

# Completing the Economic Transition in the FSU Countries

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Michael Bleyzer  
Dr. Edilberto Segura

# 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 Nations - Assured Interdependence

- The polarization in the world is growing leading to envy and instability
- Wealth redistribution idea is flawed and outdated
- Instead replication of wealth creation capacity is needed
- This can only be accomplished through a combination of precisely targeted aid and active engagement
- Methodology and tools are necessary to develop implementation plans and measure progress

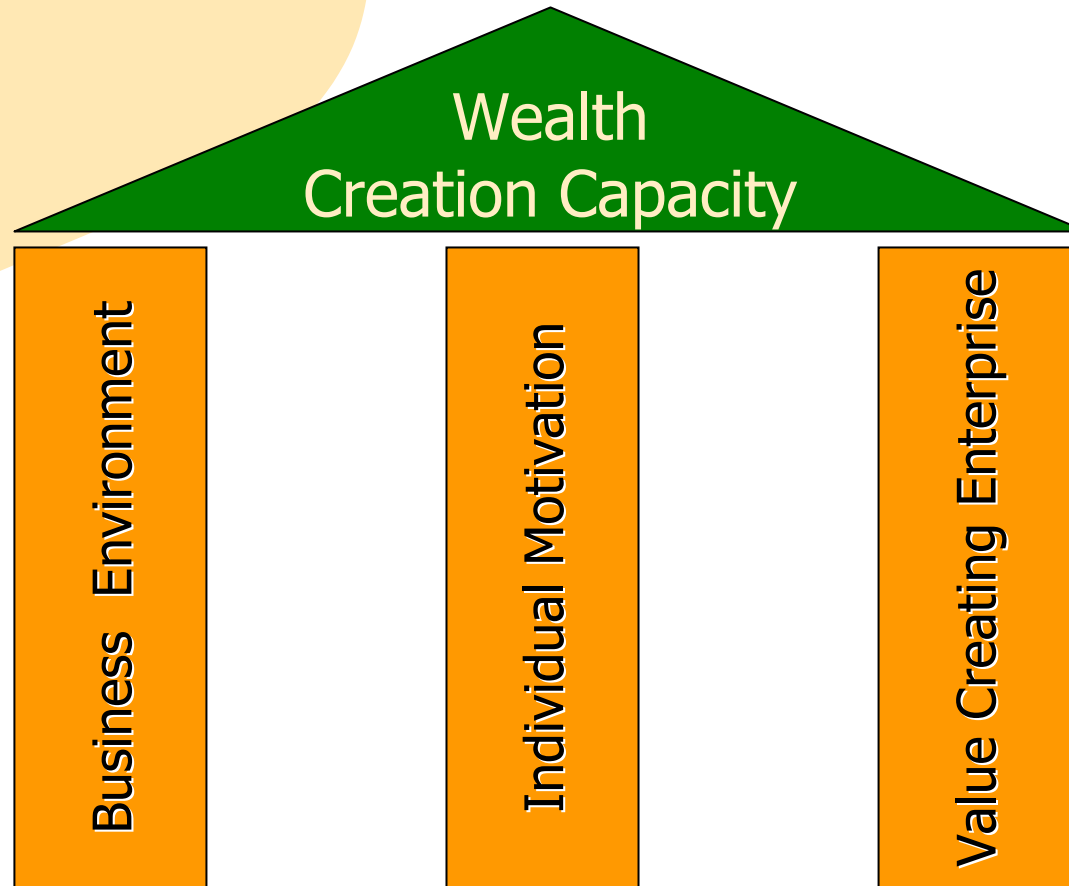
# Three Alternatives

- **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. Will only lead to a global welfare system
- **Tradeoff** – Jointly apply best practices to manage change in the developing countries. On the 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 and capital-friendly

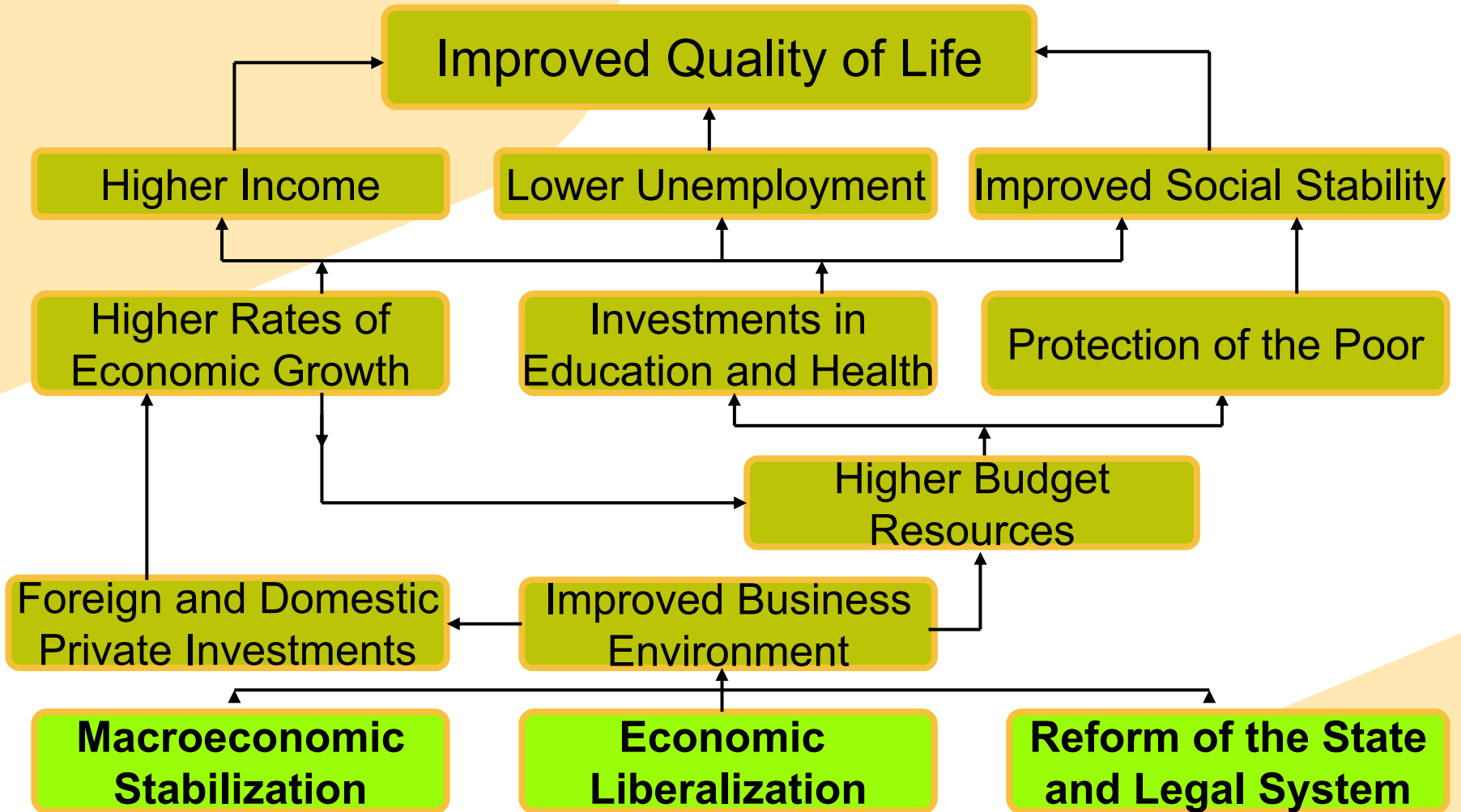
# Wealth Creation Capacity Replication (WCCR)

- 28 “developed countries” not only accumulated most of the wealth, but more importantly most of the wealth creation capacity
- To fight poverty and move the rest of the world (the other 160+ countries) towards market economy, democracy and stability WCCR is necessary

# Three Pillars of Wealth Creation Capacity



# Why Transition?



# Transition to Market Economy

	<b>Centrally Planned Economy</b>	<b>Transition Economy</b>	<b>Market Economy</b>
<b>Decision Making</b>	Centralized	Chaotically Decentralized	Mainly Decentralized
<b>Sources of Savings for Investments</b>	The State	Initially, without domestic savings, source is principally foreign capital, and primarily debt.	Savings of Individuals and Corporations (Retained Earnings)
<b>Coordination</b>	Compulsory Plans, Overly Restricted	Weak State and Inefficient Markets	Primarily Market, but with some State Regulation
<b>Ownership</b>	The State	State, Legally Private, Semi-Private, and Shadow	Primarily Private
<b>Incentives:</b>	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.**

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

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

	<u>1984-89</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
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

# FDI Flows to FSU Countries

- Given low domestic savings, the FSU countries will need to attract Foreign Direct Investments (FDI).
- So far, FDI have been low: All 15 FSU countries got only \$50 billion in the ten years since independence.
- 70% of these flows went to oil-rich countries: Russia, Kazakhstan and Azerbaijan.
- By comparison, only in 2000, other countries attracted large net FDI: China \$38 billion; Brazil \$33 billion; South Korea \$9 billion; Mexico \$13 billion, Poland \$9 billion; Czech Republic \$5 billion; Chile \$4 billion.
- How can the FSU attract part of these FDI funds?
- The international experience shows that investments and economic growth will be induced by well-defined economic policy actions: Investment Drivers.

# 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
- IPCTF Steering Committee included a number of multinational private companies as well as International Financial Institutions

# IPCTF Effort Milestones

- IPCTF creation – 1999
- Benchmarking, drivers identification, framework development, econometric modeling, Action Plan development – 2000
- Presentation to Cabinet of Ministers – February 28, 2001
- Final report published – April 22, 2001
- Ukrainian President signs a decree to improve investment climate based on the IPCTF recommendations – July 12, 2001
- Bleyzer Initiative to complete transitions in FSU countries is developed, IPCTF framework applied to 15 countries of FSU – 2001
- A number of Laws passed by Rada consistent with the Action Plan
- Cabinet of Ministers approves Government Program to implement the decree – December 2001
- Millennium Challenge Account initiative is announce by President Bush – March 2002
- The Bleyzer Initiative Book is published in Ukraine – September 2002
- Joint SigmaBleyzer – Thunderbird team is conducting a detailed study of 15 FSU countries and updating the model September 2002 – January 2003

# IPCTF Economic Policy Framework

- The Objective of the IPCTF Economic Policy Framework is to provide the basis to transform a developing country into a country with:
  - an improved quality of life,
  - better per-capita income,
  - less income inequality, and
  - fair protection of the disadvantaged poor.
- Countries with these better conditions are less susceptible to terrorism and political instability.
- The IPCTF Economic Policy Framework has two components:
  - Macroeconomic Stabilization Policies
  - Policies for Sustainable Investments or investment drivers

# Macroeconomic stabilization policies and investment drivers

- Macroeconomic Stabilization
  - Fiscal policies
  - Monetary policies
- Investment Drivers (Initially 70 investment drivers were identified, analyzed and grouped into the following key government policy action groups, which stimulated foreign direct investments in successful transition economies)
  - 1. Liberalization and deregulation of business activities**
  - 2. Stability and predictability of legal environment**
  - 3. Corporate and Public Governance**
  - 4. Liberalization of Foreign Trade and International Capital movements**
  - 5. Financial Sector Development**
  - 6. Corruption Level**
  - 7. Political Risk**
  - 8. Country Promotion and Image**
  - 9. Targeted Investment Incentives**

# Five Conditions for Free-Enterprise Capitalism to Work

- Private Property
- Rule of Law
- Enterprise-friendly culture (unwritten rules)
- Diversity and competition
- Encouraging framework of tax and regulation

Margaret Thatcher," STATECRAFT", 2002

# Aid Can Actually Be Counterproductive

- Many of the old models of economic development assistance are outdated. Money that is not accompanied by legal and economic reform are often wasted. In many poor nations, corruption runs deep. Private property is unprotected. Markets are closed. Monetary and fiscal policies are unsustainable. Private contracts are unenforceable
- When nations refuse to enact sound policies, progress against poverty is nearly impossible. In these situations, more aid money can actually be counterproductive, because it subsidizes bad policies, delays reform, and crowds out private investment
- In sound policy environments, aid attracts private investment by two to one

President Bush, March 14, 2002

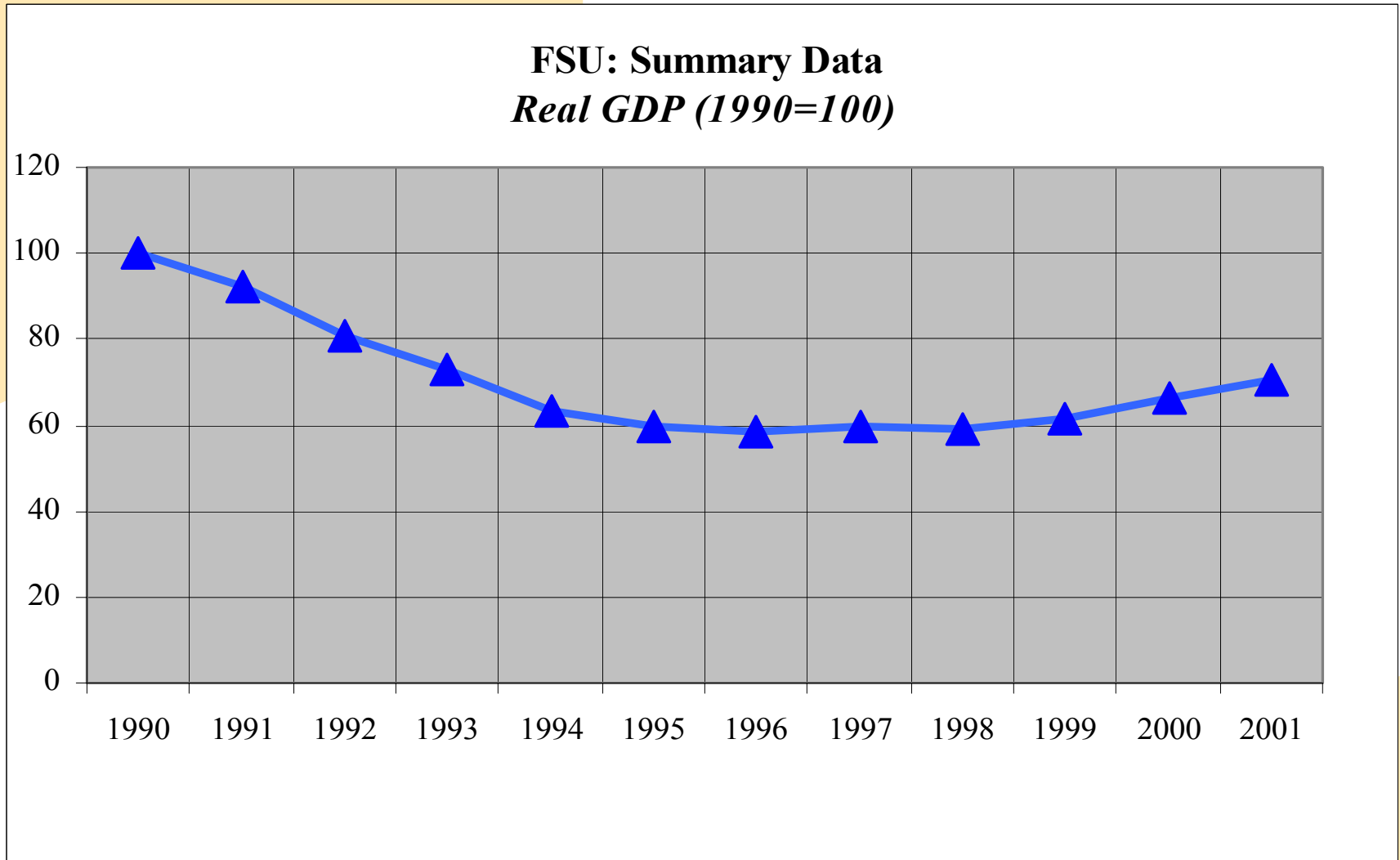
# More from President Bush

- ***I have an ambitious goal for the developed world, that we ought to double the size of the world's poorest economies within a decade***
- The world's help must encourage developing countries to make the right choices for their own people
- Millennium Challenge Account will have a set of clear, concrete and objective criteria for measuring progress

# MCA and IPCTF

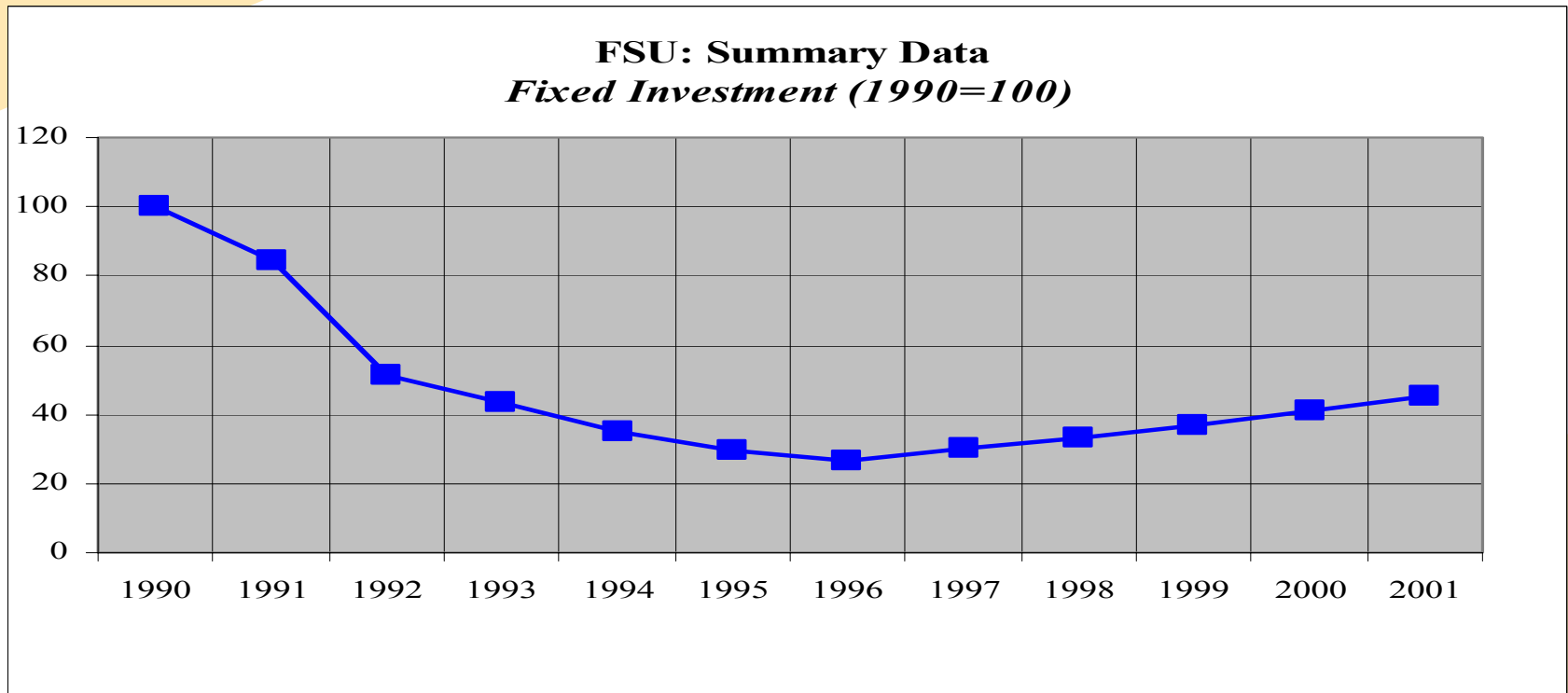
President Bush	IPCTF Framework
<p><b>Good governance. Rooting out corruption, upholding human rights, and adherence to the rule of law are essential conditions for successful development</b></p>	<ul style="list-style-type: none"> <li>⇒ <b>2. Provide a Stable and Predictable Legal Environment</b></li> <li>⇒ <b>3. Enhance Governance &amp; Reform Public Administration</b></li> <li>⇒ <b>6. Eliminate Corruption</b></li> <li>⇒ <b>7. Reduce Political Risks (non-economic country risks)</b></li> <li>⇒ <b>8. Expand Country Promotion</b></li> </ul>
<p><b>Sound economic policies that foster enterprise and entrepreneurship. More open markets, sustainable budget policies, and strong support for development will unleash the enterprise and creativity for lasting growth and prosperity</b></p>	<ul style="list-style-type: none"> <li>⇒ <b>1. Liberalize and De-Regulate Business Activities</b></li> <li>⇒ <b>4. Remove International Capital &amp; Trade Restrictions</b></li> <li>⇒ <b>5. Facilitate Financing of Businesses</b></li> <li>⇒ <b>9. Rationalize Investment Incentives</b></li> <li>⇒ <b><i>Sound fiscal and monetary policies (framework pre-condition)</i></b></li> </ul>

# Is FSU countries GDP Growth Sustainable?



# Investments and Sustainable Growth

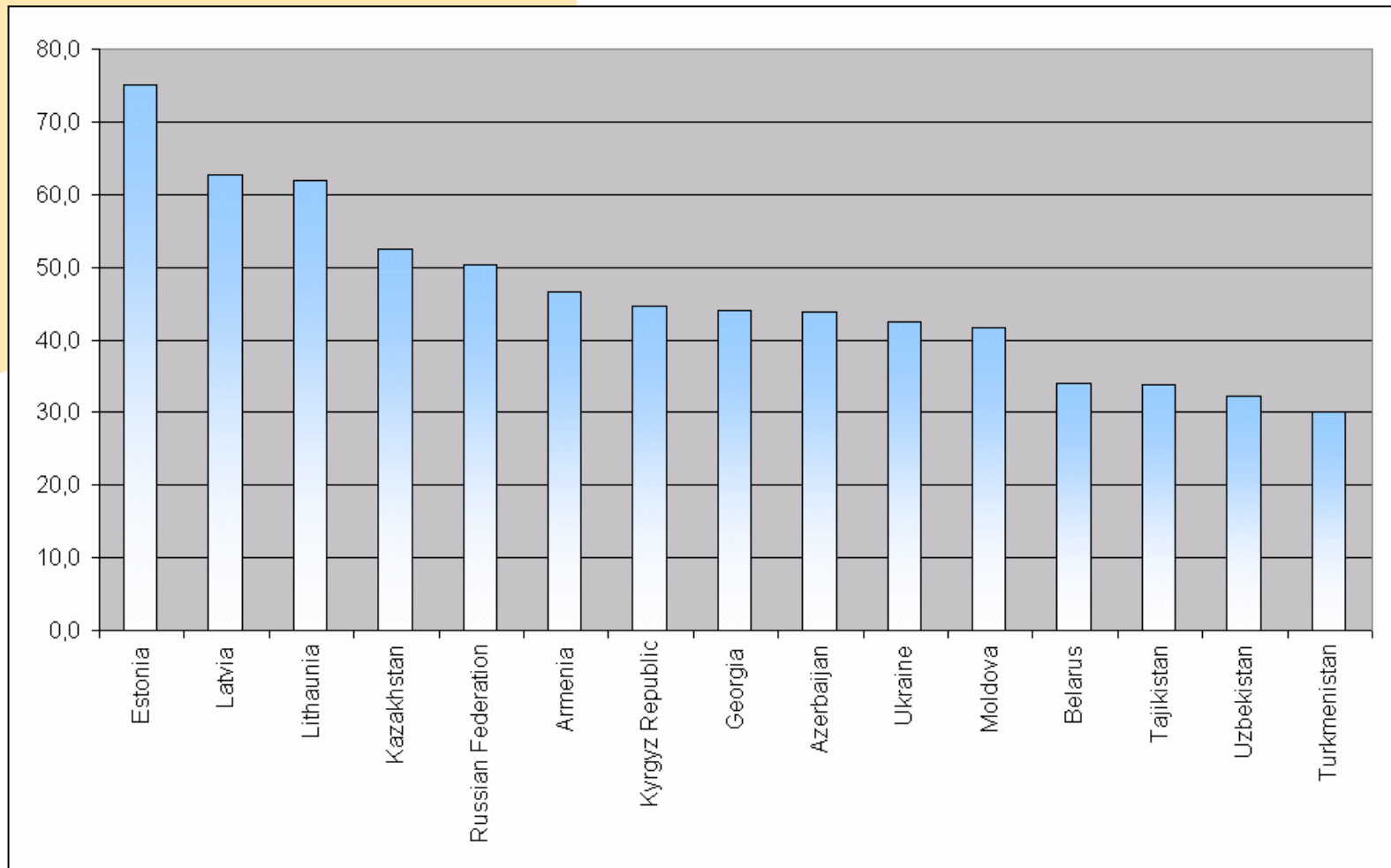
- To sustain growth the FSU will need to increase significantly its investments.
- To modernize its productive apparatus the FSU will require about \$800 billion in investments.
- But investments in fixed assets are still only 40% of the 1990 levels:



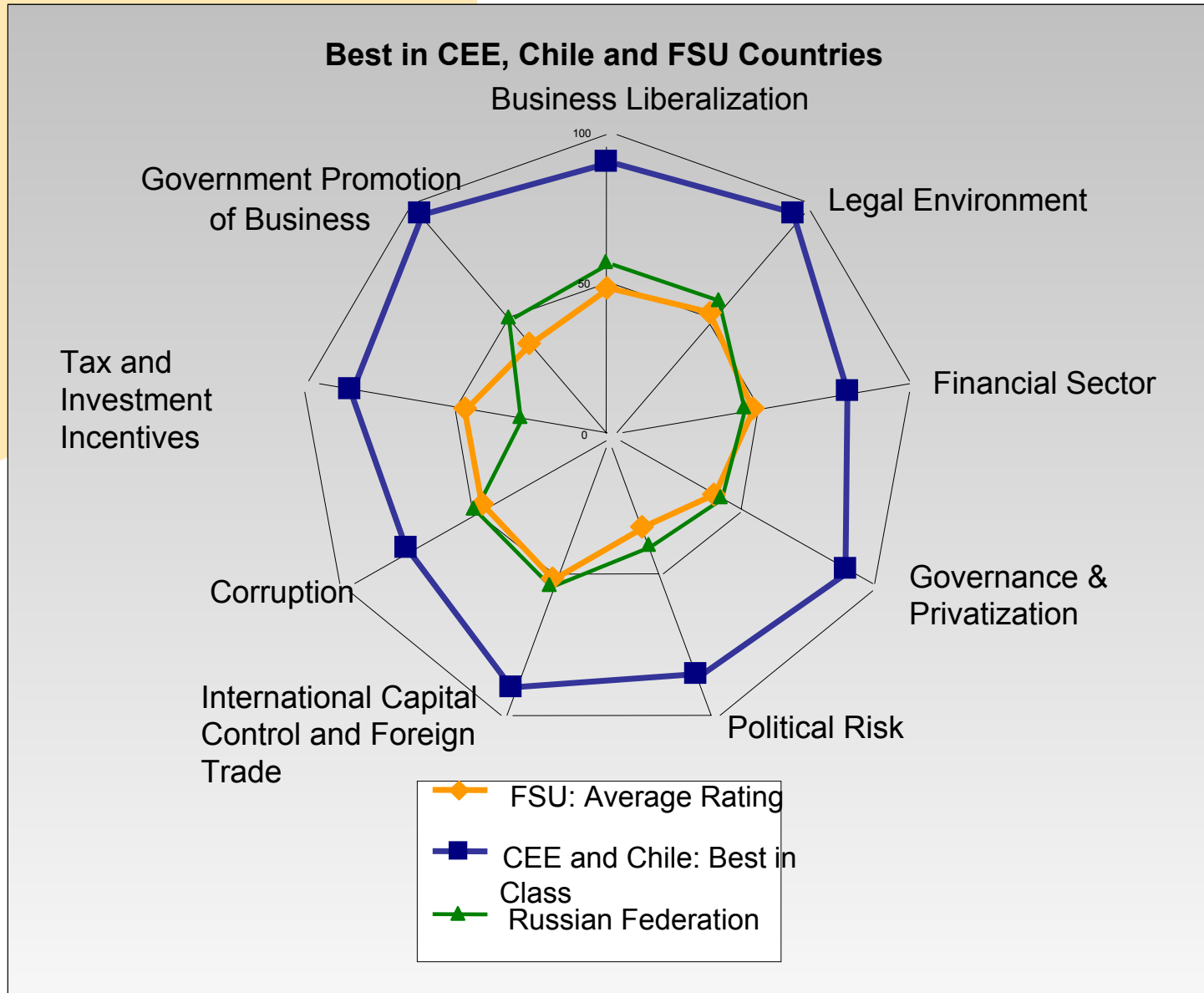
# IPCTF Ratings include reviews of the following indexes

- World Bank ratings
- Heritage Foundation Index of Economic Freedom
- Euromoney Indexes
- UNDP index
- Transparency International Index on Corruption
- International Country Risk Guide
- EBRD indexes

# Average IPCTF Rating of the FSU Countries

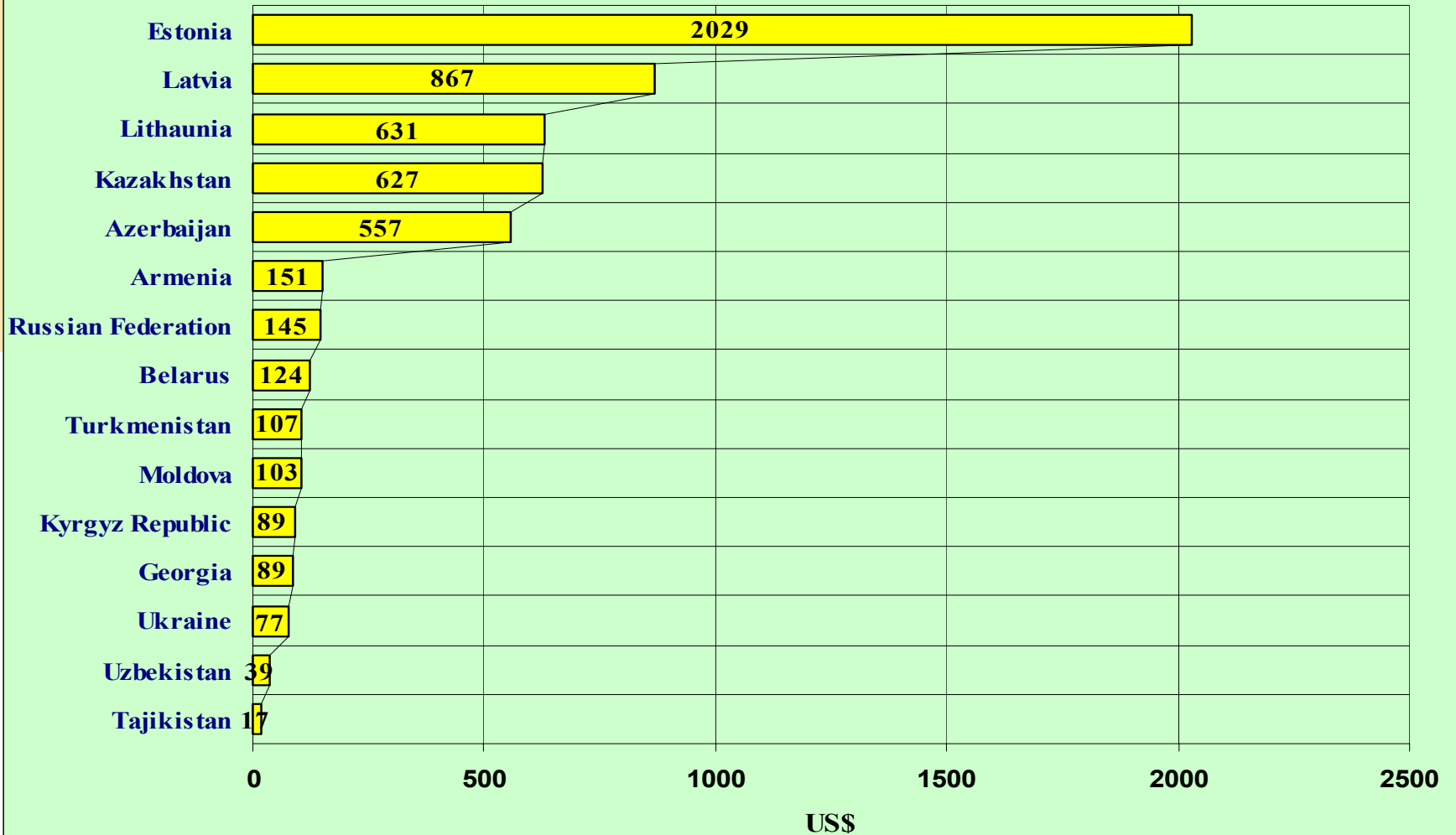


# IPCTF NONAGON

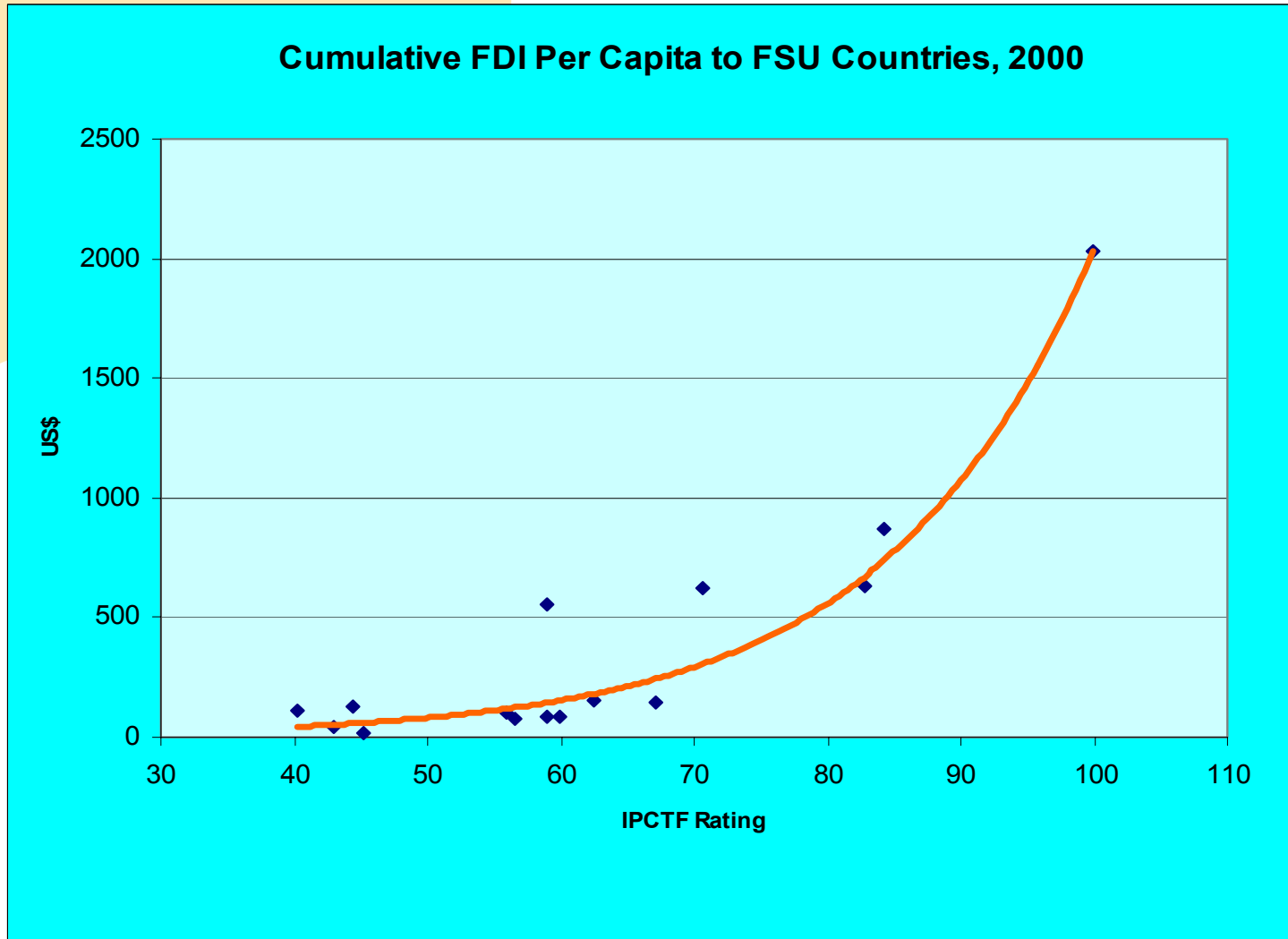


# Cumulative FDI per Capita

## Cumulative FDI per Capita to FSU Countries, 2000

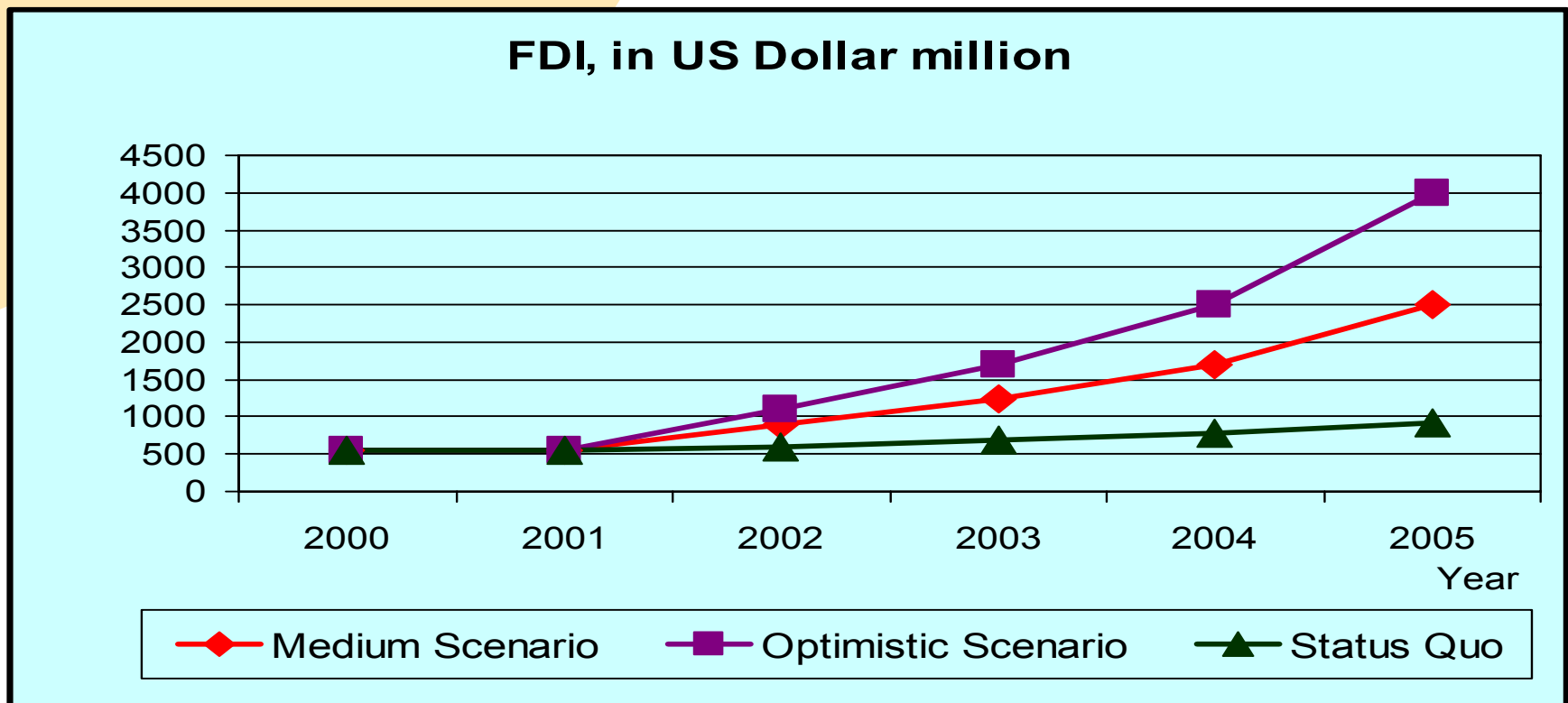


# Relationship between FDI and ICTF Ratings



# FDI For Ukraine- Possible Scenarios

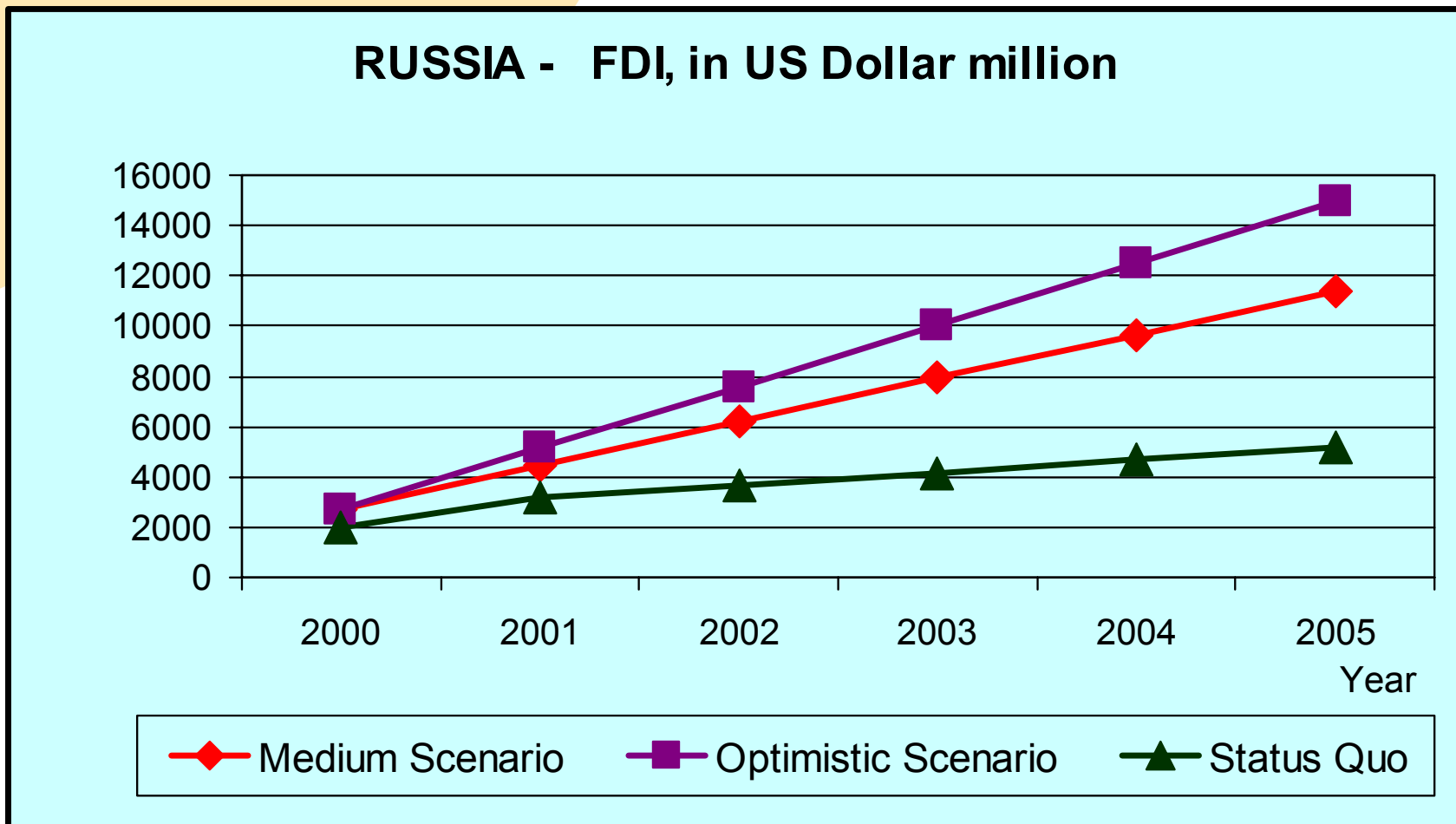
- Ukraine's government policies will determine the FDI flows over the next 5 years



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

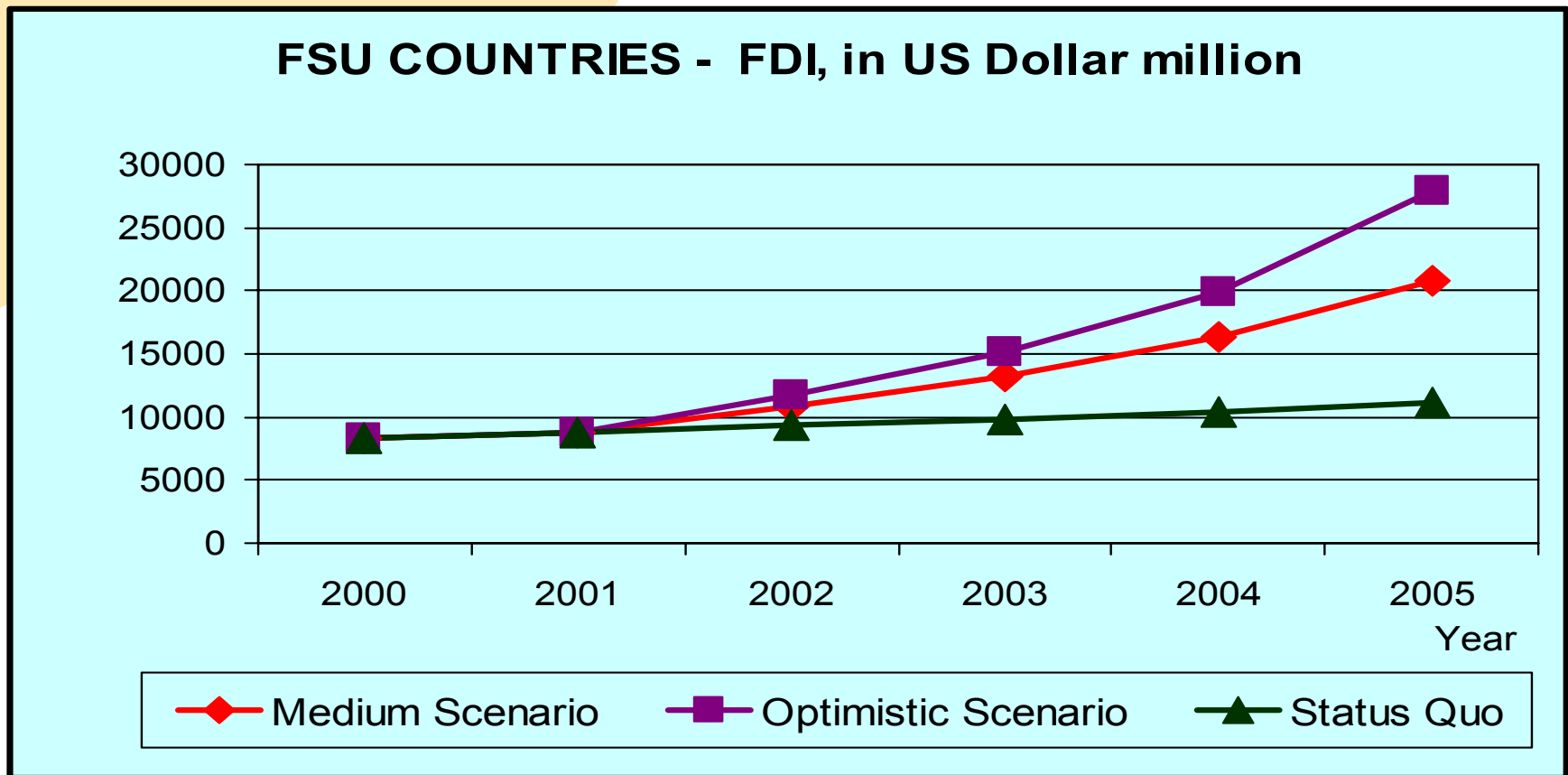
# FDI For Russia- Possible Scenarios

- Russia's government policies will determine the FDI flows over the next 5 years



# FDI For FSU- Possible Scenarios

- Government policies in the FSU will determine the FDI flows over the next 5 years



# Conclusions for FSU

- **With continuation of current policies**, FDI flows will increase only slightly from its current levels, reaching in 2005 \$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 all FSU countries could increase annual FDI to about \$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 \$28 billion for all FSU countries.

# 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**

# Unique Features of the IPCTF Methodology

- “Quantifies” (statistically) the relative importance of individual economic policies (investment drivers) on FDIs and economic growth
- Allows prioritization of the Government action, based on the quantification of policy impacts
- Allows to predict the increases in foreign direct investments over time, based on closing the gaps with the best-in-class countries
- Other economic reform indexes say little about the relative importance of individual policy areas and do not attempt to quantify their relative impact on real economic performance

# Unique in the World

- We have not seen any other index or a framework anywhere in the world that uses all of the following:
  - Benchmarking Government Policies
  - Identifying best practices in government policies
  - Measuring reforms progress based on gap analysis
  - Measuring statistical significance of different economic policies
  - Measuring / quantifying impact of economic policy changes on investments and therefore economic growth
  - Predicting future flows of investments using non-linear mathematical model where the values of regression coefficients are not constant but change depending on the value of the individual indexes. This allows to account for evolving relative importance of each of the nine policy action groups

# 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 and grants in place of debt
- Leverage private capital investments with financial assistance dollars
- **But structure financial assistance as “private equity funds” managed by money managers from private sector whenever possible!**

# BLEYZER INITIATIVE

- Replicate the Developed countries Wealth Creation Capacity in Developing Countries, beginning with FSU countries
- **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**