and Privatization Score** | | | | | |
| 29 | 30 | 89 | 82 | 80 | 65 |

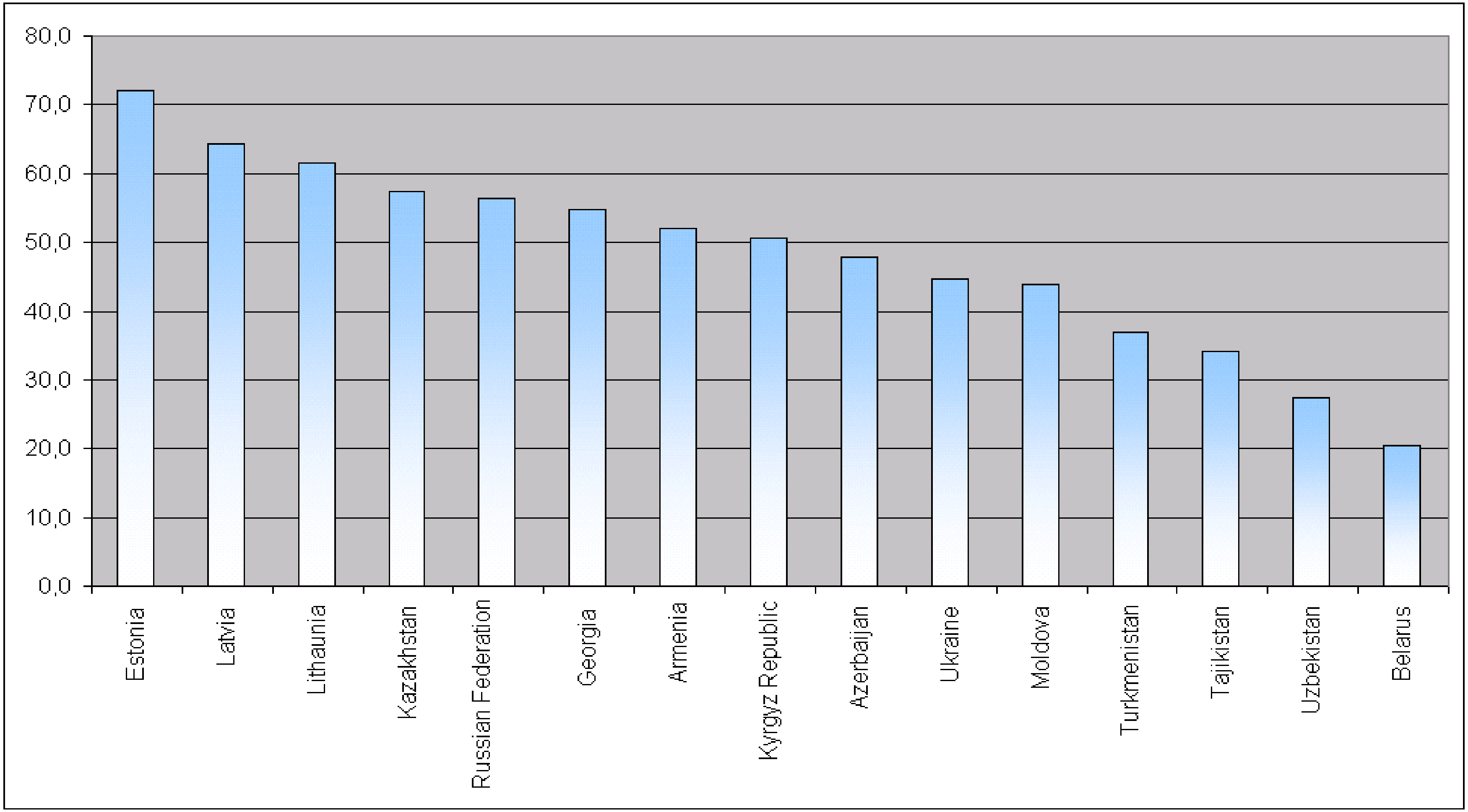
# Benchmarking Results

| | UKRAINE | RUSSIA | POLAND | HUNGARY | CHILE | ARGENTINA |
|---|---|---|---|---|---|---|
| **Political Risk Score** | 65 | 49 | 83 | 82 | 71 | 75 |
| **International Capital Controls & Foreign Trade Score** | 63 | 45 | 78 | 79 | 84 | 69 |
| **Corruption Score** | 15 | 21 | 41 | 52 | 74 | 35 |
| **Governmental Promotional Effort Score** | 20 | 30 | 80 | 100 | 90 | 75 |
| **Tax and Investment Incentives Score** | 31 | 48 | 78 | 82 | 63 | 70 |

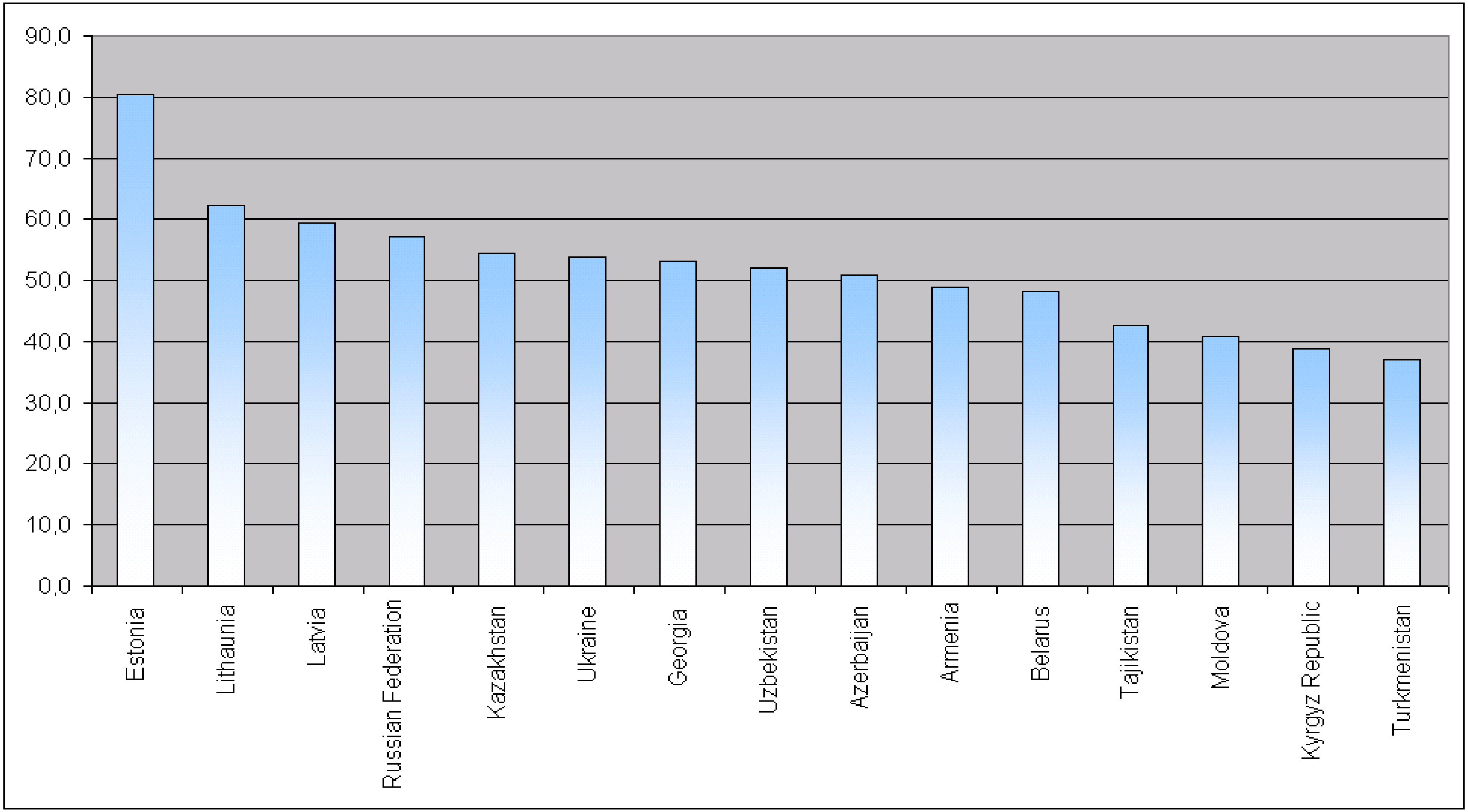
# IPCTF Ratings Reveal Major Policy Differences



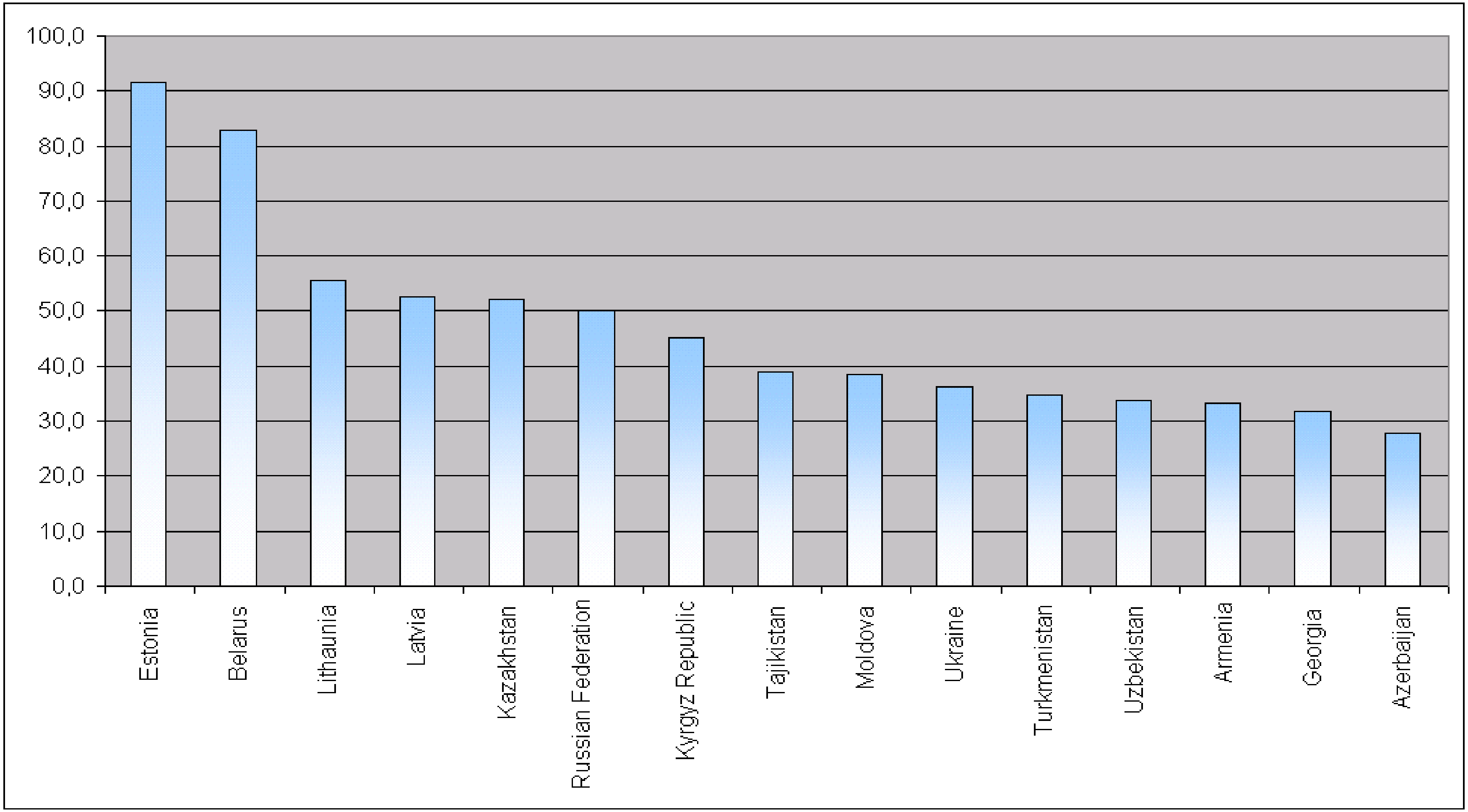
# IPCTF Ratings: Business Liberalization



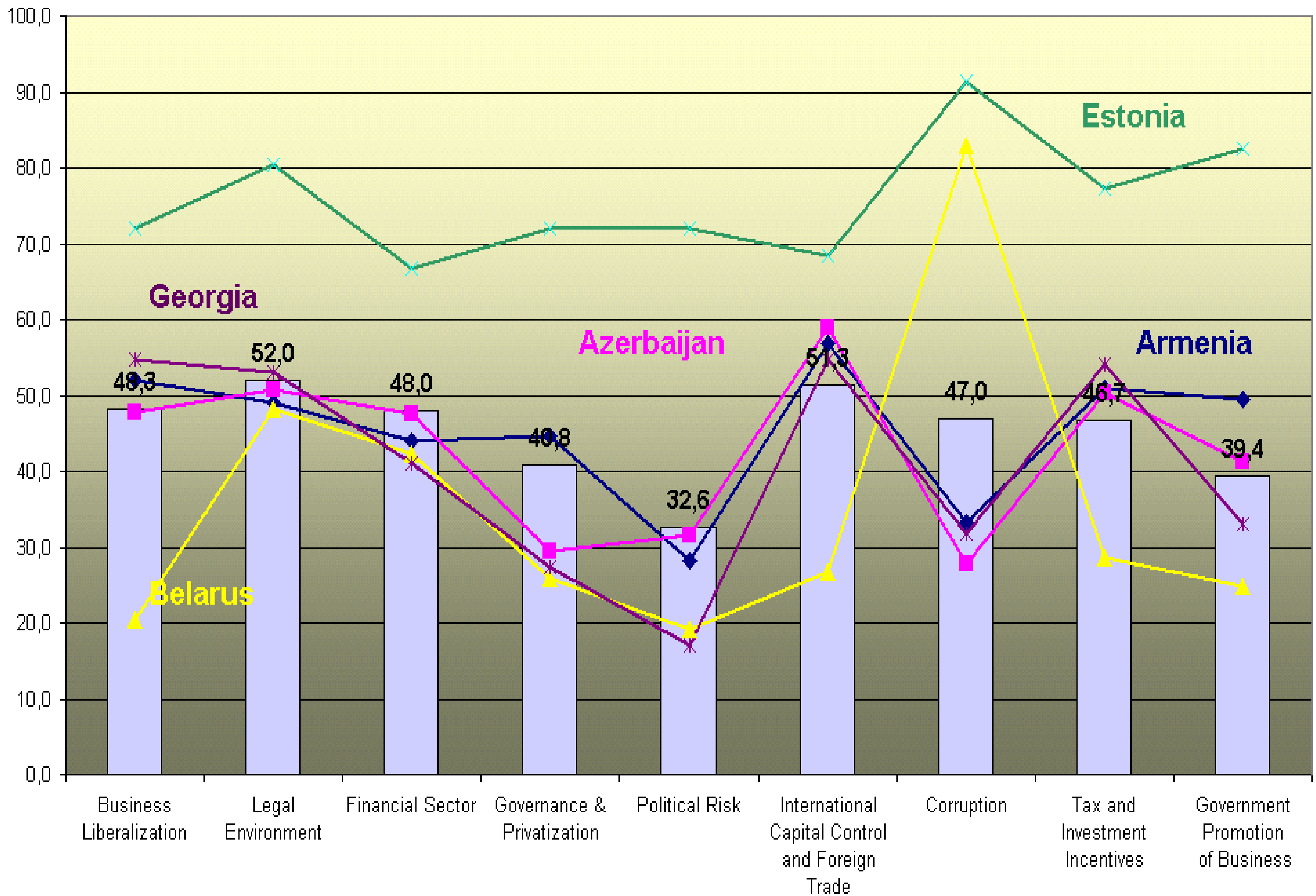
# IPCTF Ratings:
## Legal Environment



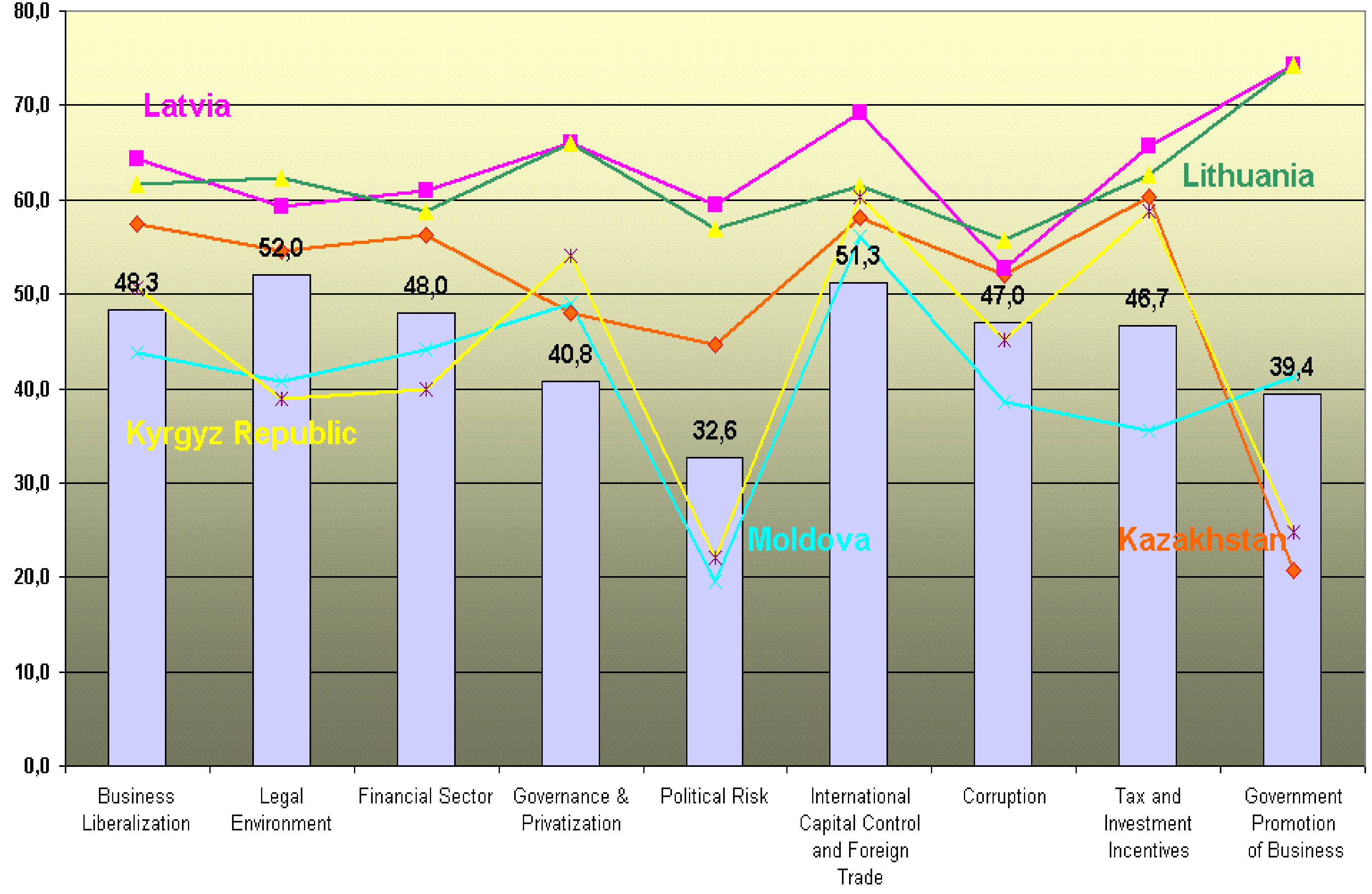
# IPCTF Ratings: Corruption



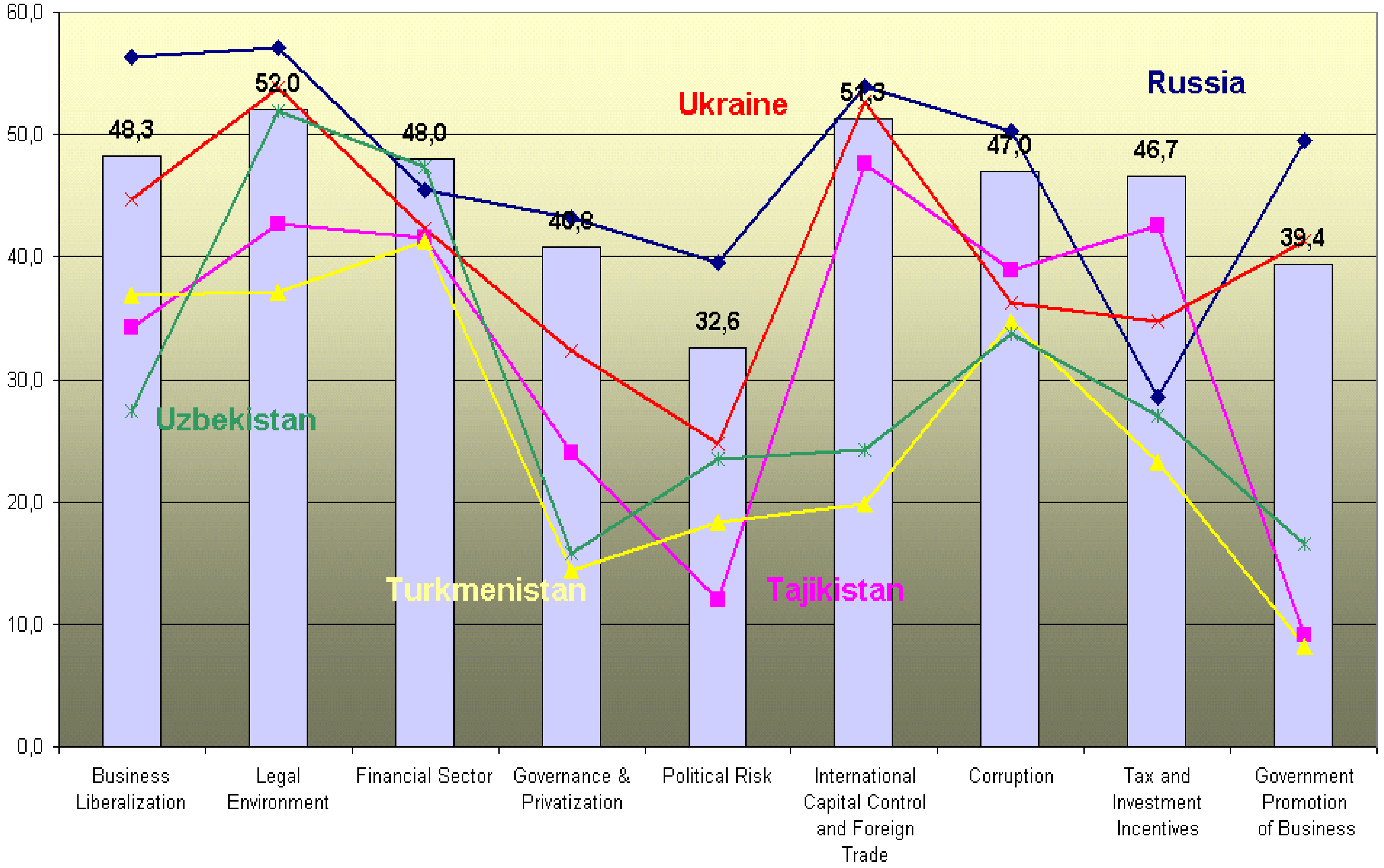
# Benchmarking Analysis for FSU Countries, 2000-2001



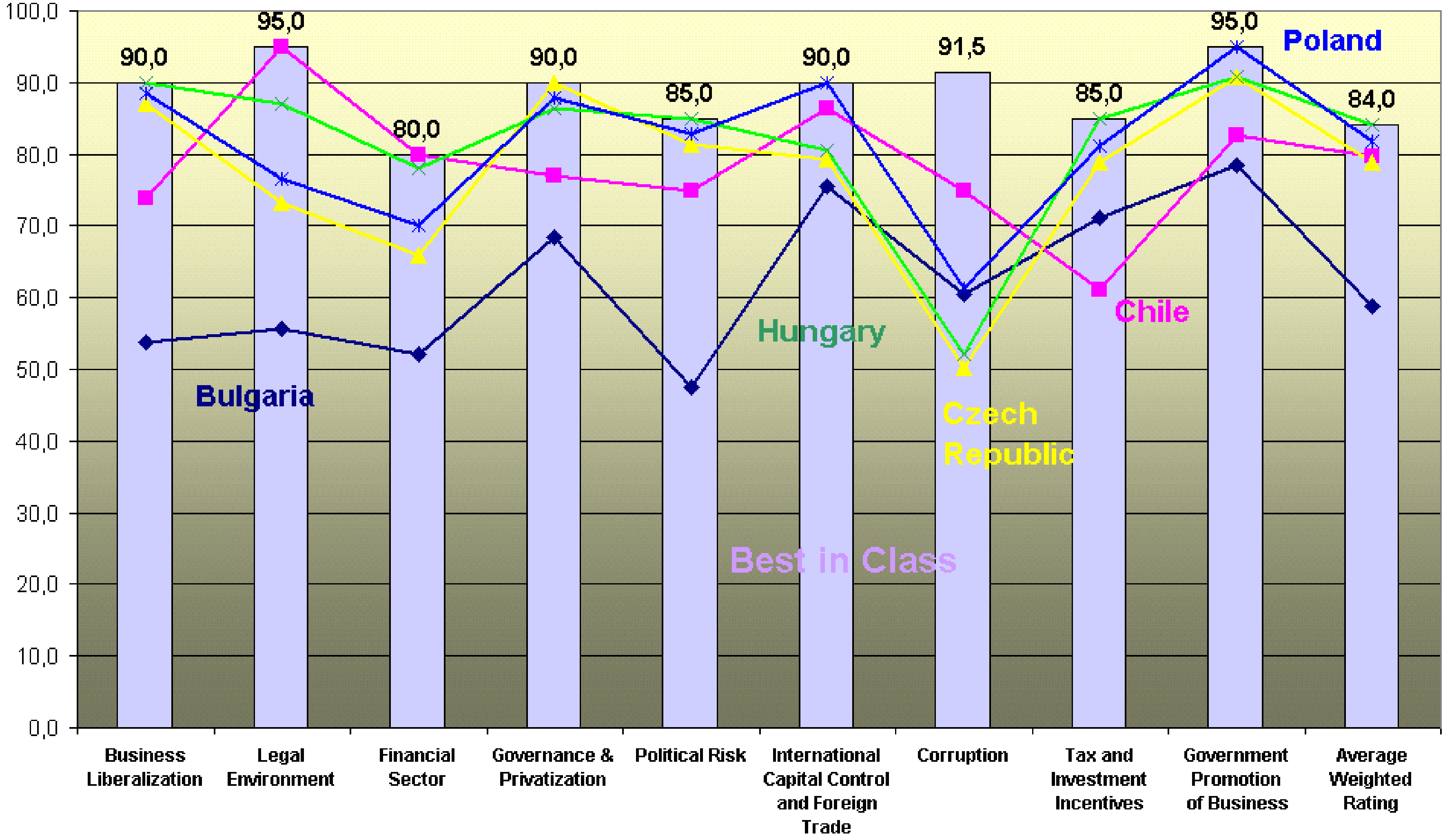
# Benchmarking Analysis for FSU Countries, 2000-2001 (continued)



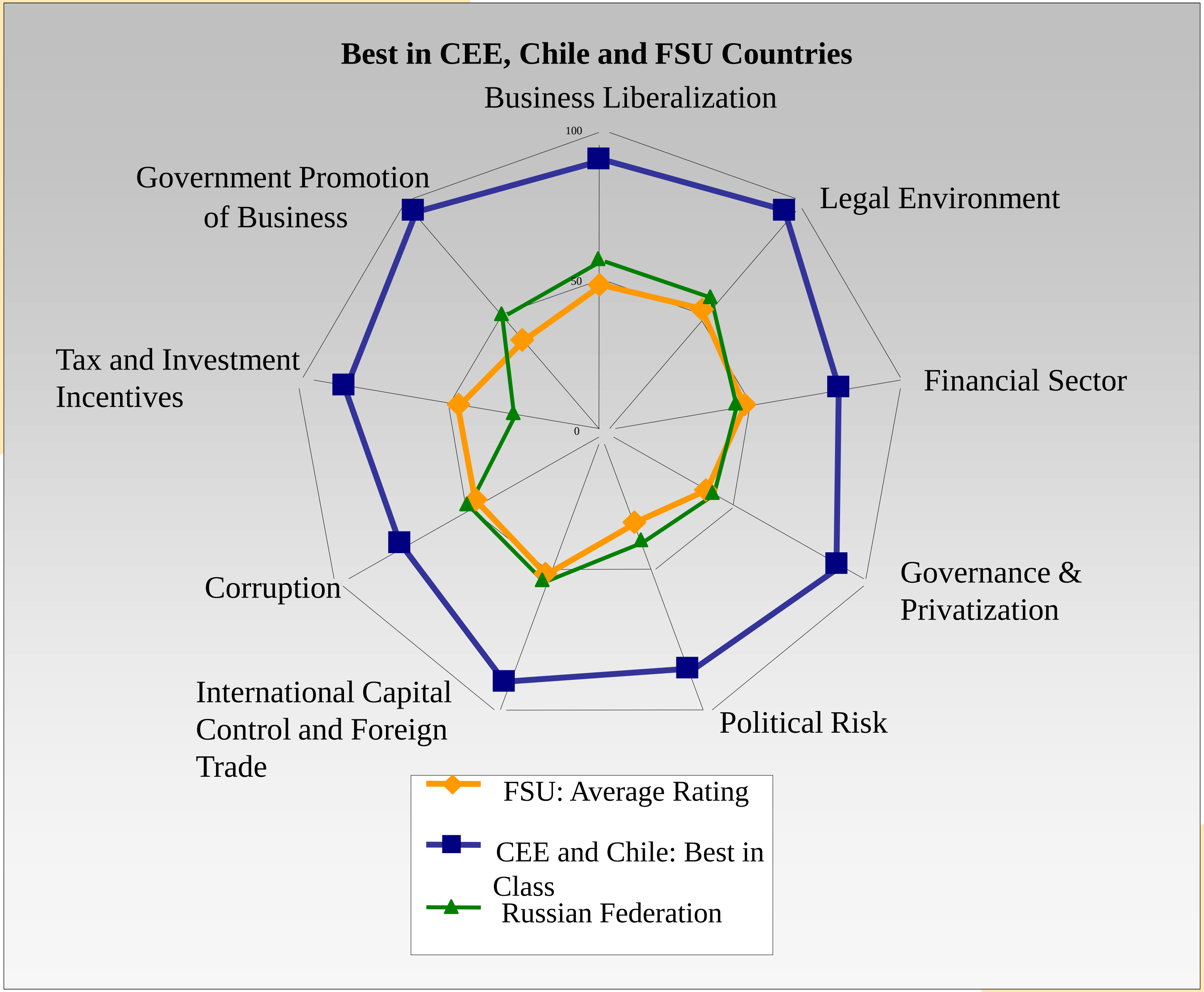
# Benchmarking Analysis for FSU Countries, 2000-2001 (continued)



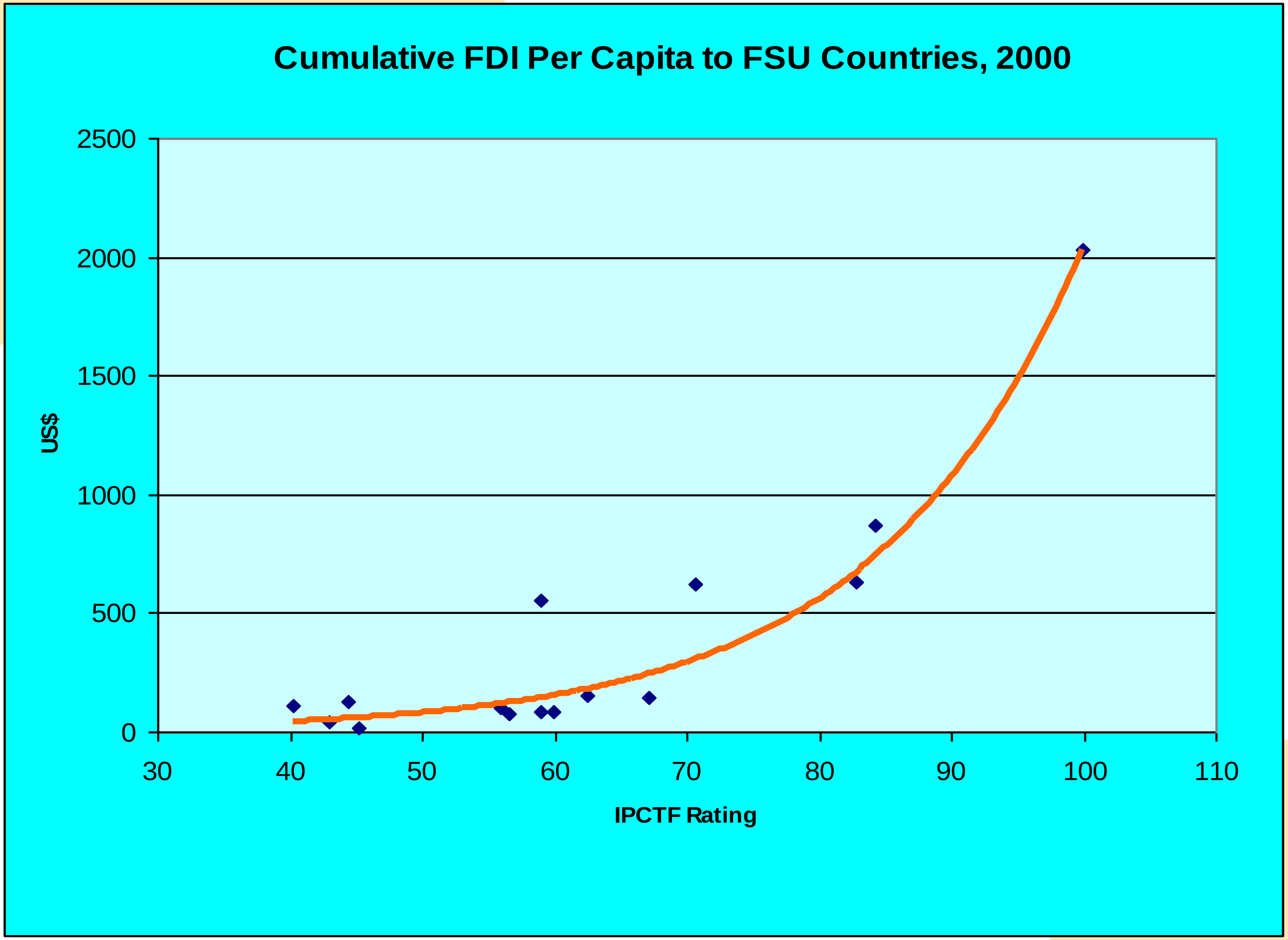
# Benchmarking Analysis for CE Countries and Chile, 2000-2001



# IPCTF NONAGON

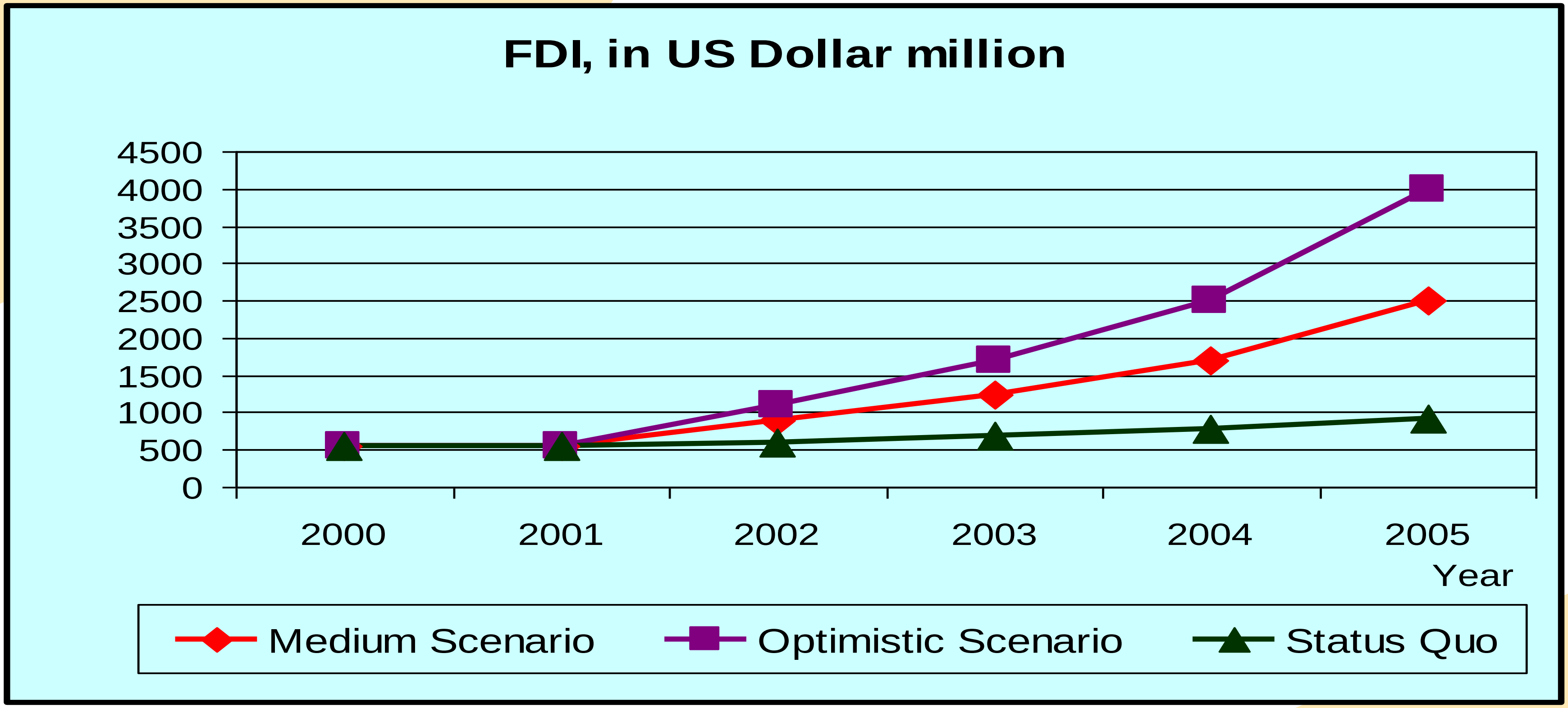


# Relationship between FDI and Policy Ratings



# FDI For Ukraine- Possible Scenarios

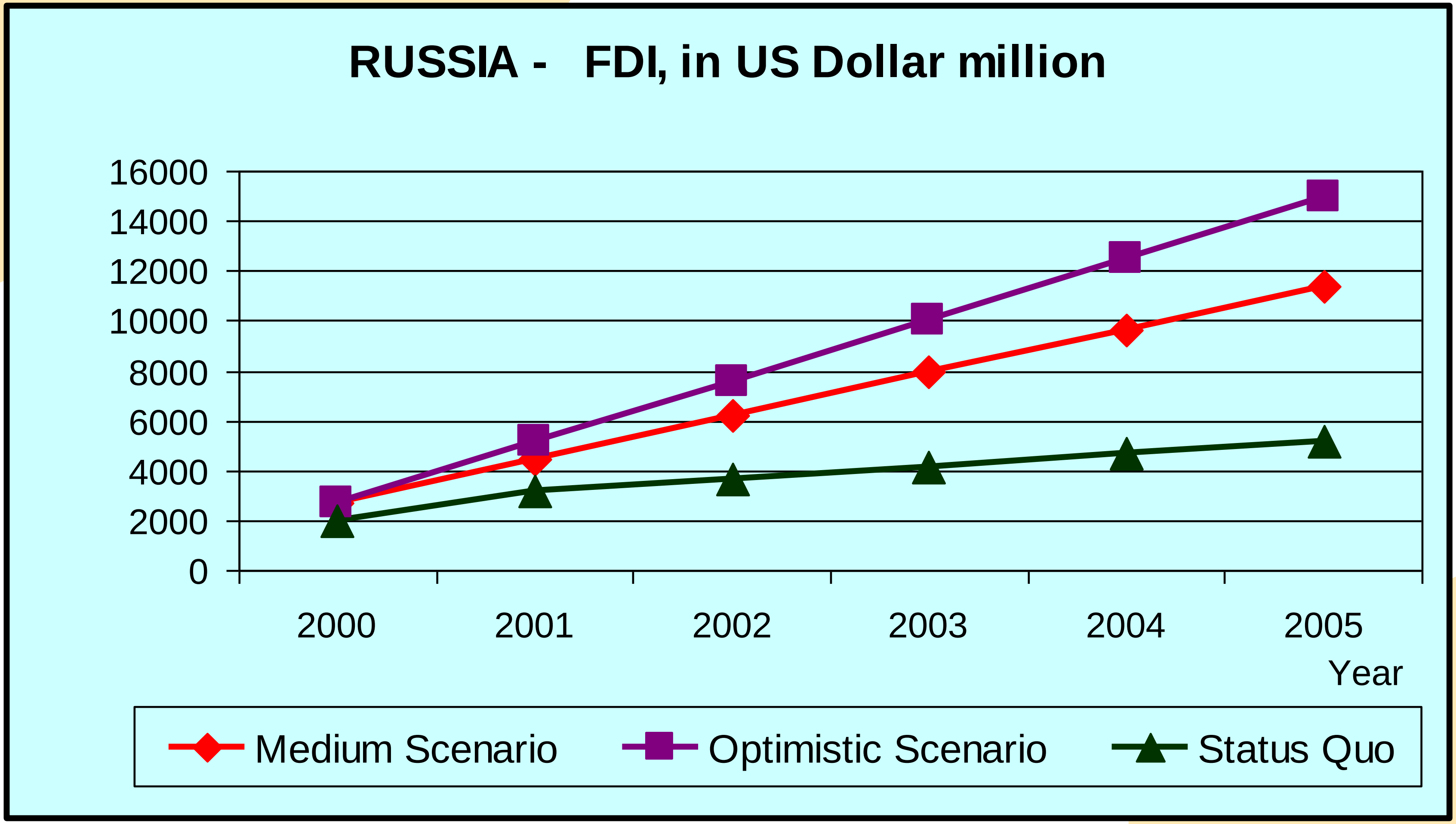
- Ukraine's government policies will determine the FDI flows over the next 15 years (5 years shown)




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

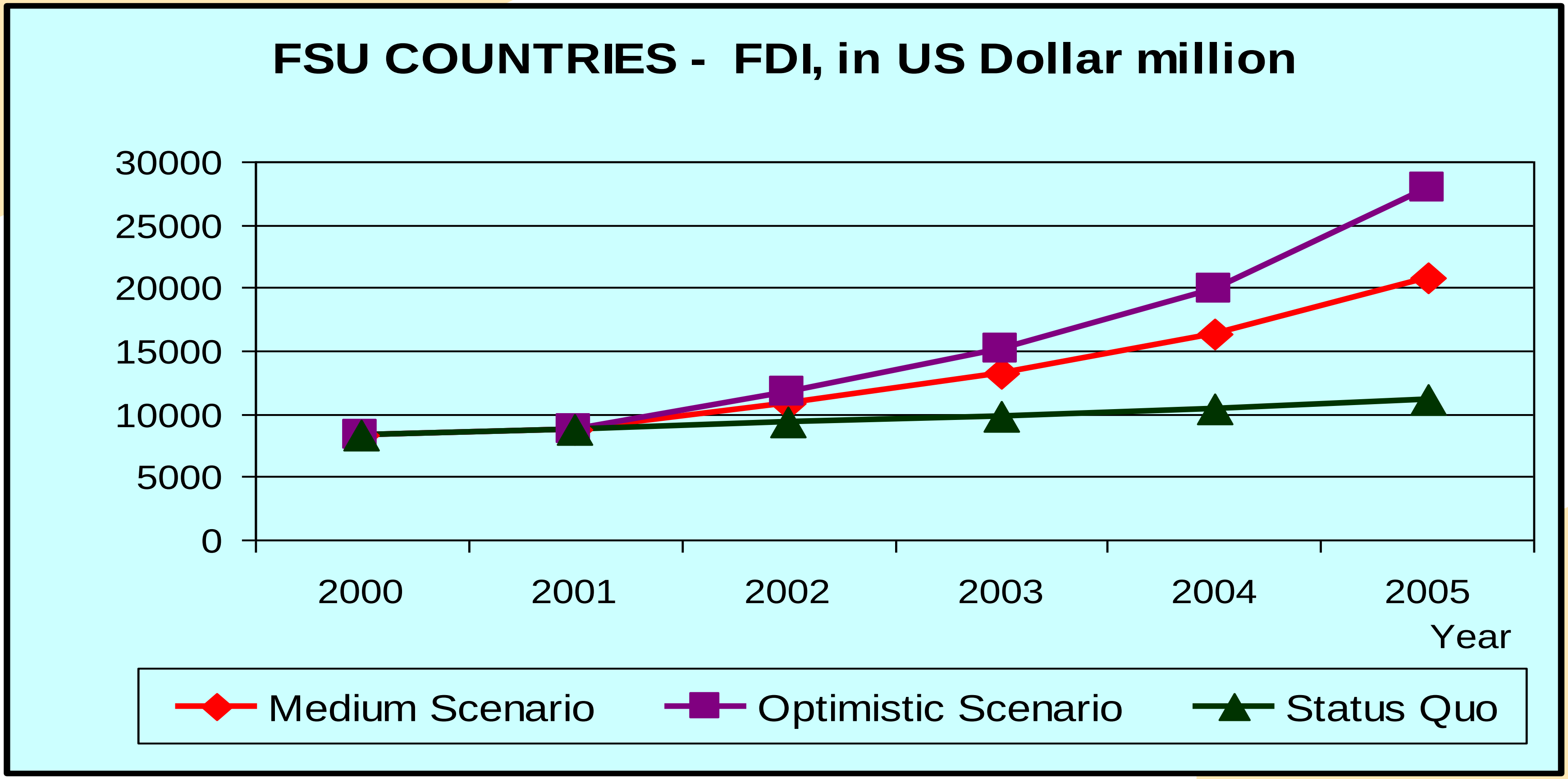
# FDI For Russia- Possible Scenarios

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



# FDI For FSU- Possible Scenarios

- Government policies in the FSU will determine the FDI flows over the next 15 years (5 years shown) as follows:



# Conclusions for Russia, Ukraine and FSU

- **With continuation of current policies**, FDI flows will increase only slightly from its current levels, reaching in 2005 $5.0 billion per year for Russia, $1.0 billion per year for Ukraine and $11 billion for all FSU countries.
- **Under a middle scenario**, with policy actions to reduce in five years 50% of the policy level differential with the Best-in-Class, by 2005 Russia could increase annual FDI to about $11.0 billion per year, Ukraine to $2.5 billion per year by 2005, and all FSU countries to $21 billion.
- **Under a more aggressive scenario**, with stronger policy actions to reduce in five years 80% of the policy level differential with the Best-in-Class, the level of foreign direct investments could increase by 2005 to $15.0 billion per year for Russia, $4.0 billion per year for Ukraine, and $28 billion for all FSU countries.

# Three Alternatives

- **Standoff** – current state of affairs. Developed countries enjoy relative stability and prosperity, but attempt to isolate their economies. Developing countries struggle to develop; but continue to be immersed in poverty, inequality, instability, and envy
- **Payoff** – wealth redistribution idea on a global scale. Substantial increases in foreign aid to avert future troubles in the world.
- **Tradeoff** –Jointly apply best practices to manage change in the developing countries. On one hand, developed countries provide know-how, better access to their markets, foreign direct investments, and precisely targeted aid. On the other hand, developing countries fully implement agreed upon necessary changes to make the business environment more attractive.

# IPCTF Framework – A Tool for Action

- A generic prescription for government policies based on benchmarking and best practices definition
- Low correlation between FDI flows and “natural characteristics” (e.g., location, size, resources, etc.)
- High correlation between government policies and FDI flows
- Private Capital likes Uniformity and Business Standards
- Measuring economic impact of government policies based on the gap between a given country and the best in class in each of the nine government policy areas
- Econometric model of a transition economy predicting FDI flows based on government policies
- Priorities for 9 points may be different in different countries but all will need to be addressed to attract stable flows of FDI
- IPCTF Framework provides a **comprehensive tool** for building consensus and developing an **Action Plan** for **any transition economy**

# Financial Assistance to FSU Countries

- Must be focused on Economic Growth through the development of private enterprises.
- Minimize government-to-government money transfers and blind pools of money
- The use of proceeds is just as important as the conditionality of lending
- Reduce adjustment lending and budget deficit financing
- Maximize equity investments in place of debt
- Leverage private capital investments with financial assistance dollars
- Structure financial assistance as “private equity funds” managed by money managers from private sector

# BLEYZER INITIATIVE

- Refocus multilateral and bilateral assistance to FSU countries on the creation of market economies and stronger private sector
- Use IPCTF framework to create capital-friendly environment in the FSU countries and attract private equity capital
- Focus most financial assistance on creating private businesses – SMEs and conditions for large multinationals operations in the FSU countries
- Leverage private capital with donor's money
- Implement comprehensive coordinated assistance program to the FSU countries: use donor capital to create the environment, which attracts private capital

# BLEYZER INITIATIVE

## Action Plan

- Convince US and EU governments at the most senior levels of the need to ***actively*** support the creation of market economy and democracy in the FSU countries to sustain economic growth
- Build an alliance of developed countries to promote the market-economy-focused program in FSU countries and later in Africa, Asia and other developing countries to achieve stability and improved security in the World
- Use IPCTF framework as broad conditionality for all financial assistance to the developing countries
- Work with the FSU countries' governments to create specific Action Plans for each country using IPCTF framework
- Create a series of satellite private equity funds in the FSU countries to advance Action Plans implementation (later in other countries)
- Publicize the program in the Western press to attract private capital