UKRAINE: Harvesting its Investment Potential

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UKRAINE -- Economic Highlights

- Few non-oil producing countries can show the following combination of economic achievements over the past three years:
  - High average rate of economic growth of about 9% pa
  - Low average annual inflation rate of less that 7% pa
  - Low average fiscal deficit of about 1% of GDP
  - High current account **surplus** of more that 8% of GDP
  - Fairly stable foreign exchange rate
  - High international reserves (currently $9.5 billion) in excess of three months of imports
  - Very low ratio of external debt to GDP of 20%

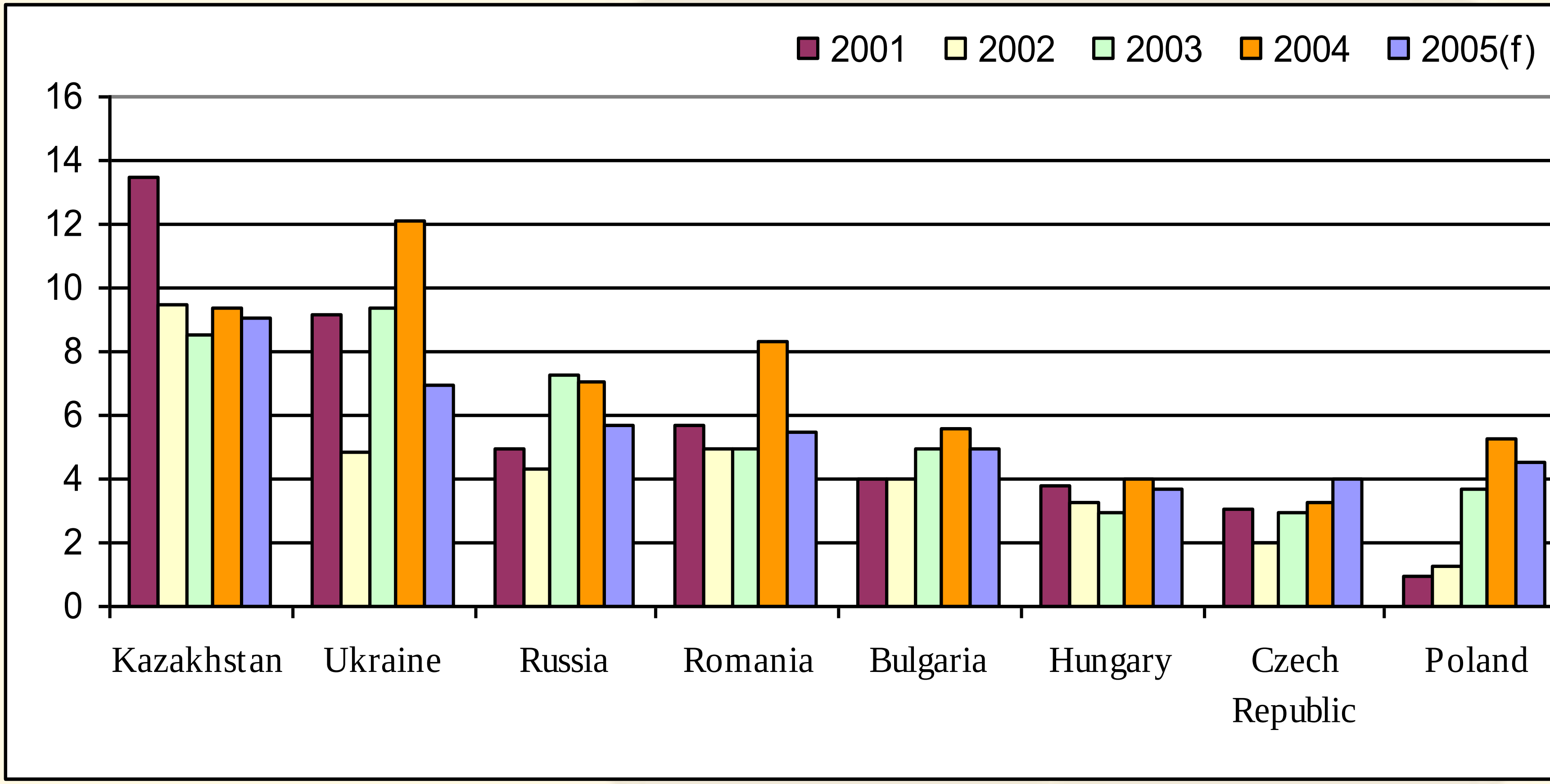
Economic Performance

	2000	2001	2002	2003	2004	2005 1/
Real GDP Growth	6.0%	9.2%	4.8%	9.4%	12.1%	5.0%
Fiscal Balance (% GDP)	0.6%	-0.3%	0.7%	-0.5%	-3.3%	3.8%
Consumer Inflation	25.8%	6.1%	-0.6%	8.2%	12.3%	14.7%
Exchange Rate (Hr/$)	5.4	5.4	5.3	5.3	5.3	5.05
Current Account ($bn)	1.2	1.4	3.2	2.9	7.0	1.7 2/
(as % of GDP)	3.7%	3.7%	7.7%	6.3%	11.%	10.6% 2/
International Reserves ($bn)	1.6	1.7	4.4	6.9	9.5	13.0
Foreign Debt/GDP	32%	27%	24%	22%	23%	18%

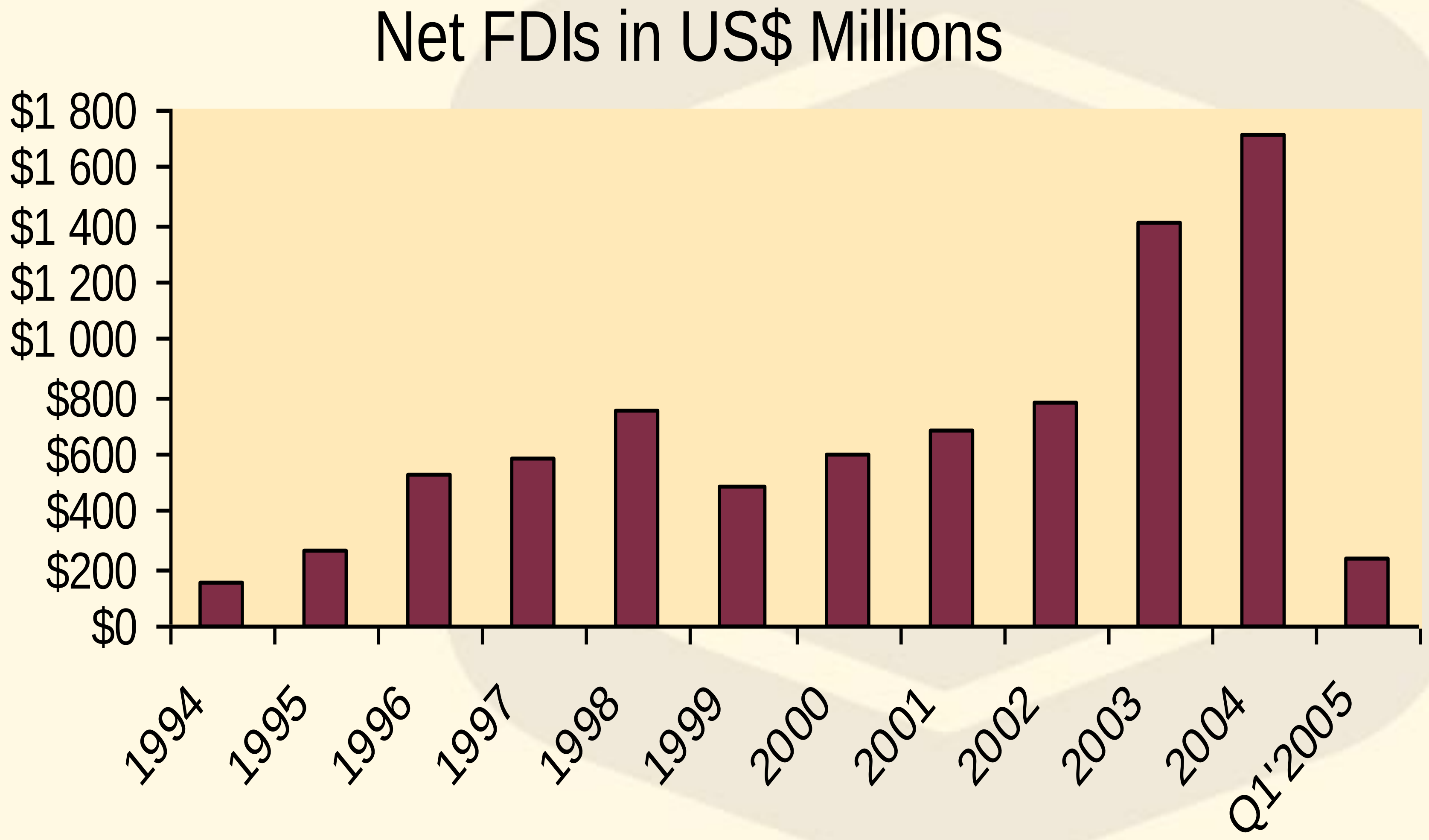
1/ Data for January-April 2005

2/ Preliminary numbers for January-March 2005

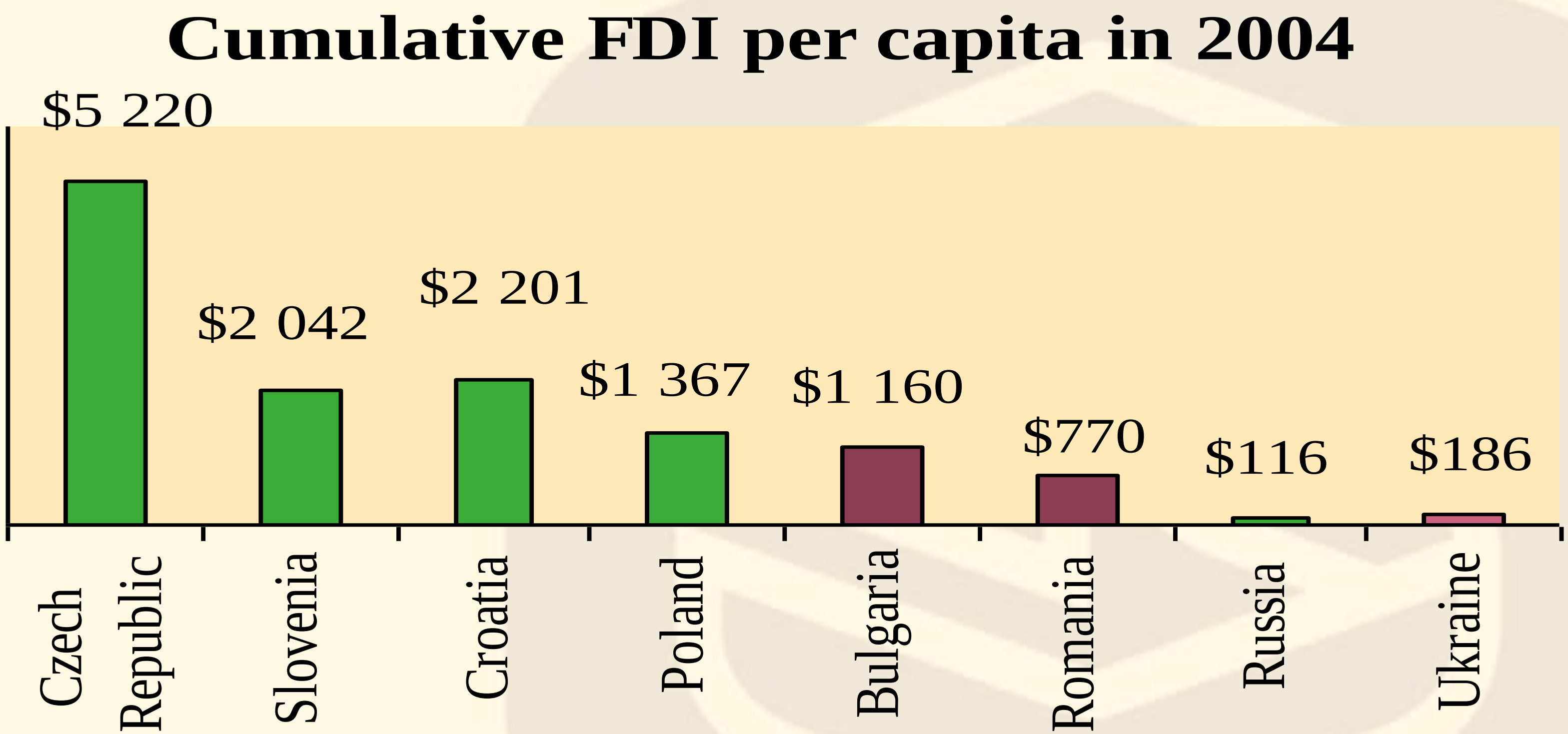
Real GDP Growth (%) in Ukraine compares favourably with other Transition Economies:



Based on this performance, Net FDI inflows have been increasing…



Nevertheless, cumulative FDI in Ukraine is still extremely low compared to other economies in the region….



- **The bulk of FDIs goes to a handful of countries:** Five developing countries (China, Mexico, Brazil, Poland and Chile) account for over 60% of these inflows.
- The Rest of the World does not offer attractive business environments and is therefore left out of the loop

What Explains these differences in FDIs:

- Since 2000, SigmaBleyzer/The Bleyzer Foundation have been doing studies 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, in 2000, SigmaBleyzer chaired a steering committee (IPCTF) to carry out a study on FDIs.
- 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 Study

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 Policy 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
- Foreign investments on the other hand 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

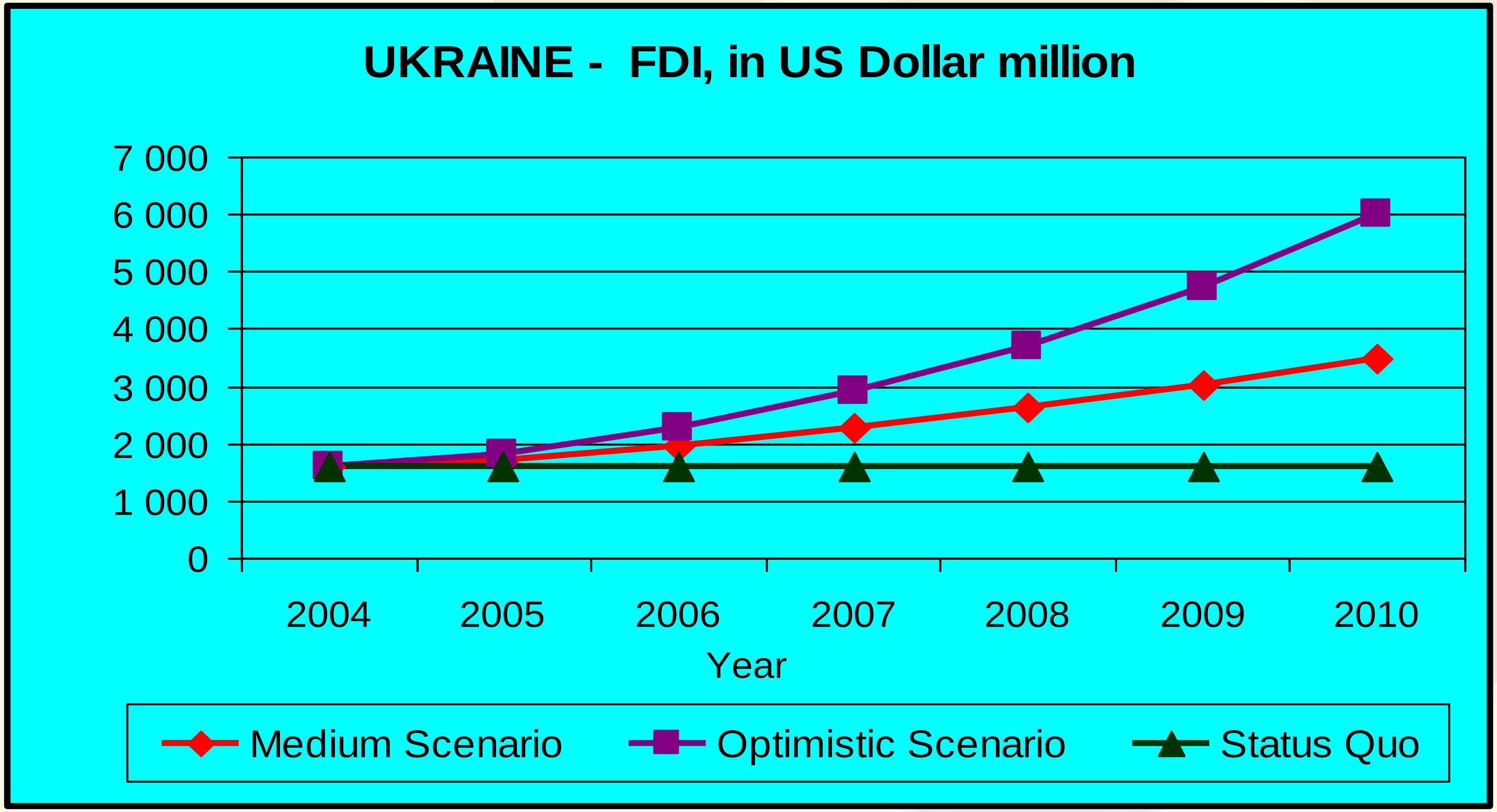
- The key determinants of a "Favorable Business Environment" were the following nine policy variables or "FDI drivers":

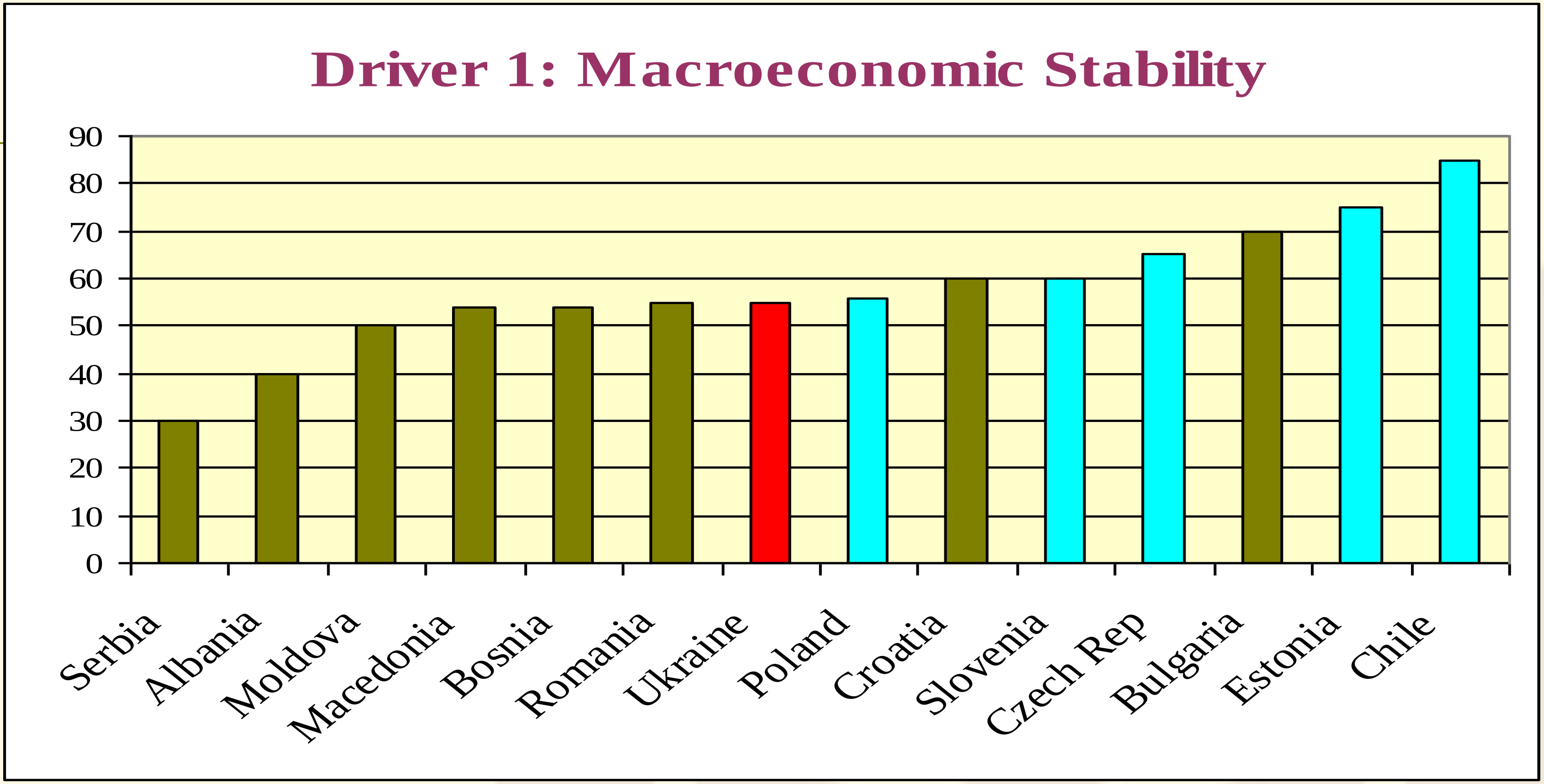
  1. Sustain Macroeconomic Stability
  2. Liberalize and De-Regulate Business Activities
  3. Provide a Stable and Predictable Legal Environment
  4. Enhance Governance & Reform Public Administration
  5. Remove International Capital & Trade Restrictions
  6. Facilitate Financing of Businesses by the Financial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

- 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

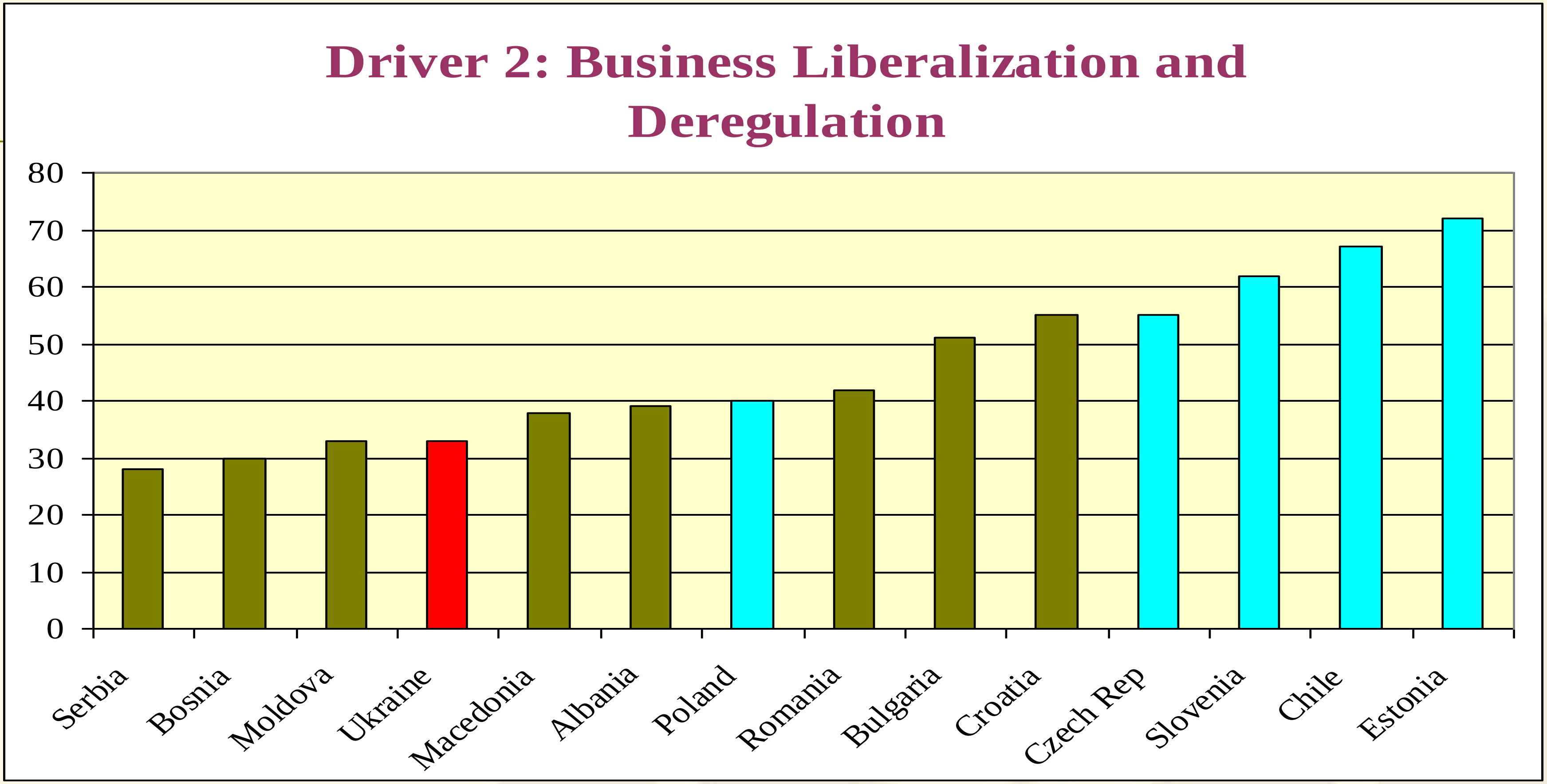
FDI For Ukraine- Possible FDI Scenarios

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

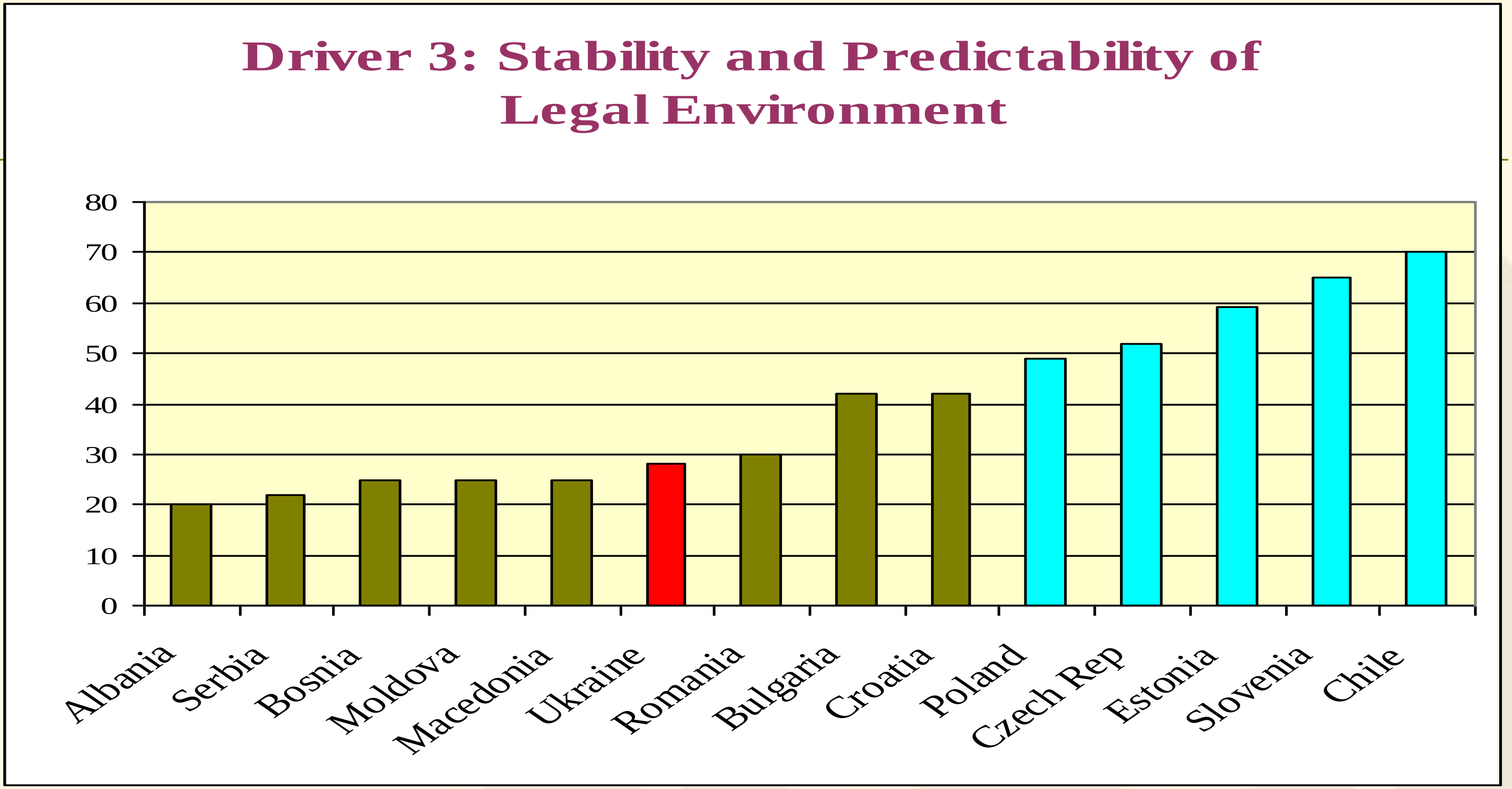




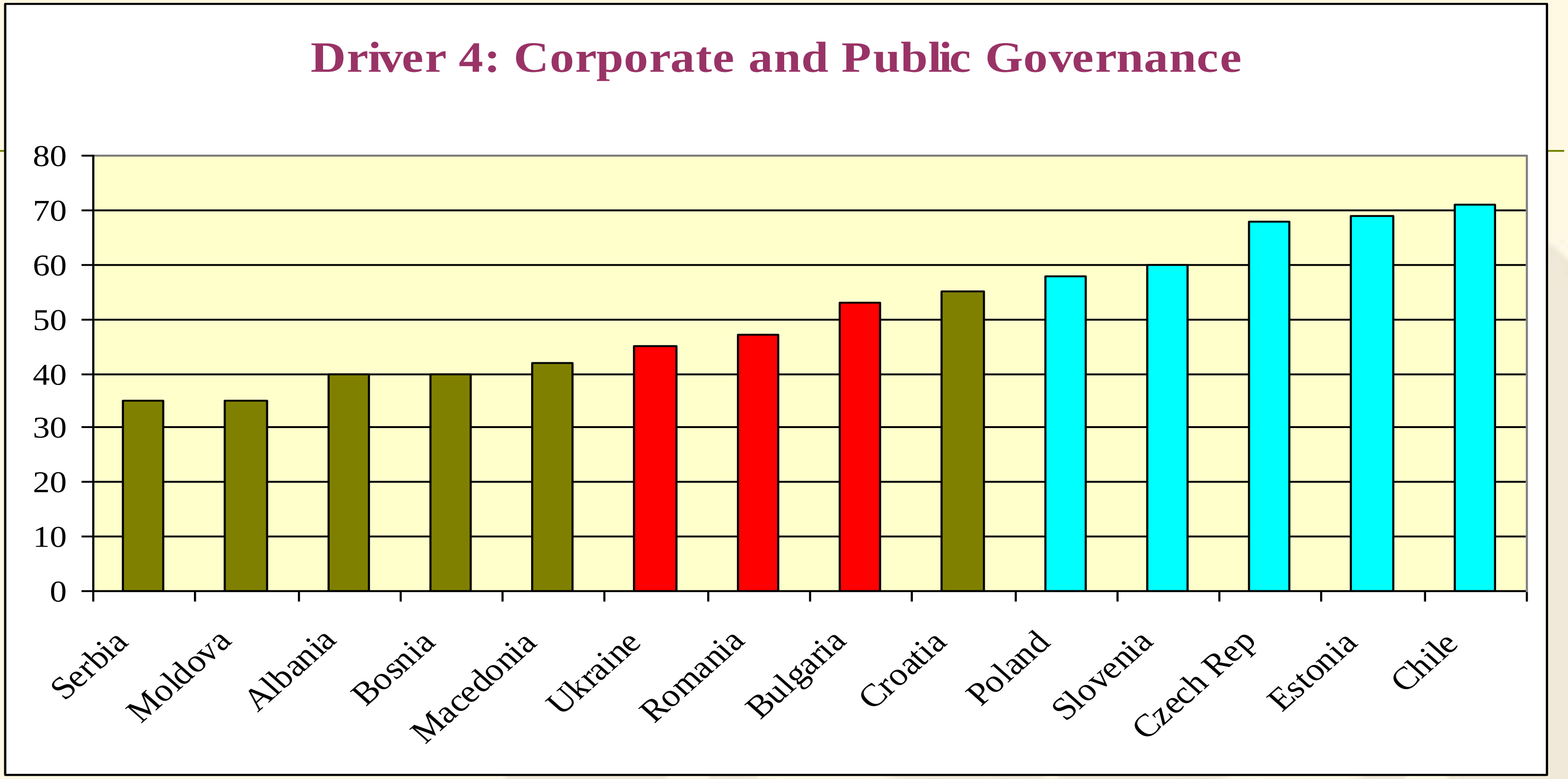
- Further deal with inflationary pressures that resulted from recent fiscal loosening (increase in pensions).
- For the future, fiscal sustainability will require the execution of a comprehensive “audit” of the public sector and its role.
- Strengthen monetary and foreign exchange rate policies.



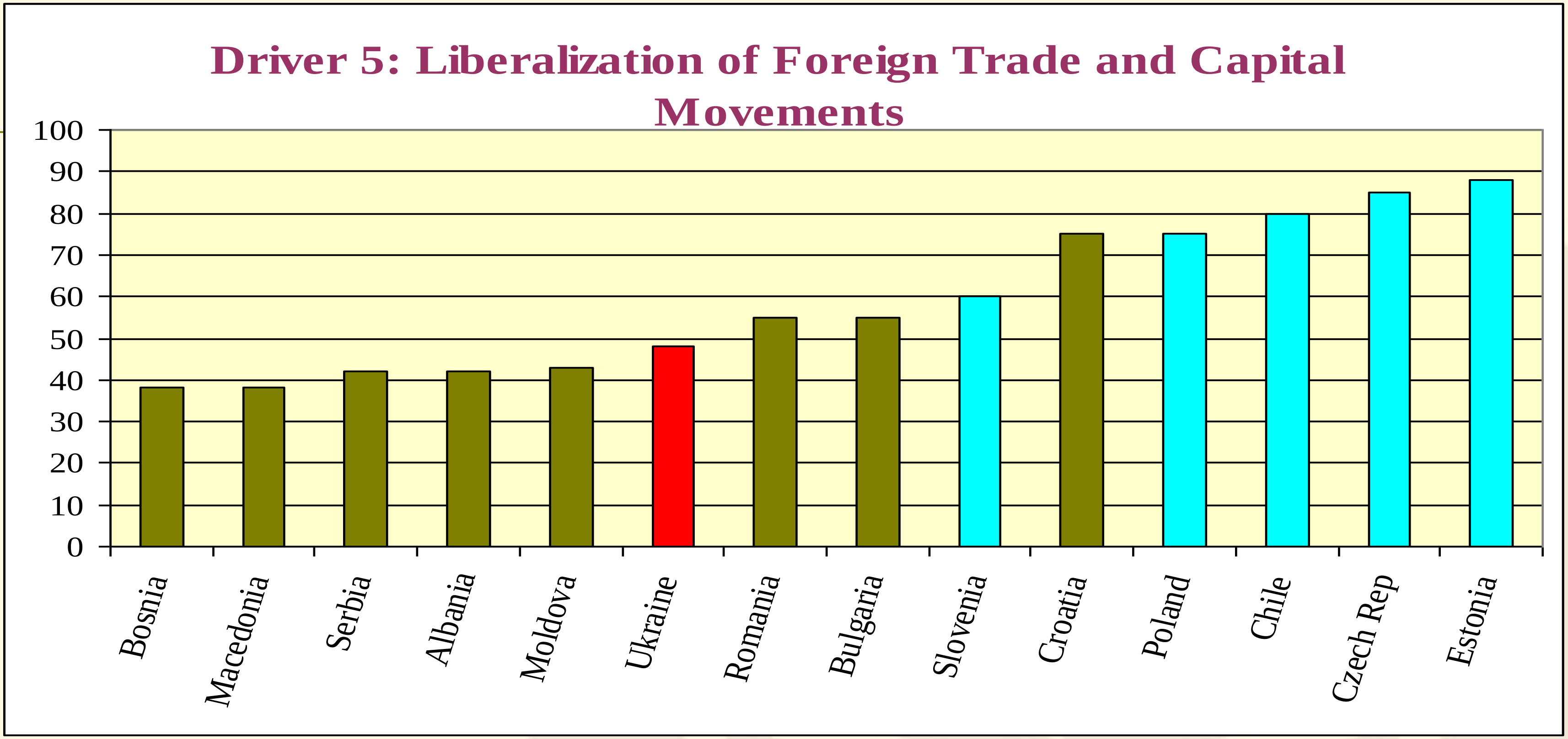
- Carry out a quick & drastic de-regulation (possible based on the "regulatory guillotine" principle that establishes a deadline)
- Eliminate excessive Government interventions in businesses
- Abolish the incentives of state agencies to intervene in business



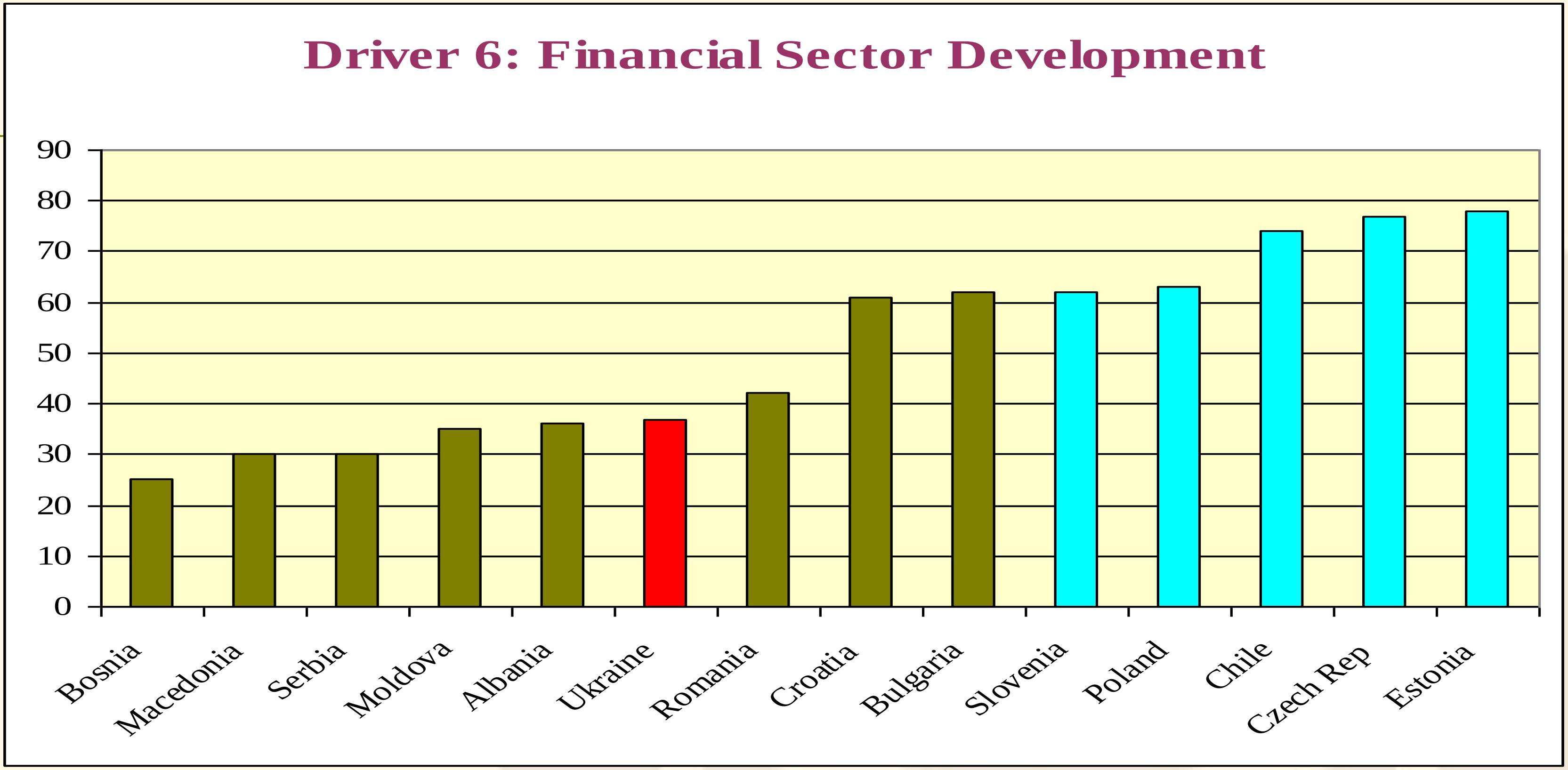
- Ensure Judiciary independence by improving financing of courts, increase salaries of judges, and improve training programs
- Enhance commercial courts for settling disputes
- Improve procedures for drafting of legislation and enact key pending legislation, such as the Adm. Court Procedures Code.



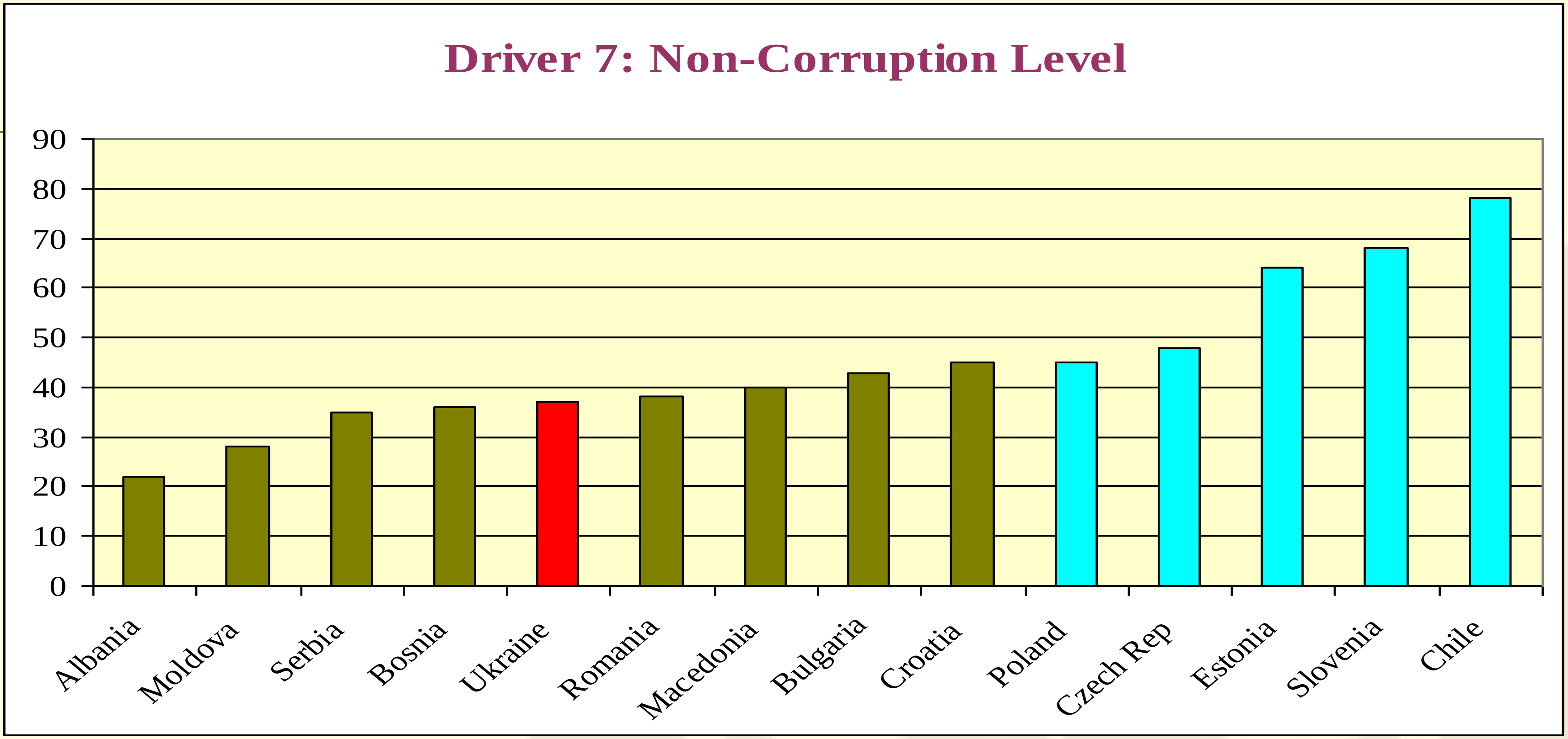
- Adopt the Joint Stock Company Law, according to international standards and develop corporate governance codes
- Carry out a comprehensive public administration reform to define role of government, cut corruption and streamline decision-making
- Establish transparent and competitive privatization procedures and clarify policy on past privatizations



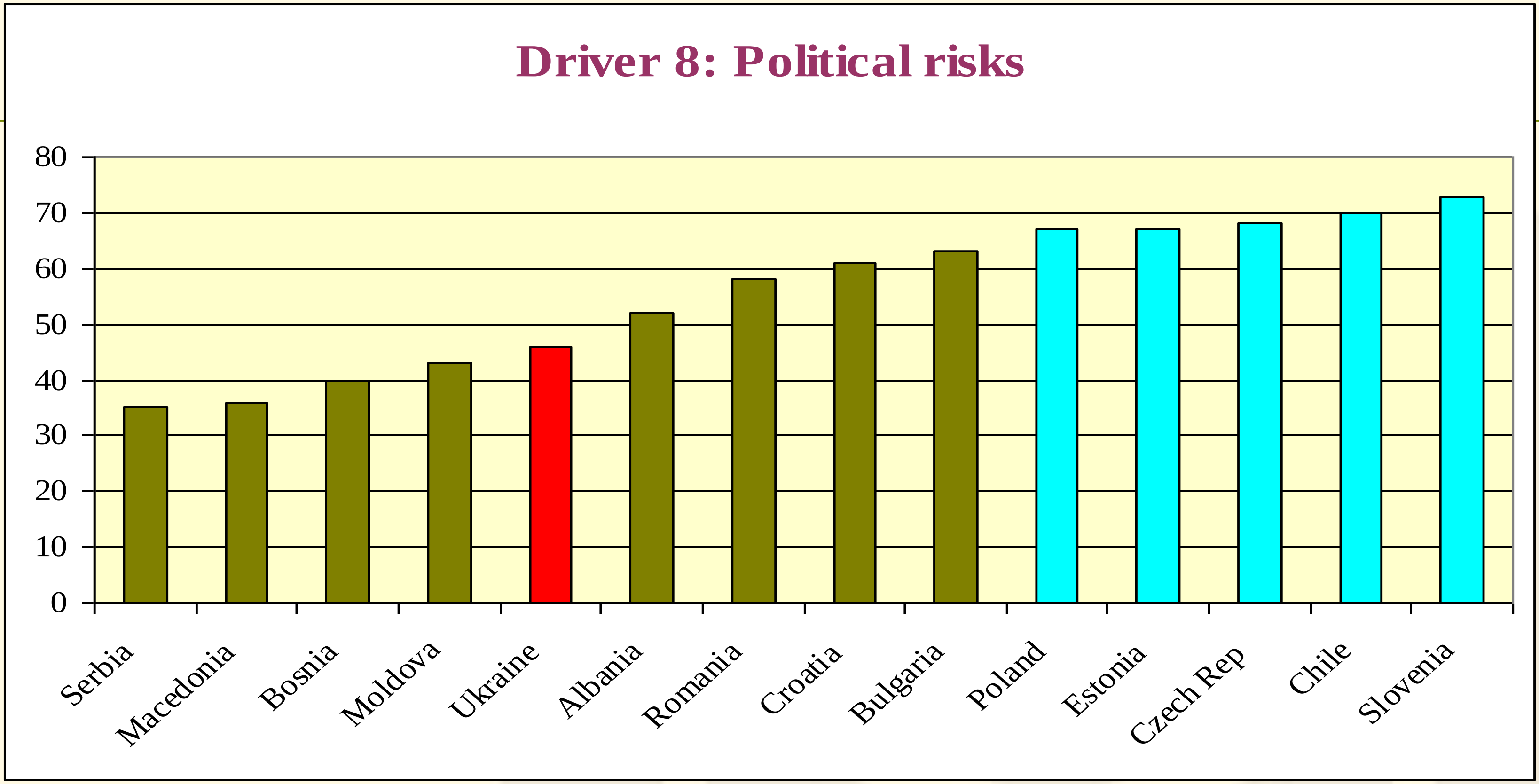
- Secure market economy status from the EU and the US and entry into the WTO
- Sign Free Trade Agreements with the country's main trading partners (EU, USA, CIS countries)
- Streamline customs procedures and formalities to ensure prompt consideration and to reduce rent-seeking



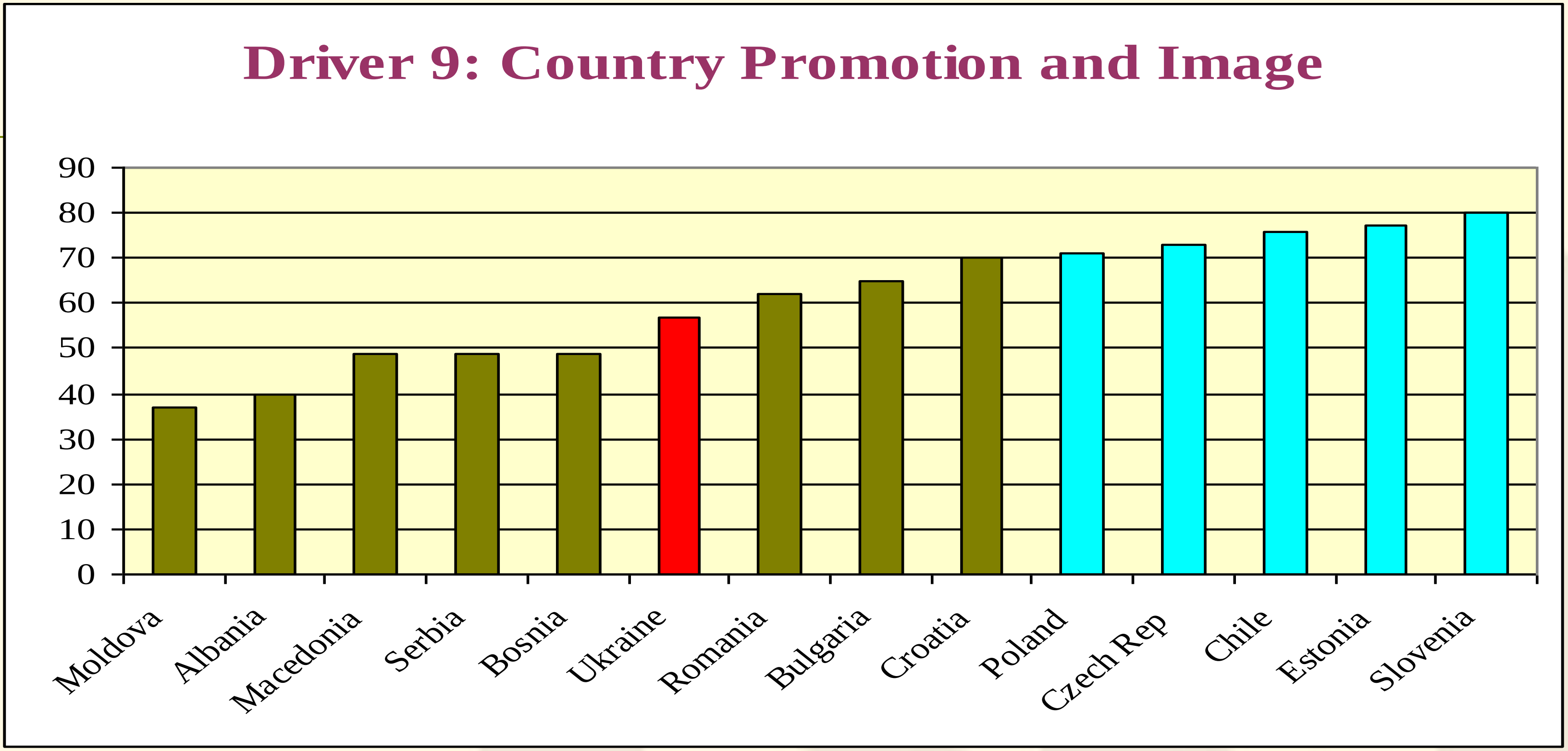
- Further improve banking supervision, including stronger prudential regulations (loan classification and provisioning, capital adequacy, lending to related companies, etc.);
- Encourage stock market transactions to be made on the organized market;
- Facilitate the development of private pension funds.



- Implement public administration reform to improve transparency of decision-making process;
- Reduce the ambiguity of government regulations and raise accountability of the public servants for their decisions;
- Strengthen the internal audit office.

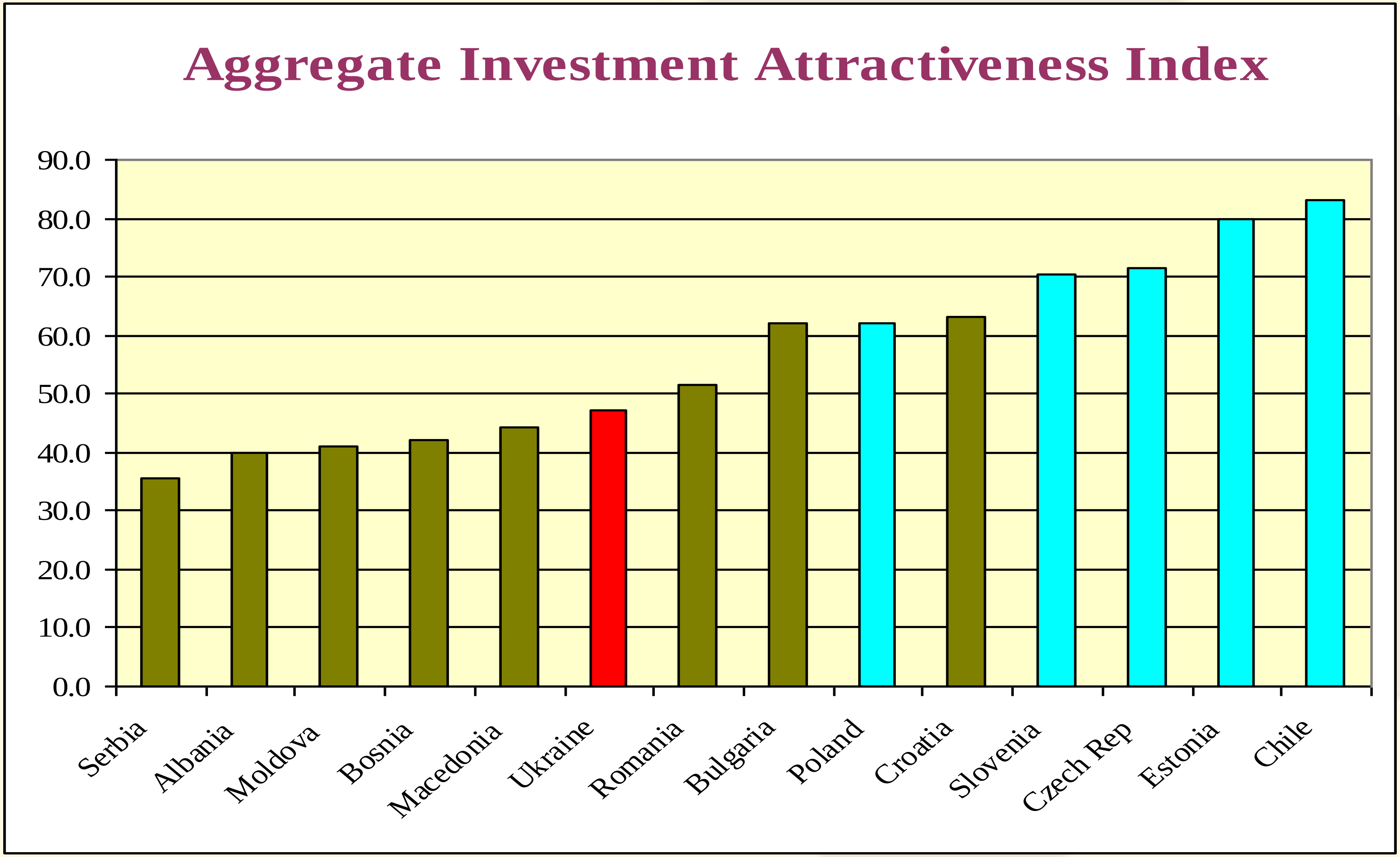


- Take measures to eliminate power abuses at different levels of the authorities.
- Deal with the perception that the government is not united
- Decentralize some government activities to diffuse regional disparities and concerns.



- Improve image through better and more frequent communications and transparency
- Continuously interact with representatives of the private sector in to learn the problems they are facing.
- Ensure effective functioning of the investment promotion agency;

Overall Investment Drivers – Country Ratings



Why Ukraine has been slow in improving its investment drivers?

- "Vested Interests" have been identified as a major reason.
- But another 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.

The Role of the Private Sector

- Ukraine should encourage the international Private Sector to be more involved in a collective manner in supporting the design and implementation of policy reforms.
- 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.
- We proposed the creation of a Private World Fund to serve this objective and complement the work of the International Financial Institutions.

The Private World Fund

- 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.

…..The Private World Fund

- 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 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.

Conclusions

- Experience across transition economies shows 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.
- The Nine-Driver Framework provides a useful tool to identify necessary policy measures.
- The international private sector could be more engaged in assisting the government in the implementation of this policy framework through a vehicle such as the Private World Fund.
- The success of the new Government will be measured by the extent to which these necessary policy measures are expeditiously implemented and results are visible.