SigmaBleyzer

Where Opportunities Emerge.

International Private Capital Task Force

Benchmarking and Statistical Study

December 7, 2000

OUTLINE

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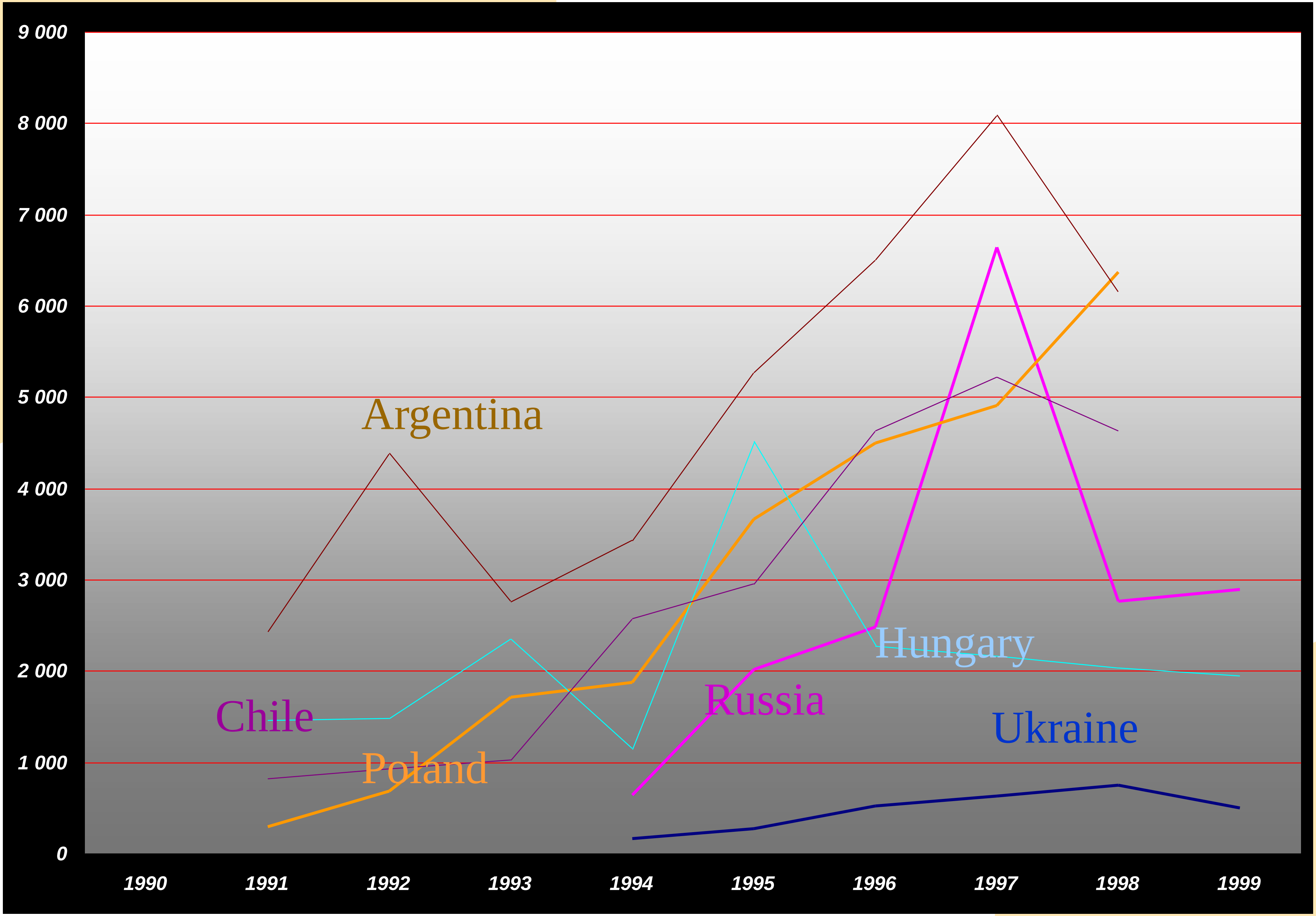
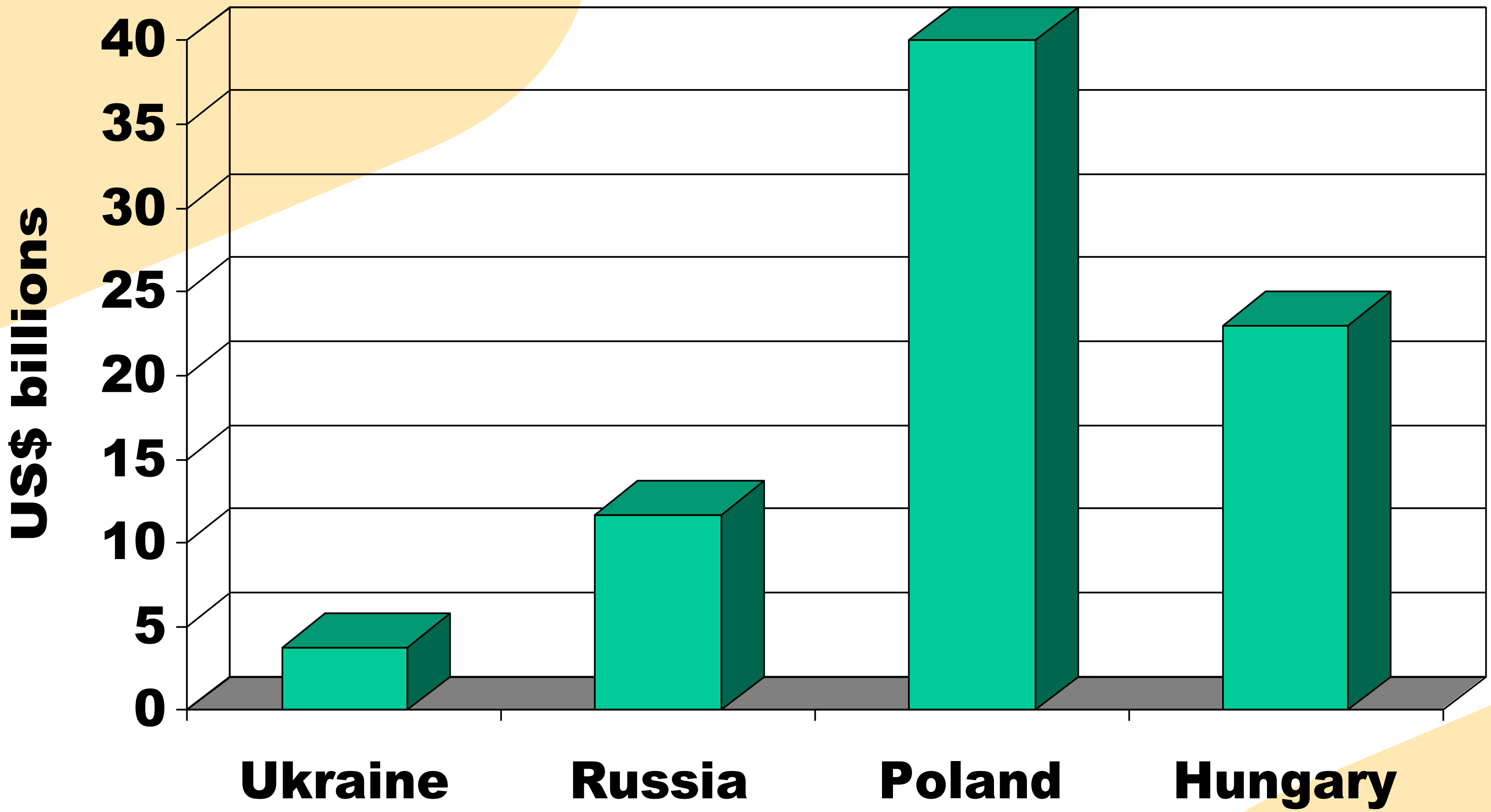
I. Introduction

- Official international lending is necessary to prevent future financial instability.
- But it will not provide sufficient financing for sustainable long term growth.
- The country needs now to attract international private capital.

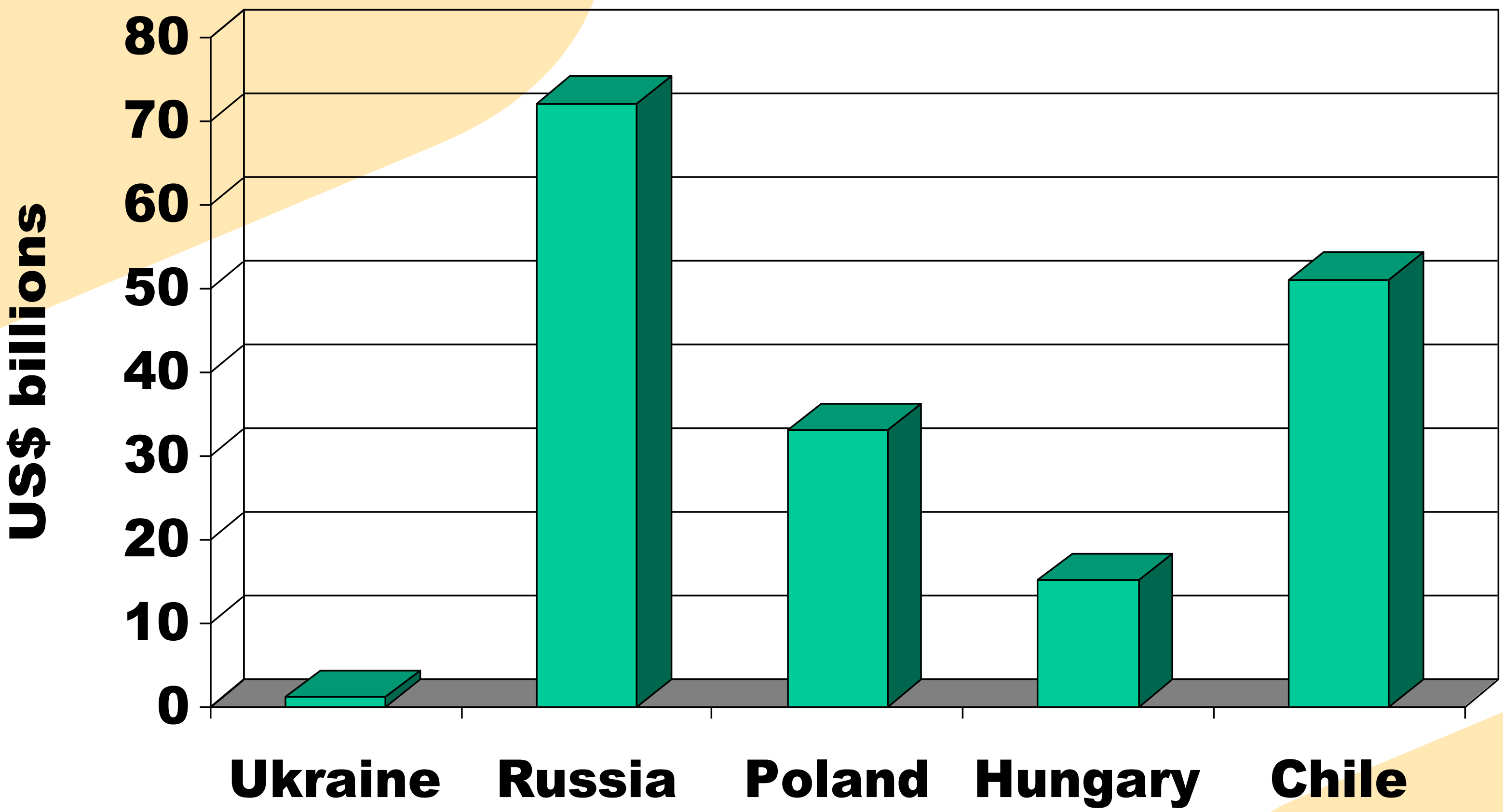
Foreign Direct Investments – Selected Countries



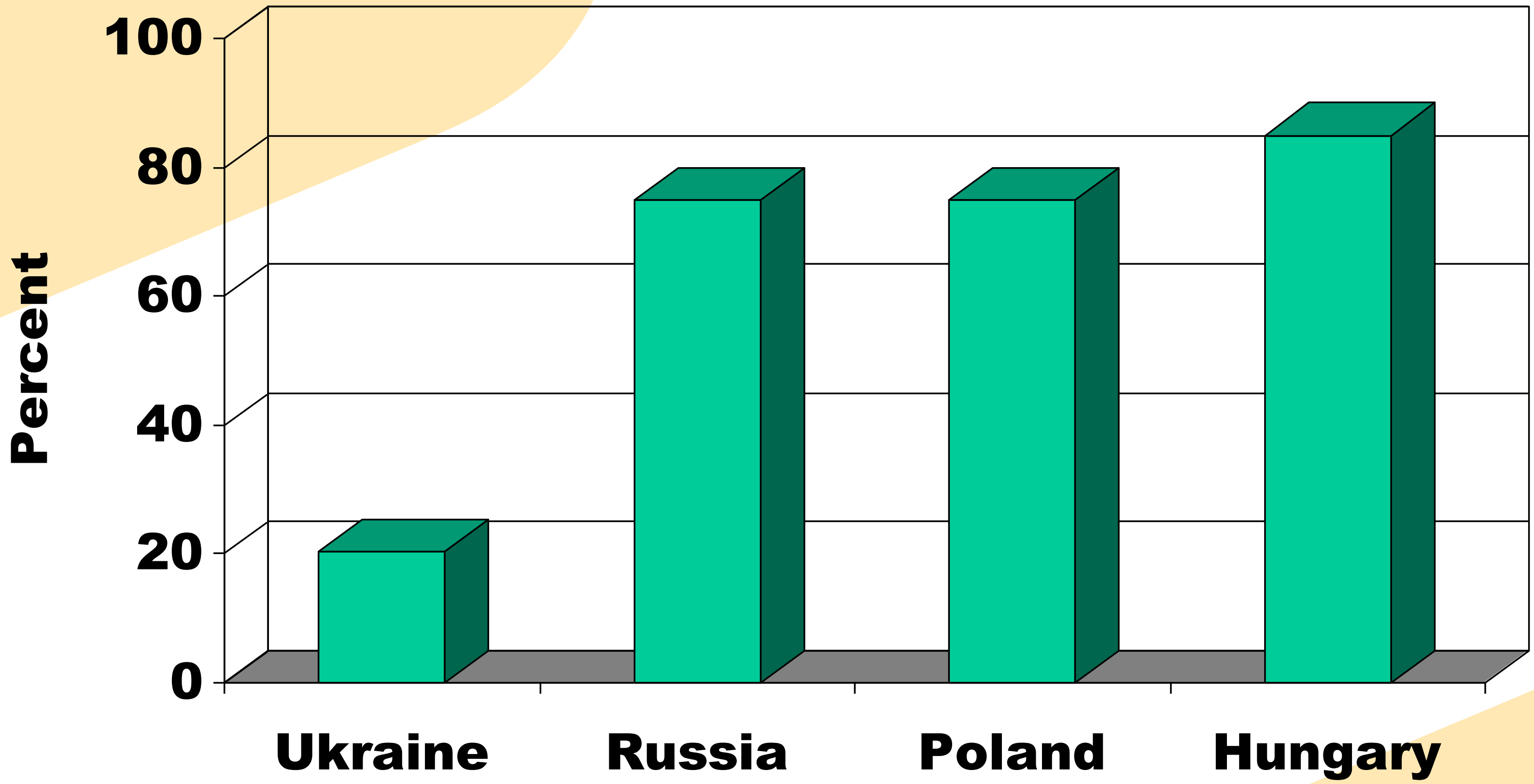
Cumulative FDI inflow



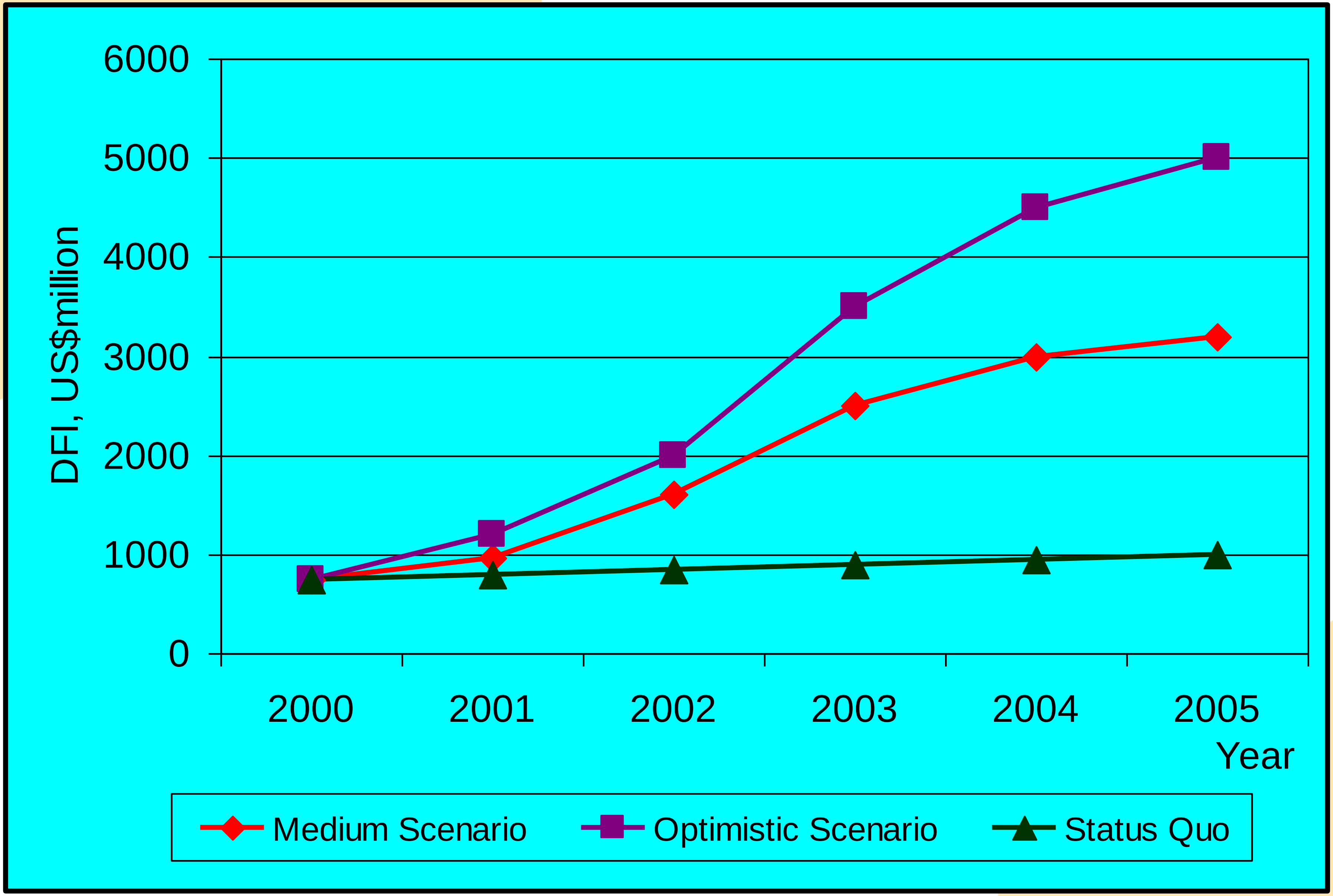
Equity Market Value



Private Sector Contribution to GDP 1999



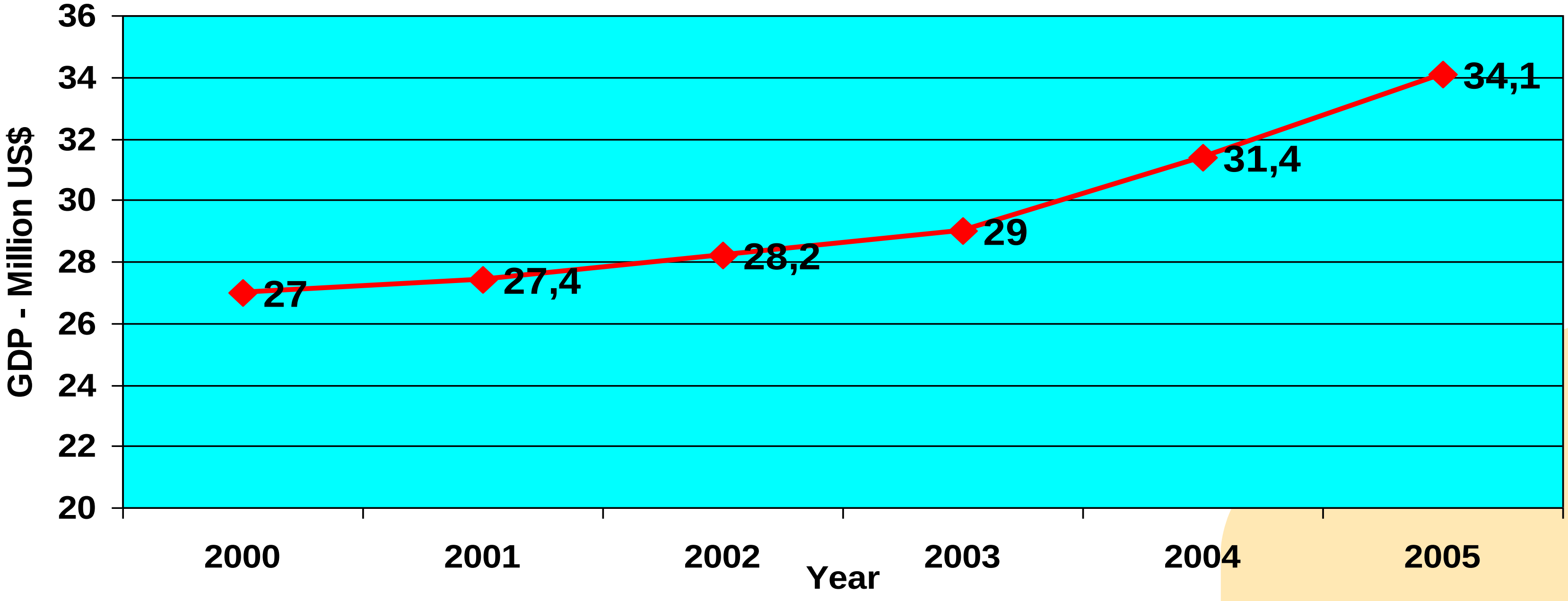
FDI For Ukraine- Possible Scenarios



Effect of DFI on GDP Growth

Foreign Investments will have a multiplier effect in GDP growth:

- An Incremental Capital Output Ratio (ICOR) of 4.0 is feasible in Ukraine.
- Under the Middle Scenario, incremental Direct Foreign Investments would generate the following GDP figures, which represent a GDP growth rate of 4.8% per annum:



II. Int’l Private Capital Task Force

- SigmaBleyzer agreed to organize a Task Force to identify concrete policy actions to attract foreign capital.
- The Task Force includes:
  - the heads of the largest foreign private companies in Ukraine,
  - representatives of multilateral and bilateral agencies,
  - Economic NGOs, and
  - Government officials.
- The Task Force agreed to the execution of a Benchmarking and Statistical Study by the Thunderbird Corporate Management Group, one of the best management schools in the USA.
- The study includes a Decision and Risk Analysis Model based on the experiences of many other countries.

Study Overview

- Objective: To analyze and understand the imperatives driving capital inflows in selected countries and develop an appropriate model for Ukraine
- Approach: The focus of the study is predominantly "strategic" by way of applying lessons learnt in benchmarked countries, rather than "analytical".

Methodology

- Two parallel analyses:
  - Benchmarking Analysis
  - Statistical Analysis
- The lessons from the benchmarking analysis were ratified by statistical analysis and served as inputs for the mathematical & spreadsheet model

III. Benchmarking Analysis

Benchmarked Countries

1. Concrete economic policy actions that affect foreign investments were assessed in the following five countries, and compared to Ukraine:
    - Argentina
    - Chile
    - Hungary
    - Poland
    - Russia
2. The level of foreign investments were then correlated to these policy actions to establish a relationship between the two.

Factors Affecting Business Climate

The study identify the following key “policy actions” or “drivers” that generate foreign investments:

1. Liberalize Business Activities
2. Provide a Stable and Predictable Legal Environment
3. Facilitate Financing of Businesses by the Financial Sector
4. Enhance Corporate Governance & Accelerate Privatization
5. Minimize Political Risks
6. Remove International Capital & Foreign Trade Restrictions
7. Deal with Corruption Perception
8. Expand Government Business Promotion
9. Rationalize Taxes & Investment Incentives

Benchmarking Methodology

- Scores were assigned to individual line items in all countries, based on our own research and research done by others.
- To minimize subjectivity in assigning values to the stated factors, we only reviewed research carried out by prestigious institutions.
- Our original research was conducted in benchmarked countries to further ratify and validate the accuracy of the estimations.
- Data was aggregated from multiple sources to eliminate evaluator bias.
- Values (Ratings, scores etc.) for individual line items were normalized using a scale of 0.00 to 5.00 with higher scores indicating a better item score.

1. *LIBERALIZE BUSINESS ACTIVITIES*

- Regulation/Deregulation of Businesses
- Bureaucracy Climate
- Administrative Reforms
- Encouragement to Entrepreneurship (Proxy: Number of SMEs)
- Foreign Trade (Export/Import) Liberalization
- Lack of Shadow Economy (Proxy: Graft)
- Land Reforms and Ownership(Proxy:Percentage of land in private hands)

1. BUSINESS ACTIVITIES SCORE (0-35)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
6.3	14.7	26.2	24.0	26.8	18.6

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2. PROVIDE A STABLE AND PREDICTABLE LEGAL ENVIRONMENT

– Legal Reforms (Proxy: Rule of Law)
– Contract Enforcement
– Bankruptcy Laws

2. LEGAL ENVIRONMENT SCORE (0-10)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
1.7	6.2	9.9	9.3	8.9	6.5

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3. *FACILITATE BUSINESS FINANCING BY THE FINANCIAL SECTOR*

- Banking Reforms (Proxy: Liberalization in Banking Industry)
- Security Markets' Role in Financial Market Development (Proxy: Market Capitalization/GDP)
- Government as a Participant in Financial Markets
- Interrelating Different Aspects of Financial Markets (Proxy:Correlation between liberalization elements)
- Absence of Commodity Exchanges & Barter

3. FINANCIAL SECTOR SCORE (0-25)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
2.7	9.8	15.7	17.1	18.6	9.7

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4. ENHANCE CORPORATE GOVERNANCE & ACCELERATE PRIVATIZATION

– Corporate Governance Issues
– Transparency (Proxy: Voice and Accountability)
– Internationally Accepted Audits and Accounts Implementation
– Privatization (Proxy:Private GDP/Public GDP)
– Large Scale Privatization
– Withdrawal of Subsidies to SOE

4. CORPORATE GOVERNANCE & PRIVATIZATION SCORE (0-30)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
8.6	8.9	26.5	24.6	23.9	19.4

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5. MINIMIZE POLITICAL RISKS

- This index is available under the International Country Risk Guide.
- Political Risk is comprised of the following risk indicators:
  - economic planning failures;
  - law and order tradition;
  - political terrorism;
  - lack of political leadership;
  - military in politics;
  - organized religion in politics;
  - Lack of political party development.
  - racial and nationality tensions;
  - external conflict;
  - civil war; and

5. POLITICAL RISK SCORE (0-100)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
65.0	49.0	83.0	82.0	71.0	75.0

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6. REMOVE INTERNATIONAL CAPITAL & FOREIGN TRADE RESTRICTIONS

- This index is developed by UNDP (International Business Climate).
- It is constituted by various risk sub-components such as:
  - Financial Transfer Risk
  - Direct Investment Risk
  - Export Market Risk
- The final score is a mixture of:
  - restrictions on foreign equity,
  - restrictions on local operations,
  - taxation discrimination,
  - repatriation restrictions,
  - restrictions on foreign trade,
  - exchange controls,
  - tariff and non-tariff barriers,
  - investment restrictions etc.

6. INT'L CAPITAL CONTROLS & FOREIGN TRADE SCORE (0-100)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
63.0	45.0	79.0	79.0	84.0	69.0

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7. *DEAL WITH CORRUPTION PERCEPTION*

- This Index is developed by Transparency International.
- Its Corruption Perceptions Index (CPI) ranks 90 countries in terms of the degree to which corruption is perceived to exist among public officials and politicians.
- It is a composite index, drawing on 16 different polls and surveys from 8 independent institutions carried out among business people, the general public and country analysts.
- Scoresaare on a scale of 1 to 10 with higher scores indicating less corruption

7. CORRUPTION PERCEPTION SCORE (0-10)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
1.5	2.1	4.1	5.2	7.4	3.5

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8. EXPAND GOVERNMENT PROMOTIONAL EFFORTS

This index includes an assessment of promotion efforts, including:

- Number of Promotional Offices Overseas
- Number of Promotional Offices Within the Country
- Total Manpower for these Programs
- Total Annual Budget
- Qualitative Evaluation of the Programs

8. GOVERNMENT PROMOTIONAL EFFORT SCORE (0-100)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
20.0	30.0	80.0	100.0	90.0	75.0

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9. RATIONALIZE TAX & INVESTMENT INCENTIVES

This index includes an assessment of the following:

- Investment allowances
- Govt. provision of land
- Other government grants & subsidies
- Govt. supported low interest rates
- Reduced tariff for utilities
- Corporate income tax rates.
- Tax holidays.
- Reduced tax rates for special projects.
- Accelerated depreciation,

9. TAX & INVESTMENT INCENTIVES SCORE (0-100)

UKRAINE	RUSSIA	POLAND	HUNGARY	CHILE	ARGENTINA
31	48	78	82	63	70

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IV. Statistical Analysis

- The scores on the nine factors presented above were statistically tested against the capital inflows in 23 countries to arrive at a prescriptive diagnosis.
- The objective of these tests was to determine the ‘relationship’ between capital inflows and actionable policy factors and attributes in these 23 countries.
- Tests ranged from simple correlation models to multiple regression techniques to structured equation modeling.
- FDI (Foreign Direct Investments) was used as a representative proxy for capital inflows.
- The relative weights of the nine factors as evidenced by the coefficients in the multiple regression results served as directional pointers to develop a predictive FDI model for Ukraine.

Countries in Statistical Study

Argentina
Bangladesh
Bulgaria
Chile
Colombia
Czech Republic
Egypt
Hungary
Indonesia
Kenya
Nigeria
Pakistan
Peru
Poland
Romania
Russia
South Africa
Sri Lanka
Thailand
Ukraine
Venezuela
Zambia
Zimbabwe

Multiple Regression Analysis - Coefficients

	Standardized Coefficients	t	Sig.	95% Confidence Interval for B	
	Beta			Lower Bound	Upper Bound
(Constant)		-2,071	0,059	-6,649	0,14
Govt Pol	1,778	2,859	0,013	0,008	0,061
Polit Risk	0,76	1,448	0,171	-0,012	0,059
Corrupt	0,422	1,213	0,247	-0,01	0,034
Cap/TF R	0,272	0,967	0,351	-0,02	0,053
Tax/Inv Inc	0,036	-0,165	0,872	-0,008	0,07

Multiple Regression Analysis - Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of Est.
1	0,715	0,511	0,323	0,350
Predictors: (Constant), Govt Pol, Tax/Inv Inc, Corrupt, Cap/FT Rest, Polit Risk				

Research Done by Others

- 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* validates the results from our own primary statistical tests, 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 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.

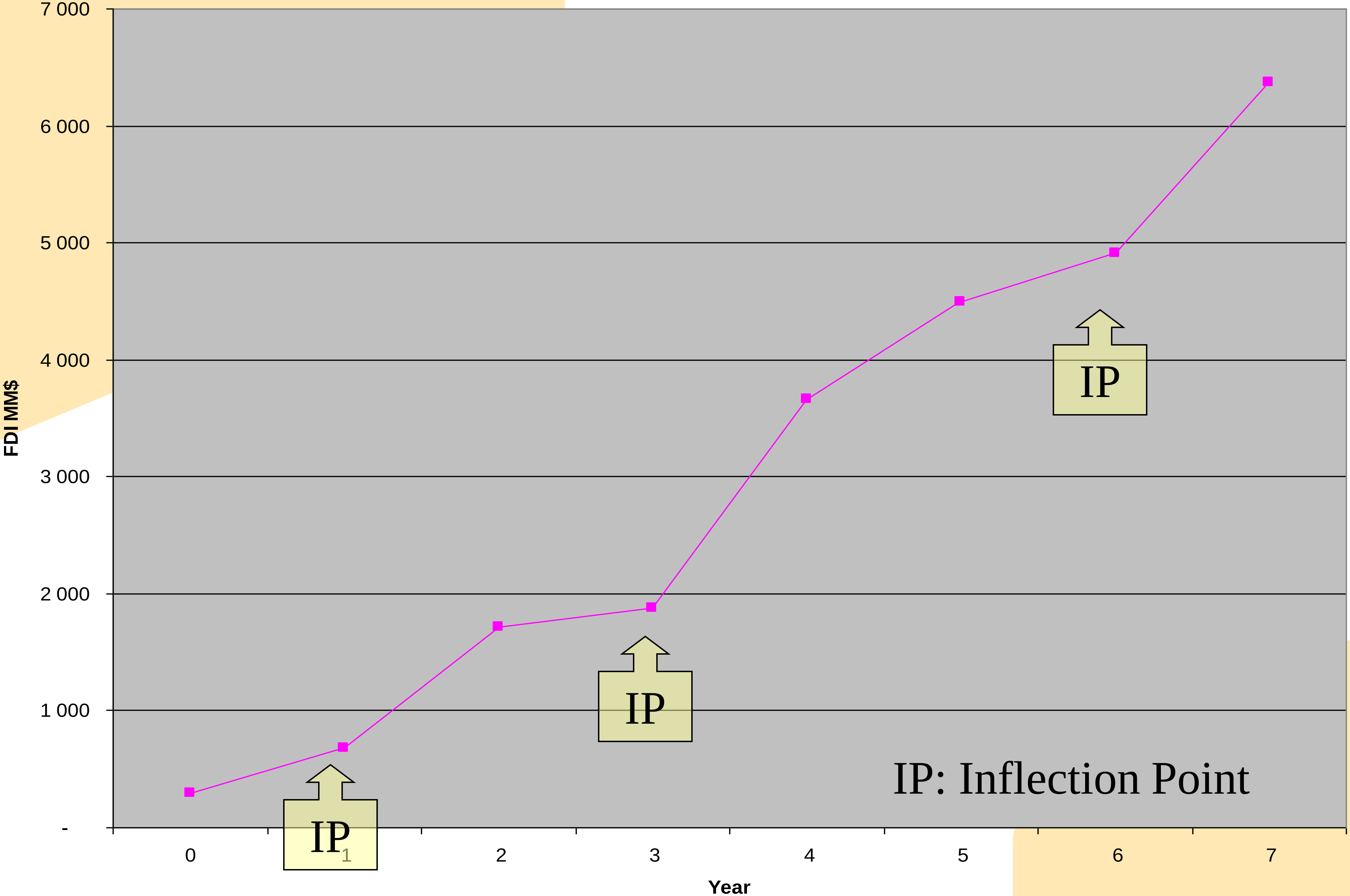
Morgan Stanley Model

	Standardized Coefficients	t
	Beta	
(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**	

V. Formula for Direct Foreign Investments

- The Benchmarking Analysis and the Statistical Analysis were used to construct a formula to explain flows of international capital based on policy actions.
- The coefficients of this formula were refined on the basis of their effects in Poland.
- Characteristics of Poland:
  - Continuously upward sloping FDI curve, with greatest percentage increase in FDI.
  - Proximity to Ukraine with comparable population.
  - First country to reach pre 1990 levels of production.
  - Stable macroeconomic conditions.
  - Sustainable growth in GDP, at 4-6% growth from 1993 to 2003.

Poland FDI Analysis



Formula Construction

- The Normalized Scores for the nine factors are “adjusted” to derive a formula for predicting FDI
- The adjustment is made on the basis of the results of the statistical regression tests and gleanings through primary research
- Relative weights (coefficients) are assigned to factor values to construct the formula
- Coefficient determination is made on the basis of the value of the said factor

Coefficient Determination

	< 65	65-69.9	70-80	>80
Cap/TF R	2	3	4	5

	<70	70-80	>80
Polit Risk	1	1,5	2

No. of Equations possible - 5760

	<	[illegible]	[illegible]	5	>75
Corrupt	1	3	10	15	20

	<35	35-39.9	40-44.9	45-64.9	65-75	>75
Govt Pol	7,5	8	10	30,58	40	53,7

	<33.33	33.34-49	50-83.33	>83.33
Tax/Inv In	2	4	6	8

	<25	25-39.9	40-65	>65
Prom Eff	1	4	6	8

Coefficient Determination

	< 65	65-69.9	70-80	>80
Cap/FT R	2	3	4	5

	<70	70-80	>80
Pol Rsk	1	1,5	2

	<20	20-29.9	30-49.9	50-75	>75
Corrup	1	3	10	15	20

	<35	35-39.9	40-44.9	45-64.9	65-75	>75
Govt Pol	7,5	8	10	30,58	40	53,7

	<33.33	33.34-49	50-83.33	>83.33
Tax/Inv Inc	2	4	6	8

	<25	25-39.9	40-65	>65
Prom Eff	1	4	6	8

Sample Formula

	Cap/TF R	Polit Rsk	Corrup	Govt Pol	Tax/In Inc	Prom Eff
(IF) Value	62	85	34	42	48	62
(THEN) Coefficient	2	2	10	10	4	6

Formula: 2(Cap/FT)+2(Pol Rk)+10(Corr)+10(Govt Pol)+4(Tax/Inv In)+6(Prom Eff)

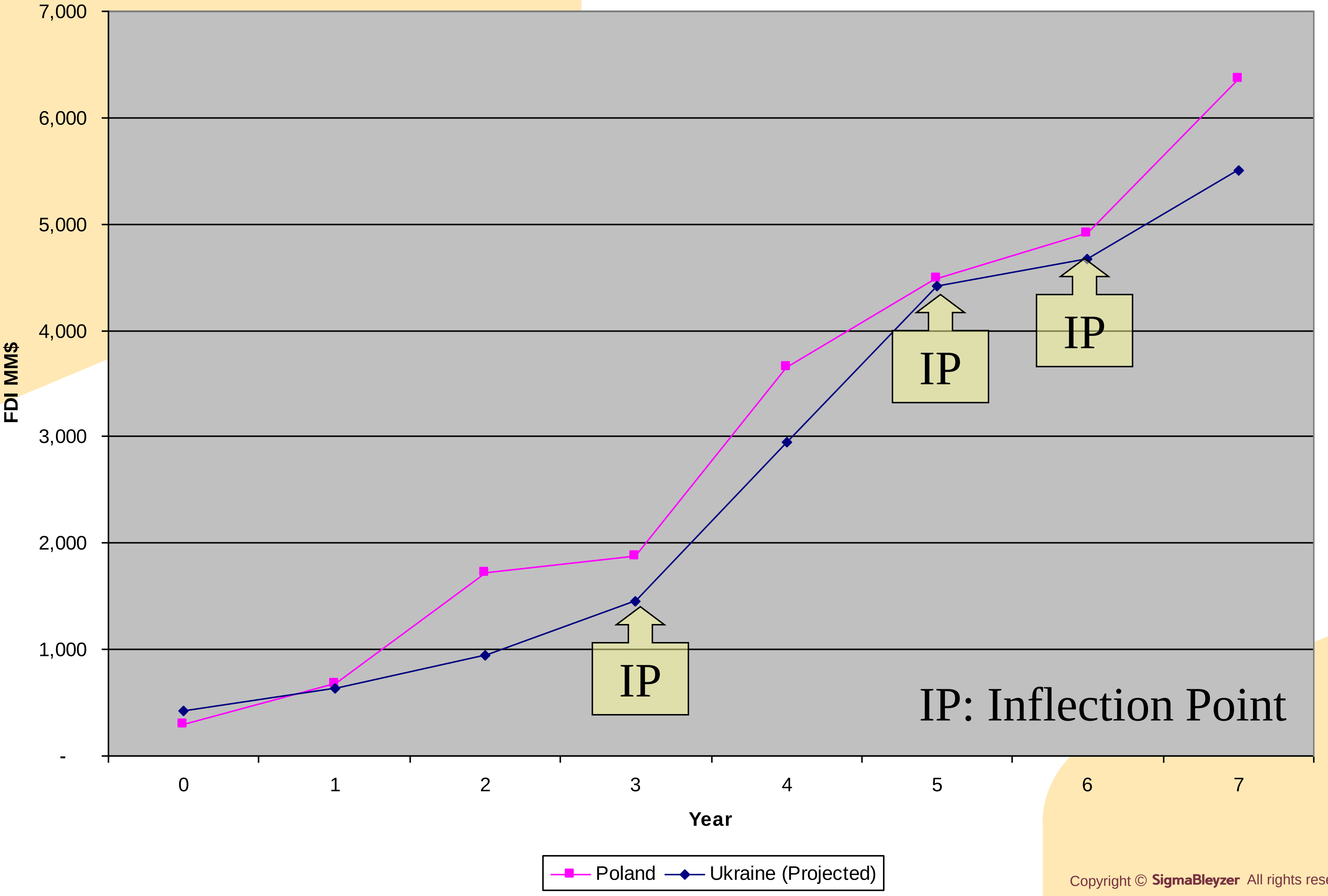
FDI Value (MM$) -	**1618**

Poland "Curve"

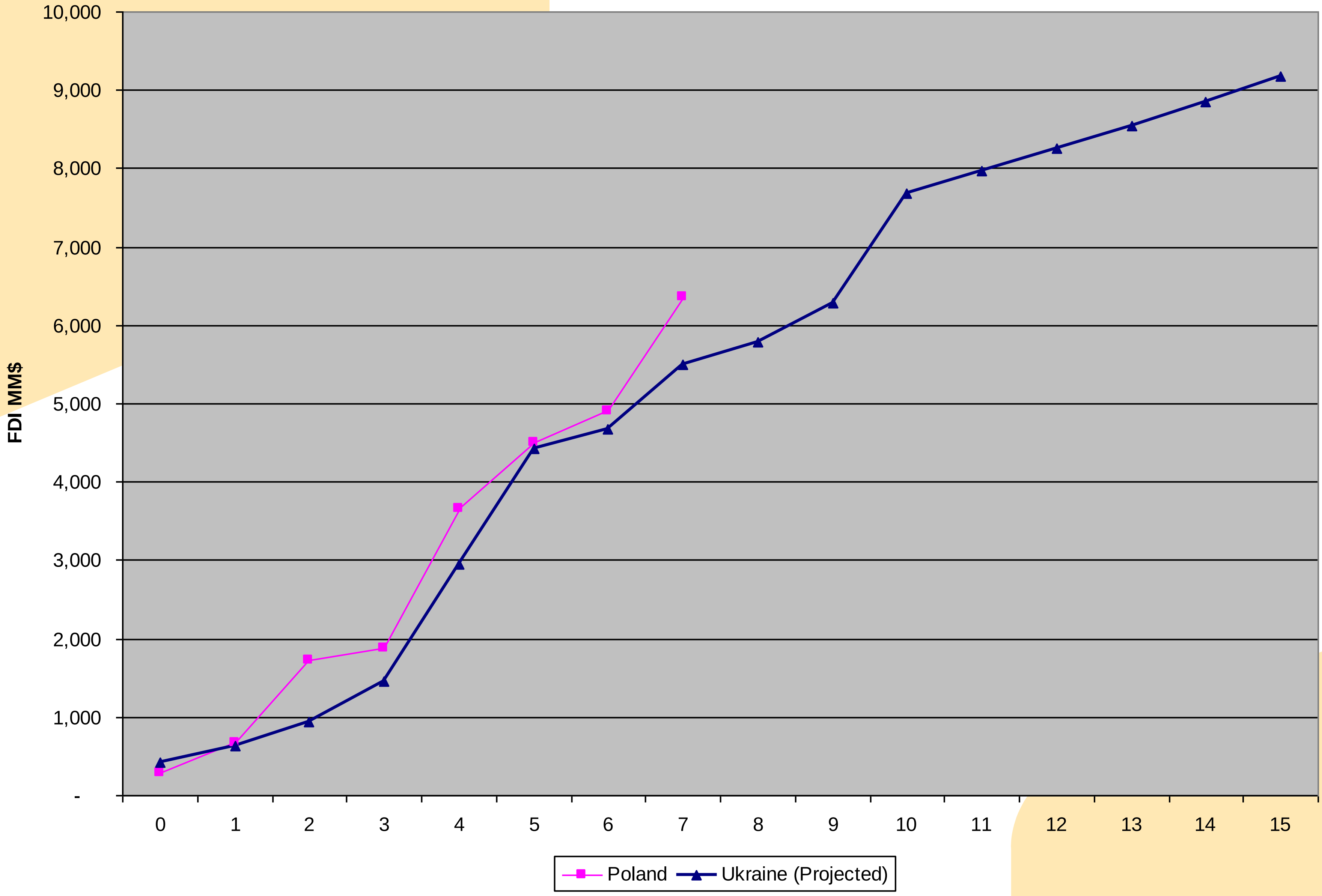
YEARS	1991	1992	1993	1994	1995	1996	1997	1998
Foreign Cap/FT Rest	63,0	66,0	71,0	72,5	74,1	75,7	77,3	79,0
Political Risk	65,0	71,0	81,0	81,4	81,8	82,2	82,6	83,0
Corruption	15,0	21,0	31,0	32,8	34,7	36,7	38,8	41,0
Major Govt Policies	19,4	36,0	41,0	44,0	64,0	66,7	73,2	78,3
Tax/Inv Incentives	27,5	35,0	51,0	55,6	59,0	64,3	70,0	78,3
Promotion Efforts	20,0	26,0	41,0	53,5	66,0	75,8	87,1	100,0
ADJ Foreign Cap/FT Rest	63,0	66,0	284,0	290,1	296,4	302,8	309,3	316,0
ADJ. Political Risk	65,0	106,5	162,0	162,8	163,6	164,4	165,2	166,0
ADJ. Corruption	15,0	63,0	310,0	327,8	346,7	366,6	387,7	410,0
ADJ.Maj Govt Policies	73,5	198,0	410,0	440,0	1971,2	2668,0	2928,0	4204,7
ADJ.Tax/Inv Inc	55,0	140,0	306,0	333,4	354,0	385,7	420,3	470,0
ADJ.Promotion Efforts	20,0	104,0	246,0	321,0	528,0	606,5	696,6	800,0
TOTAL FDI (MM$)	**291,5**	**677,5**	**1718,0**	**1875,2**	**3659,9**	**4494,0**	**4907,1**	**6366,7**

VI. Application to Ukraine

Ukraine FDI Projection



Ukraine FDI Projection (15 years)



VII. Conclusions

The Study has the following main conclusions:

- If Ukraine were to continue its current policies, the level of capital outflows will not increase significantly from its current levels (about US$1.0 billion per year – except for ad-hoc flows related to large privatizations).
- Under a middle scenario, if Ukraine were to take policy actions to match in five years 66% of the policy level of the Best-in-Class, Ukraine would increase foreign direct investments to about US$3.2 billion per year, in 5 years, an increase of 220%.
- Under an optimistic scenario, with stronger policy actions, the level of foreign direct investments could increase to US$5.0 billion per year, in five years.
- Concrete Policy Actions to achieve these higher scenarios are presented in the final section of this presentation.

- Liberalization of Business Activities, followed by Business Financing, and Taxes and Incentives were the most important policy actions explaining lack of capital inflows today:
  - If everything else were to be done, except Business Liberalization, capital inflows in the next 5 years would be 20% less than otherwise.
  - If neither liberalization nor financial sector reforms were to advance, capital inflows would be reduced by 40% from normal values during the next 5 years.
- On the other hand, if reforms in only two areas were to be undertaken, the maximum impact would be from “Dealing with Corruption” and “Rationalizing Taxes and Incentives.
  - Implementation of these two action would increase capital flows in the next five years by 85% compared to the no action scenario.
- However, in order to get a significant increases on capital flows (i.e., 220%), actions on all nine factors are required.

VIII. Action Plan for Ukraine

I. Liberalize Business Activity

1. Publish and disseminate widely the Government's De-regulation Strategy.
2. Establish a Deregulation Council to review all existing and new legislation and assess their impact on businesses.
3. Adopt licensing requirements that conform to international standards and facilitate and reduce the amount of time require to:
   (i) register a new business,
   (ii) operate an existing business, and to
   (iii) import/export goods.

4. Eliminate incentives to excessive Government intervention, such as disallowing regulatory agencies from keeping any part of fines they collect.
5. Continue public administration reform of state agencies to redefine the Government’s role as supportive of the private sector and reduce the number of separate Government agencies that have the power to control and interfere in private business.
6. Extend administrative reform to local state bodies, including developing mechanisms to ensure the compliance by local officials with the requirements of national legislation.
7. Reduce shadow economy activities by drastically lowering cost of compliance with legislation in effect.

II. Provide an Stable and Predictable Legal Environment

1. Create an independent and incorruptible judiciary based on adequate funding.
2. Pass required civil and business legislation to provide a stable legal framework applicable to everybody, including the draft civil code, a new labor code, a new criminal code and the draft tax code.
3. Create a Legislative Center to expedite the above work and coordinate the preparation and drafting of laws and regulations.
4. Make the Civil Courts more efficient and enhance commercial courts for settling disputes and enforce contracts.

5. Empower the Courts to deal with jurisprudence, separating judicial and executive responsibilities.
6. Enact and pass adequate regulations to the Bankruptcy law.
7. Abolish the practice of backdating any legal decisions.
8. Review existing legislation from the point of view of inconsistencies among different legal documents.
9. Allow international arbitration.

III. Facilitate Business Financing by the Financial Sector

1. Pass the law “On Banks and Banking Activity”.
2. Improve and enforce commercial bank supervision and prudential regulations, bringing them to international standards.
3. Improve the independence of the banking sector.
4. Abolish the “Kartoteka” and replace it with normal court-based lien and bankruptcy procedures.
5. Take actions to encourage the growth of bank assets (Hryvnia lending) by minimizing lending risks.
6. Facilitate the growth of bank deposits and other liabilities.

7. Restructure the Savings Bank in order to improve solvency and profitability.
8. Strengthen the Securities and Stock Market State Commission.
9. Introduce in the Pension Fund capitalizable individual accounts managed by private pension funds.
12. Amend the law on “Auditing Activity” and bring the National Accounting Standards closer to International Accounting Standards.
13. Encourage competition and efficiency in the financial sector by facilitating the expansion of non-bank financial institutions.

IV. Enhance Corporate Governance and Accelerate Privatization

Corporate Governance

1. Demonstrate corporate financial discipline by closing 10-20 big loss-making companies within next two years.
2. Enact the Joint Stock Company Law of Ukraine to bring Ukrainian corporate governance legislation in line with legislation of the European Union.
3. Require all companies, starting with bigger ones with large number of shareholders, to switch over to international accounting standards and to submit annual reports on economic activity.

4. Encourage the creation of non-government organizations to support corporate governance, such as shareholder associations, and a corporate governance rating agency.
5. Implement a comprehensive corporate governance training program for supervisory board members, investors and shareholders, managers of JSCs, public officials/employees, and judges from arbitration courts and courts of general jurisdiction.
6. For all state owned companies, empower a body of auditors ("cours des comptes") to audit at the way public companies are managed and impose enforcement and correction of malpractices.

Privatization

7. Secure the early approval and implementation of:
   - the Land Code to promote private ownership of land,
   - the mortgage law,
   - a clear system for registering titles to fixed assets.
8. Encourage the independent functioning, professional development and proper funding of the State Property Fund (SPF), while subordinating it formally to the Ministry of Economy or Finance/Treasury.
9. Complete the privatization of virtually all medium and large enterprises — including the sale of "golden" shares and "blocking" minority positions in all areas including energy, telecom and agro-industry.

10. Take early actions to prepare state companies for privatization, including actions to protect minority shareholder rights, and transferring social assets to local authorities.
11. Carry out all privatizations under clear and transparent procedures.

V. Minimize Political Risks

1. Demonstrate understanding of the importance that foreign investors place to expropriation, including "creeping expropriation".
2. Bring tax collectors and local authorities to the control the central administration.
3. Give the Prime Minister and his Cabinet the total authority to do their jobs unimpeded by vested interests.

VI. Remove Int'l Capital and Foreign Trade Restrictions

1. Liberalize foreign exchange transactions.
2. Cancel all restrictions on purchase by residents of securities in foreign currency.
3. Remove restrictions to imports, including high import duties, the critical import list.
4. Remove restrictions to exports, including export quotas, export duties, existing indicative prices, advance deposits and forex surrender requirements.
5. Accelerate accession to the World Trade Organization.

6. Simplify and expedite custom services, including procedures for custom clearances.
7. Develop more modern and consistent procedures for certification requirements and standards of products, both for imported goods and goods produced domestically.
8. Eliminate restrictions on foreign direct investments in certain sectors - insurance, publishing, broadcasting and telecom.

VII. Deal with Corruption Perception

1. Undertake corruption prevention measures to reduce opportunities for corruption, and to make corruption more difficult to undertake.
2. Develop the legal framework to ensure better enforcement of anticorruption measures.
3. Get public support for anti-corruption progtams by making people aware of their rights and the rules of the game.

VIII. Expand Government Business Promotion

1. Announce widely the Government's policy and commitment to implement strong market oriented policies and show implementation progress.
2. Vocally support foreign investment by changing the attitude of officialdom at central and local levels.
3. All Ukrainian embassies abroad should have their commercial section strengthened, and go on a sales drive in each country to promote better dissemination of Ukrainian business opportunities.
4. Go a sales drive on Privatization with the backing of international organizations.
5. Operate on the principle that the best type of government promotion is to leave the private sector alone.
6. Assist in the establishment of a private investment promotion agency.

IX. Rationalize Corporate Taxes and Investment Incentives

1. Create a level-playing field by not offering special incentives to individual sectors or companies.
2. Eliminate privileges related to ‘special economic zones’.
3. Reduce the total fiscal burden on enterprises by reducing the number of taxes, duties, fees, and fines.
4. Broaden the tax base by eliminating tax privileges so that all economic activity is subject to essentially the same rates of tax.
5. Enact the new Tax Code that would decrease the number of taxes and surcharges, reduce tax rates and pay for the cut by eliminating tax privileges.

6. Rationalize the value-added tax system.
7. Rationalize the personal income tax system.
8. Rationalize the corporate income tax system.
9. Increasing consumption charges (especially for oil products) up to the average Western European level.
10. Alter the tax treatment of unrealized foreign exchange gains on equity investment made in enterprises in hard currency.
11. Aim to minimize subsequent tax changes by accompanying tax changes with a moratorium of 5 years during which it would not be modified.
12. Improve Tax Administration by putting into effect international standards for tax collection.

Thank you