

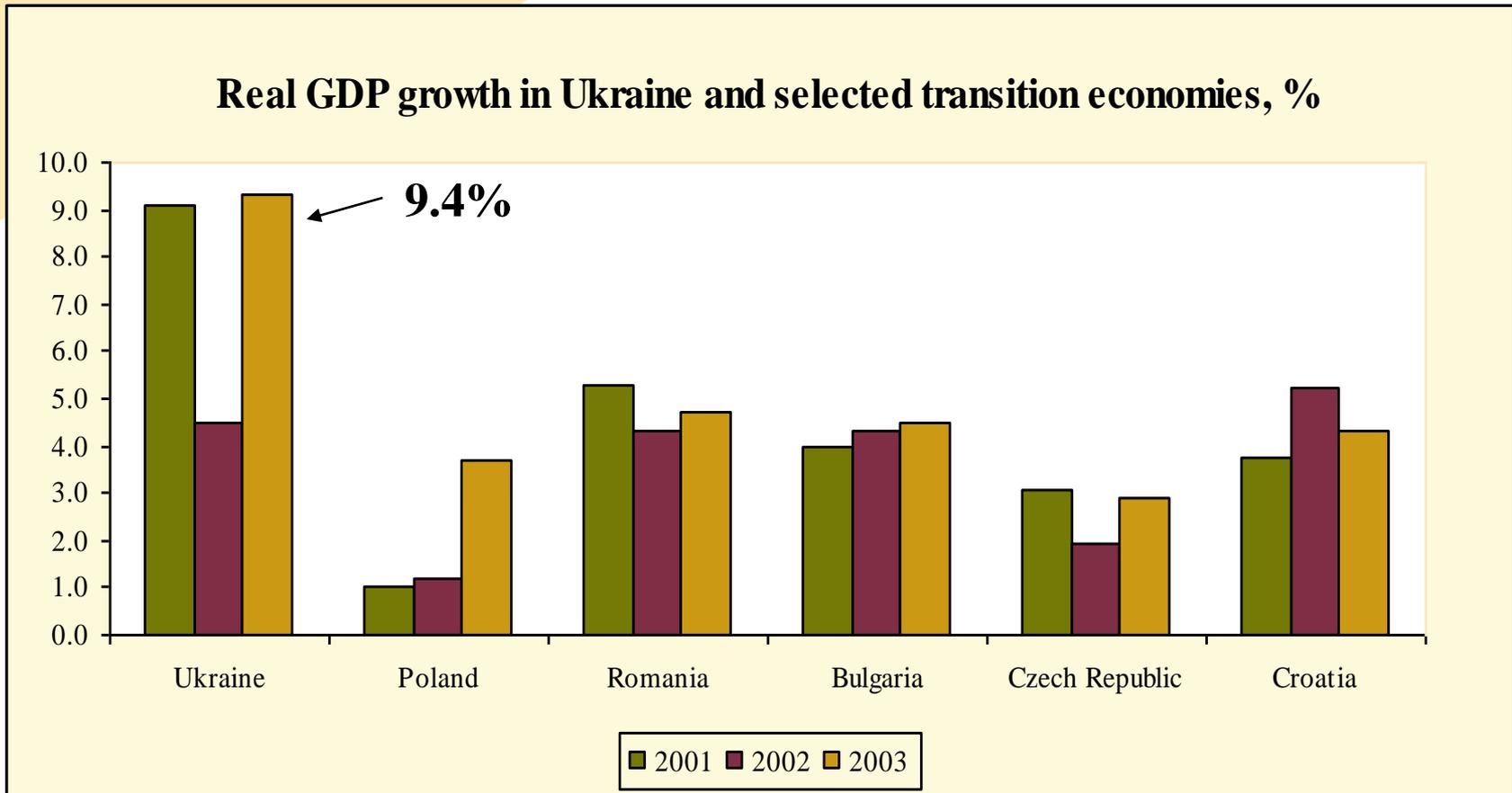


# **Ukrainian Odyssey : Economy 2004 and Investment Climate**

**October 2004**

# Macroeconomic Performance

For the 4<sup>th</sup> straight year, in 2003 Ukraine showed the best macroeconomic performance in Eastern and Central Europe



## .....Macroeconomic Performance

- **Through 2004**, the Ukrainian economy has continued to demonstrate good growth.
- In Jan-Aug 2004, real GDP growth in the country surged 13.6% year-over-year.
- In 2003, the country experienced an inflation rate of 8.2% (principally due to increases in prices of agricultural products).
- Despite some pre-election loosening, fiscal policies have been reasonable, with fiscal deficits of less than 2% of GDP.
- Inflationary pressures worsened in 2004 as the consumer price index increased by 10.7% yoy in September 2004.

## .....**Macroeconomic Performance**

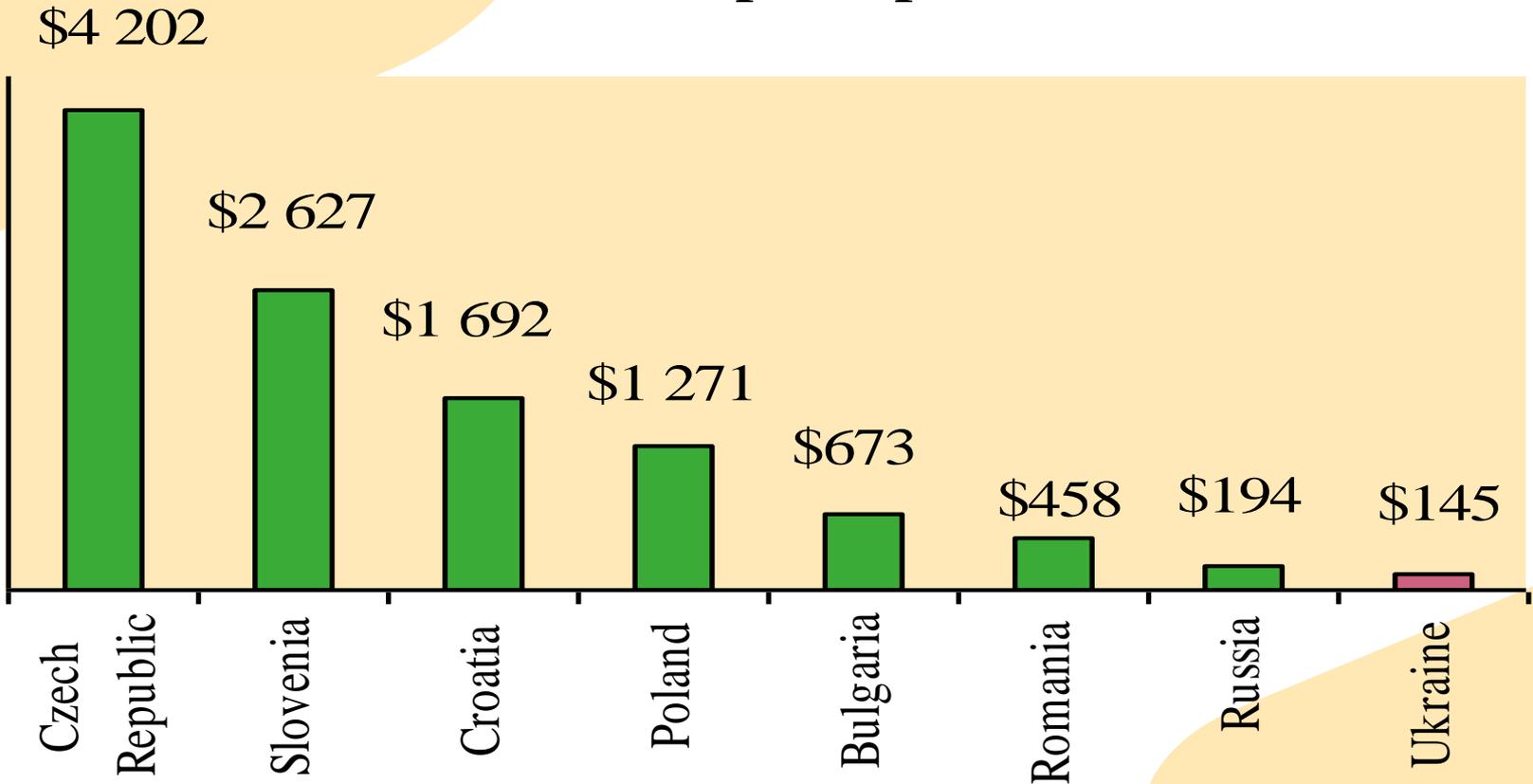
- Money supply (M3) has continued to increase at a high rate of over 45% per year in 2003 .
- The level of international reserves of the NBU has been expanding rapidly, reaching \$12.1 billion at the end of September 2004, equivalent to about 18 weeks of imports, consistent with IMF guidelines for international reserves.
- Current account balance reached \$2.9 billion in 2003 (5.9% of GDP).
- External debt amounts to \$10.7 billion, or about 22% of 2003 GDP. This is one of the lowest debt ratios in emerging markets.

## *Positive macroeconomic developments are having a positive impact on foreign direct investments (FDIs):*

- In 2003, FDIs increased by almost 80% yoy, to \$1.4 billion, reflecting growing investor's confidence.
- In the first half of 2004, net FDI inflow reached \$884 million, and for the entire year is expected to reach \$1.5 billion.
- SigmaBleyzer's study indicates that Ukraine could between \$3.5 to \$6.4 billion per year of FDI if it were to improve its business environment (under middle and optimistic scenario, respectively).

*Despite positive inflow dynamics, cumulative FDI in Ukraine is still extremely low compared to other economies in the region....*

**Cumulative FDI per capita in 2003**



*...reflecting, in part, still poor investment climate*

## Possible Risks to Economic Growth

- Strong inflationary pressures emerged as a result of:
  - Substantial fiscal loosening approved in 2004 (as a result of the increase in pensions)
  - Spending of huge privatization receipts for current, non-investment purposes
- Lack of exchange rate flexibility
- Rapid credit expansion and low quality of credit portfolio
- External shock (Ukrainian growth is, to a great extent, export-led )

## .....Risks to Economic Growth

To ensure sustainable economic growth over the  
medium term,

**sound monetary and fiscal policies**

Must be maintained and  
must be complemented by

**policies facilitating sustainable investment activity  
or “investment drivers”.**

# Where did nine investment drivers come from?

## SigmaBleyzer's Study methodology

- To identify the key factors affecting a country's investment climate SigmaBleyzer in collaboration with the Thunderbird Corporate Consulting Group conducted three types of analyses:
  - (1) Benchmarking analysis
  - (2) Cross-section statistical analysis
  - (3) Time-series analysis
- Foreign direct investment inflows were considered a good gauge defining the adequacy of a country's investment climate

## **SB Study Methodology: Benchmarking**

- The purpose of the Benchmarking Analysis was to assign values to the policy actions that could explain the flow of capital flows of a number of countries.
- Policy actions that affect foreign investments were assessed in the following **five** transition countries, and compared to Ukraine: **Argentina, Chile, Hungary, Poland, Russia.**
- **Nine** “policy actions” or “drivers” were determined as key to accelerating the flow of FDI
- Scores (scale of 1 to 100) were assigned to individual policy actions in all benchmarked countries, based on original research conducted by visiting these countries

# SB Study Methodology: Cross-Section Statistical Analysis

- The Cross-Section Statistical Analysis was used to establish the relationship between FDI and policy actions for a larger number of countries.
- The scores on the nine policy actions were statistically tested against the capital inflows in **50** developing countries.
- The beta-coefficients of the multiple regression are the relative weights of the nine factors in explaining FDI inflow.

## Results of Multiple Regression Analysis:

|                  | Standardized Coefficients | t        | Sig.              | 95% Confidence Interval for B |             |
|------------------|---------------------------|----------|-------------------|-------------------------------|-------------|
|                  | Beta                      |          |                   | Lower Bound                   | Upper Bound |
| (Constant)       |                           | -2.071   | 0.059             | -6.649                        | 0.14        |
| Mj Gov Policies  | <b>1.778</b>              | 2.859    | 0.013             | 0.008                         | 0.061       |
| Political Risk   | <b>0.760</b>              | 1.448    | 0.171             | -0.012                        | 0.059       |
| Corruption       | <b>0.422</b>              | 1.213    | 0.247             | -0.01                         | 0.034       |
| Cap/TF Restrict  | <b>0.272</b>              | 0.967    | 0.351             | -0.02                         | 0.053       |
| Tax/Inv Incentiv | <b>-0.036</b>             | -0.165   | 0.872             | -0.008                        | 0.07        |
| Sample size      | R                         | R Square | Adjusted R Square | Std. Error of Est.            |             |
| 23               | 0.715                     | 0.511    | 0.323             | 0.350                         |             |

**Major Government Policies** is an aggregated index of four major “drivers” in explaining the flow of FDI into emerging markets. These are: **Liberalization of Business Activity; Legal Environment; Financial Sector Development; Corporate and Public Governance.**

- A second set of regressions gave the following results:

### Multiple Regression Analysis

|                         | Standardized Coefficients Beta | t-values | Signif. Level | Standard Error of Beta |
|-------------------------|--------------------------------|----------|---------------|------------------------|
| Business Liberalization | <b>1,140</b>                   | 3,09     | 0,003         | 0,368                  |
| Legal Environment       | <b>0,646</b>                   | 1,99     | 0,053         | 0,325                  |
| Governance/Pub Adm      | <b>0,719</b>                   | 1,87     | 0,067         | 0,384                  |
| Investment Incentives   | <b>-1,863</b>                  | -4,54    | 0,001         | 0,409                  |

| R            | R Square     | Adjusted R Square | p-value.           |
|--------------|--------------|-------------------|--------------------|
| <b>0,779</b> | <b>0,607</b> | <b>0,574</b>      | <b>&lt;0.00000</b> |

## Research Done by Others

### USAID-funded Study:

A regression study of 67 emerging economies made by Morgan Stanley Dean Witter in July 1998 validates the results from our own 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.

## Morgan Stanley Dean Witter Study (cont-d)

- **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).

## Morgan Stanley Dean Witter Study (cont-d)

- **Finding 5:** The key determinants of “Economic Openness” were:
  - Little government interference in markets, “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.

## Study by the International Center for Policy Studies in Ukraine.

A survey made of 65 foreign companies identified the following as the four major deterrents to foreign investments:

- Instability and heavy burden from Government's regulations on businesses
- Ambiguity of the legal system
- Uncertainty of the economic environment
- Corruption

## **Study Made by German Advisory Group.**

A survey of 20 foreign companies in Ukraine ranked the following as the main impediments to foreign investments:

1. Legal Uncertainty, was rated as the first and foremost impediment.
2. Government's failure to abide by its commitments.
3. Government control and remnants of command economy.
4. Lack of support from authorities.
5. Corruption.
6. Long processes for obtaining necessary permits.

The Nine “investment drivers” identified by the SB study as a key to accelerating the flow of FDI are the following:

- (1) Macroeconomic Stability
- (2) Liberalization and de-regulation of business activities
- (3) Stability and predictability of the legal environment
- (4) Corporate and public governance
- (5) Liberalization of foreign trade and capital movements
- (6) Financial Sector Development
- (7) Corruption Level
- (8) Political Risk
- (9) Country’s promotion and image

## **SB Study Methodology: Time-Series Analysis**

- The Time-Series Analysis was carried out to find out how the above relationship between FDI and policy actions changed over time as the policy actions evolved
- The previous analyses were used to construct a model to estimate the changes over time in the flows of international capital to Ukraine as a function of the changes over time of the coefficients of policy actions.
- The following formula matrix was used to predict FDI inflows into Ukraine over time on the basis of the identified actionable policies ( $I_t$ ) :

$$FDI = \Sigma [C(I_t) \times (I_t)]$$

## Results of Time-Series Analysis

- The possible evolution of FDI inflows under three scenarios depending on the depth of policy actions aimed at improving the business climate: (i) Status Quo; (ii) Middle Scenario; (iii) Optimistic Scenario
- **According to the model, Ukraine could attract between \$3.5 to \$6.4 billion per year of FDI if it were to improve its business environment (under middle and optimistic scenario, respectively).**
- The study concludes that the flow of FDI will have a multiplier effect on GDP growth. Under the Middle Scenario, the incremental FDI would generate an incremental GDP growth of 4.8% per year.

## **SB Study results are supported by similar researches done by other reputable organizations:**

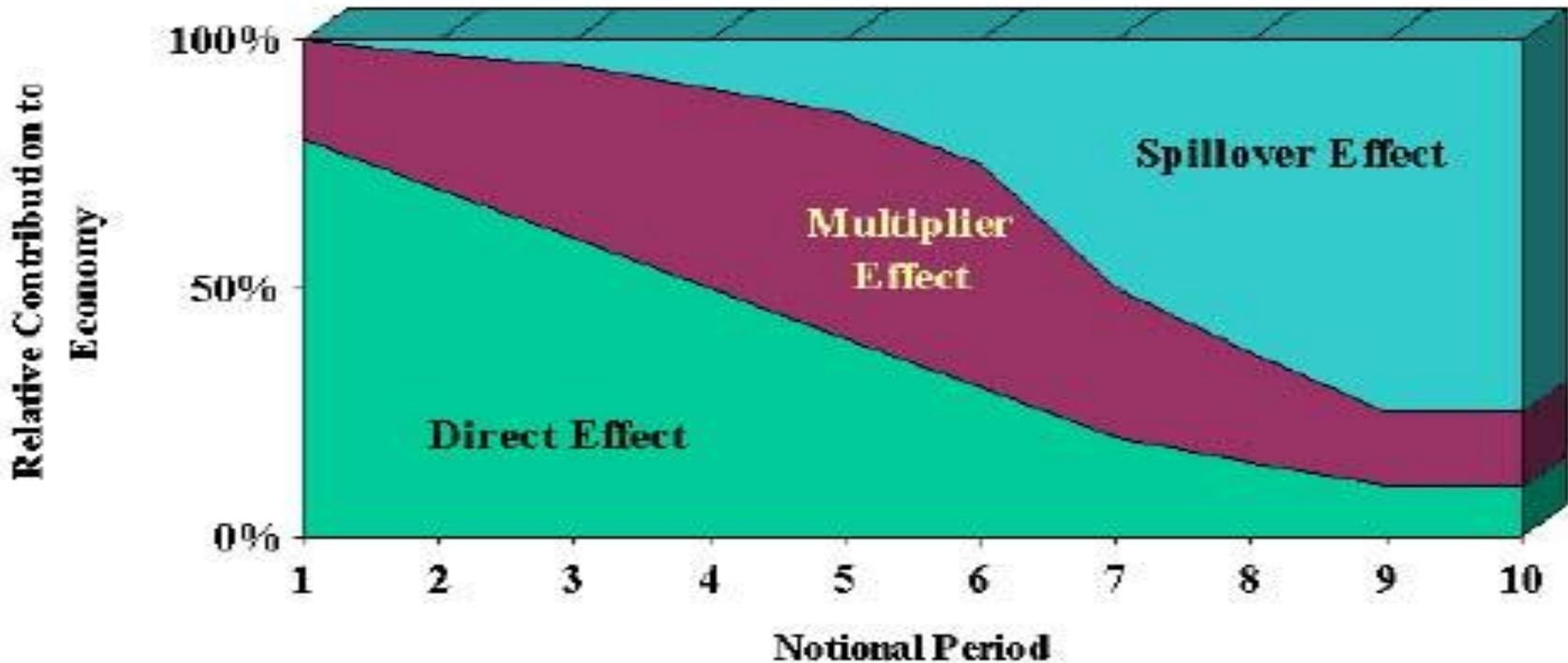
- FDI inflows are heavily influenced by the countries' policies and institutions promoting sound business environment, and very little - by “natural characteristics” (e.g. location, country size, population)
- The rate of economic growth is influenced not only by the quantity, but also by the quality of the invested capital.
- It is generally acknowledged that inflows of FDI encourage more rapid economic growth in conducive environment
- **There are three major impacts of FDI on growth and development of host country:**

**Direct effect** (increase in capital stock and employment)

**Multiplier Effect** (wage increase-related spur of domestic demand)

**Spillover Effect** (spread of modern knowledge and technology to local firms)

# Stylized Impact of FDI in Sound Business Environment: Relative contributions of direct, multiplier and spillover effects change over time



## Case Study #1: China's growth miracle

During 1979-94, China's capital stock grew 7% a year. However, capital-output ratio did not change considerably. Moreover, the share of capital in output growth was gradually declining.

| % contributions to GDP growth | Pre-1978 growth | Post-1978 growth |
|-------------------------------|-----------------|------------------|
| <b>Capital &amp; Labor</b>    | <b>82%</b>      | <b>58%</b>       |

What causes explains 42% of the GDP growth that led to almost **25 percentage points** decline of capital and labor share of post-1978 growth?

**Productivity growth was at the core of China's growth miracle!**

## Case study #1: China's growth miracle

During 1979-94, Chinese productivity increased at 3.9% a year (0.4% on average during 1960-89 in the US, about 2% during 1966-91 in “Asian tigers”).

By early 1990s, productivity's share of output growth **exceeded 50%** of Chinese output growth, while the share of capital input declined from 65% in late 70s to 33%.

**Free market-oriented reforms** that introduced freer **profit incentives** to rural collective enterprises, family farms, small private businesses, foreign investors and traders gave impetus to **productivity boom** in China.

## Case study #1: China's growth miracle

- The reforms were initiated in agriculture by introducing the contract responsibility system that provided for greater autonomy in decision-making.
- Then, the government also encouraged:
  - (1) development of small enterprises in rural areas;
  - (2) more self-management for state-owned enterprises;
  - (3) competition;
  - (4) facilitated direct contact between Chinese and foreign trading enterprises;
  - (5) foreign investments.

**Capital investments are crucial to economic growth, but only coupled with positive incentives they can result in unprecedented growth rates.**

## Case Study #2: Failure of the Argentine “machine”

In 1946, Juan Domingo Peron, the President of Argentina, believed that his country could become “an enormous machine that would function with marvellous perfection”.

Pursuing protectionist trade policy, Peron initiated a large number of public investment projects on:

- developing hydroelectric power and iron and steel industry;
- expanding coal extraction and other raw materials;
- stimulating national machine-building industry (farm machinery, planes, cars, and ships) etc.

## Case Study #2: Failure of the Argentine “machine”

**Excessive government intervention to economic activities ruined the system of incentives as a result of:**

- unwise fiscal policy;
- protectionist economic policy;
- price and wages controls;
- nationalization of economy (grain elevators, public utilities, railroads);
- state monopoly on foreign trade;
- dependent Central bank;
- compulsory membership in trade unions;
- excessive taxation.

## Case Study #2: Failure of the Argentine “machine”

**In 1940, Argentina was a developed country with standards of living comparable to Canada. Peron’s “machine” drove the country to the Third World list.**

The results of Peron’s initiatives were:

- growth slowed,
- inflation sky-rocketed
- steel production ceased to exist by 1962,
- agriculture and meat production contracted rapidly,
- international trade fell,
- real incomes and salaries declined sharply,
- indebtedness of the country increased,
- corruption flourished.

**Without economic incentives, even large capital investments, crucial for economic growth, may end up with economic disaster.**

To increase investment volumes into the country is not enough to stimulate sustainable economic growth and improvement of living standards...

...world experience shows that investment projects do not usually perform well in poor business environment.

**Thus, the basis for future sustainable economic growth lies in the improvement of Ukraine's investment climate.**

## **Policy recommendations for Ukraine are arranged within the nine investment drivers framework:**

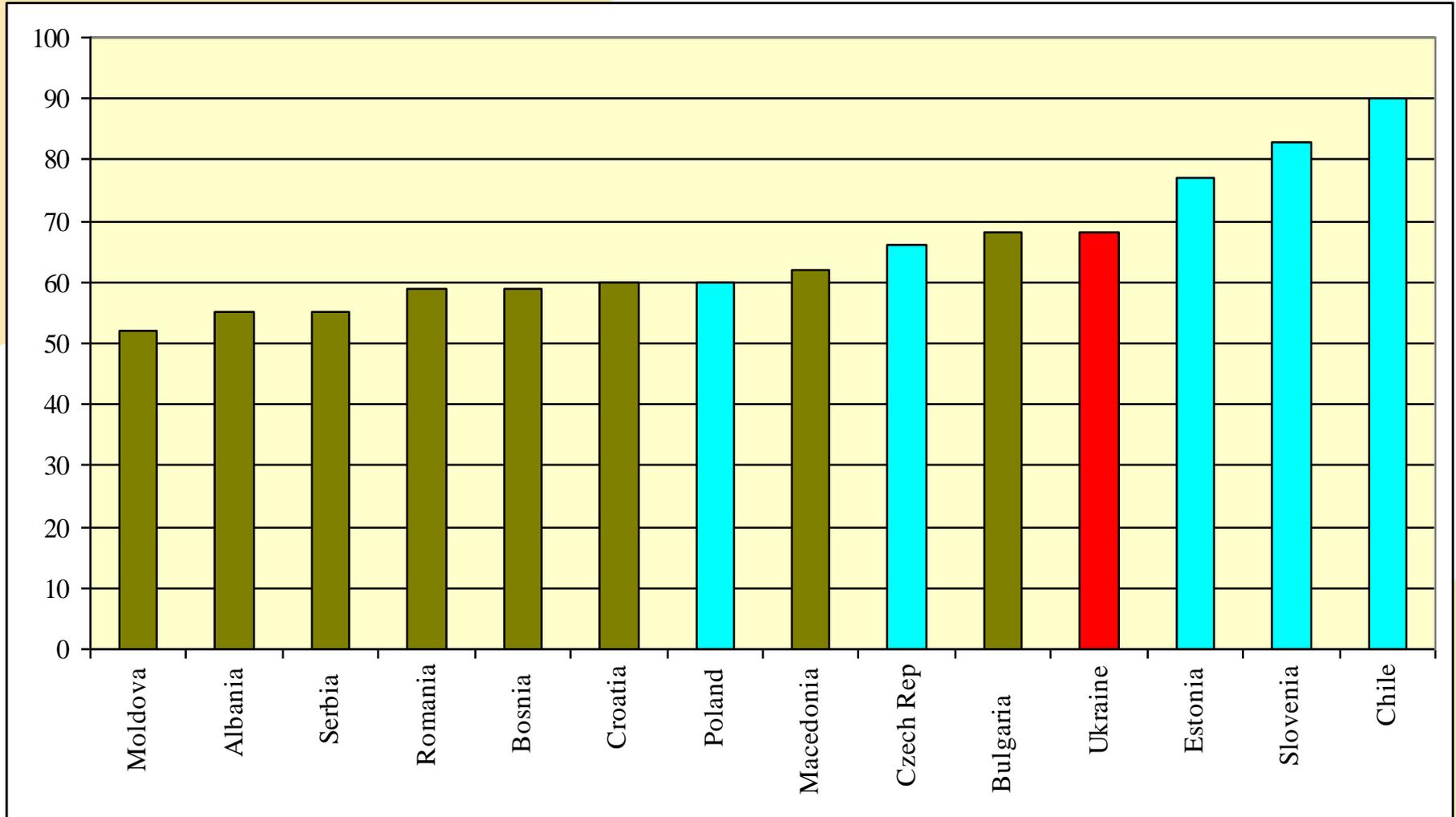
- (1) Macroeconomic stability
- (2) Business liberalization and de-regulation policies
- (3) Stable and predictable legal environment
- (4) Corporate and public governance
- (5) Foreign trade liberalization and international capital movements
- (6) Healthy financial sector
- (7) Corruption
- (8) Political uncertainties
- (9) Country promotion and image

# Driver #1: Macroeconomic Stability

In order to sustain macroeconomic stability it is necessary to:

- (1) ensure that the fiscal deficit is sustainable by eliminating tax privileges and exemptions, and ensuring that state obligations, such as repayment of VAT arrears, are met.
- (2) gradually introduce more flexibility to foreign exchange rate policy by reducing the foreign exchange surrender requirements for exporters;

# Driver #1: Macroeconomic Stability

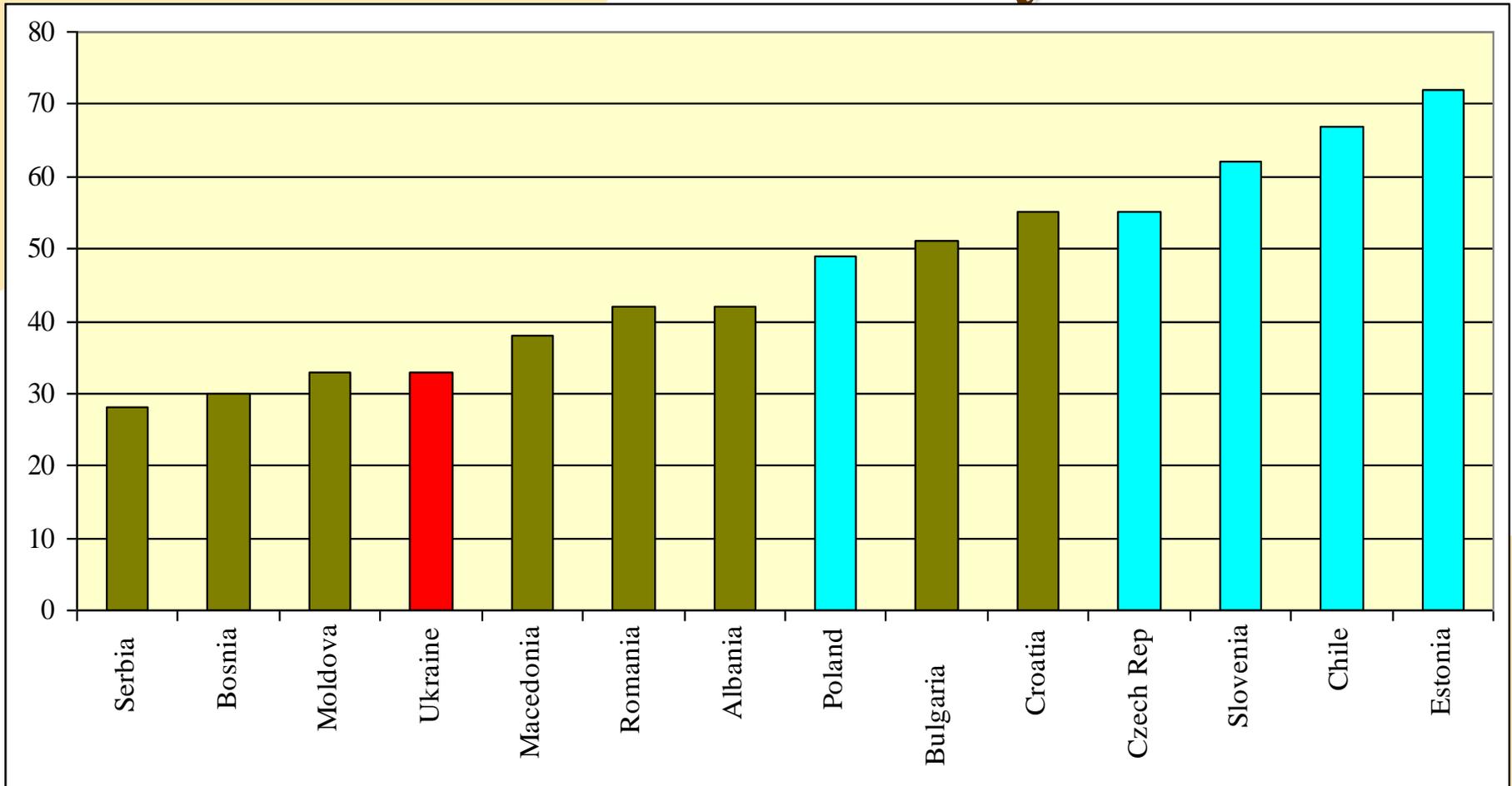


# **Driver #2: Liberalization and Deregulation of Business Activity**

Priority actions to liberalize and deregulate business environment designed to:

- (1) to eliminate excessive government intervention in businesses by abolishing the incentives of state agencies to intervene in business activities;
- (2) to develop transparent procedures for the liquidation of companies, including disclosure of information.

# Driver #2: Liberalization and Deregulation of Business Activity

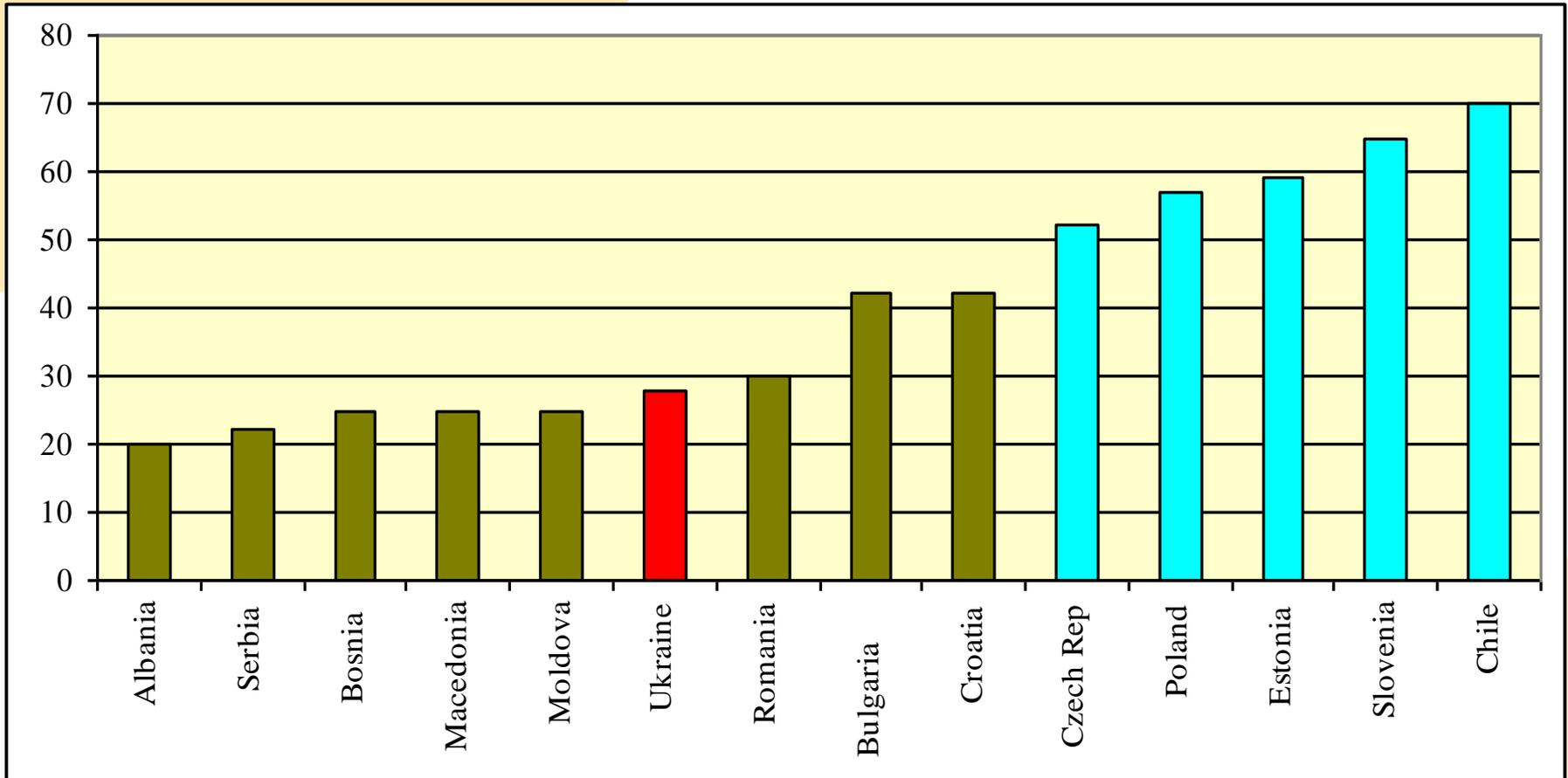


# Driver #3: Stability and Predictability of Legal Environment

To create a stable and predictable legal environment with well-defined “rules of the game” for all businesses it is necessary to:

- (1) Further improve financing of courts and increase salaries of judges to ensure their independence;
- (2) Enhance commercial courts for settling disputes;
- (3) Set the practice of thorough consideration of any kind of regulations to adopted, including their correspondence with existing legislation

# Driver #3: Stability and Predictability of Legal Environment

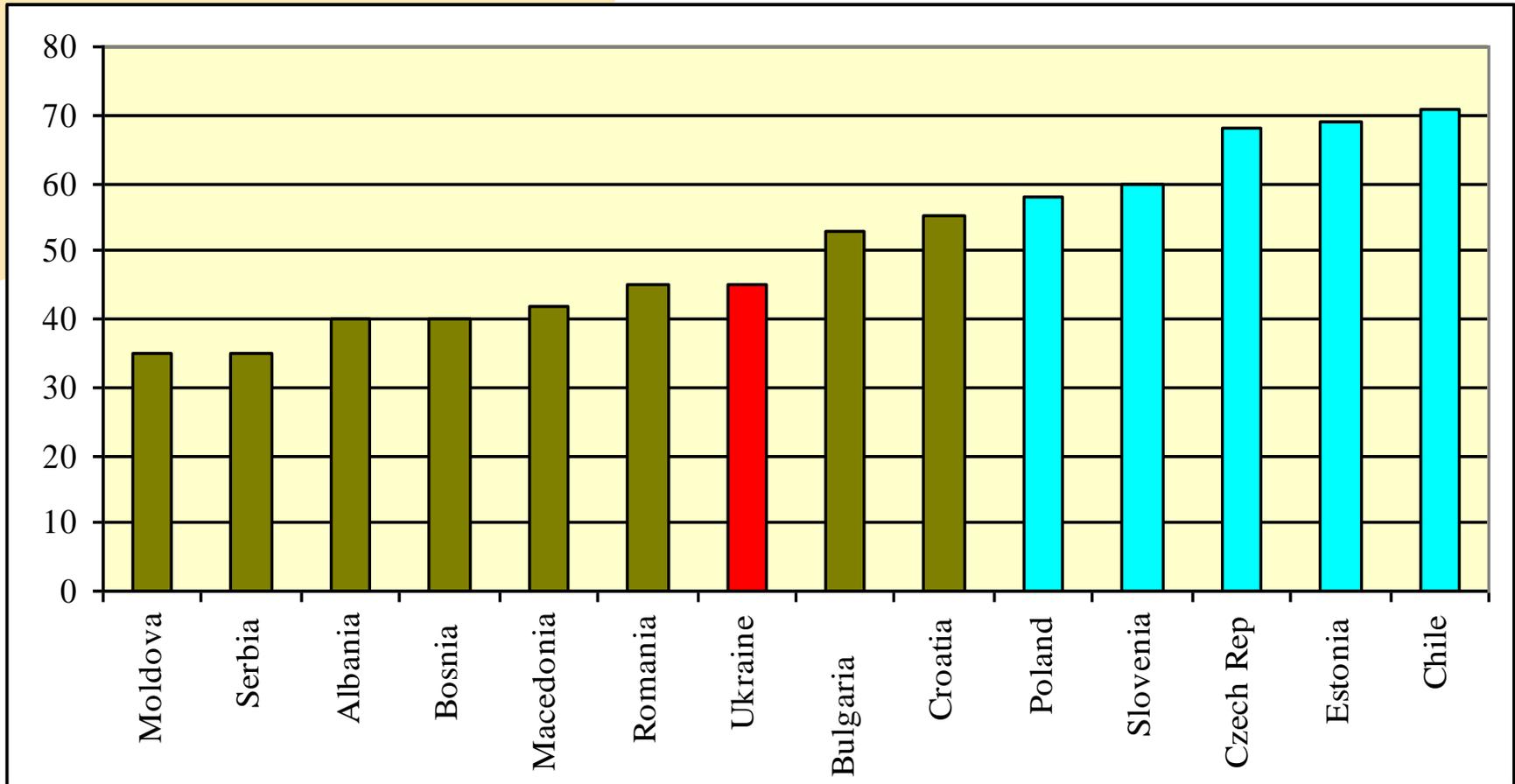


# **Driver #4: Corporate and Public Governance**

Development of **sound corporate and public governance** will benefit greatly from:

- (1) The adoption of the Joint Stock Company Law, according to international standards;
- (2) Functional and operational reviews of government agencies to streamline decision-making process;
- (3) Establishment of adequate procedures to ensure that privatization process is transparent and competitive

# Driver #4: Corporate and Public Governance

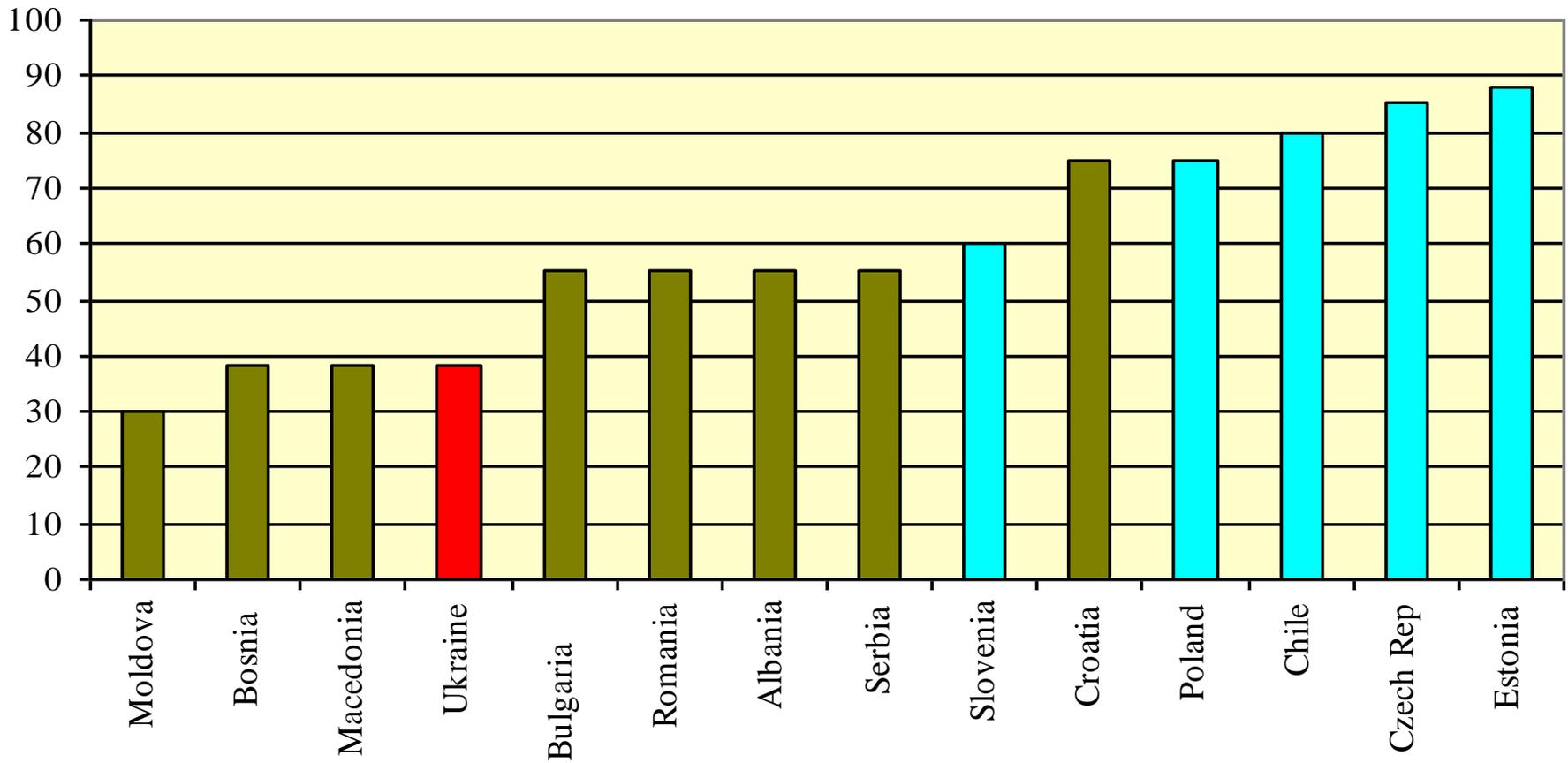


# Driver #5: Liberalization of Foreign Trade and Capital Movements

Key to further liberalization of foreign trade is to:

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

# Driver #5: Liberalization of Foreign Trade and Capital Movements

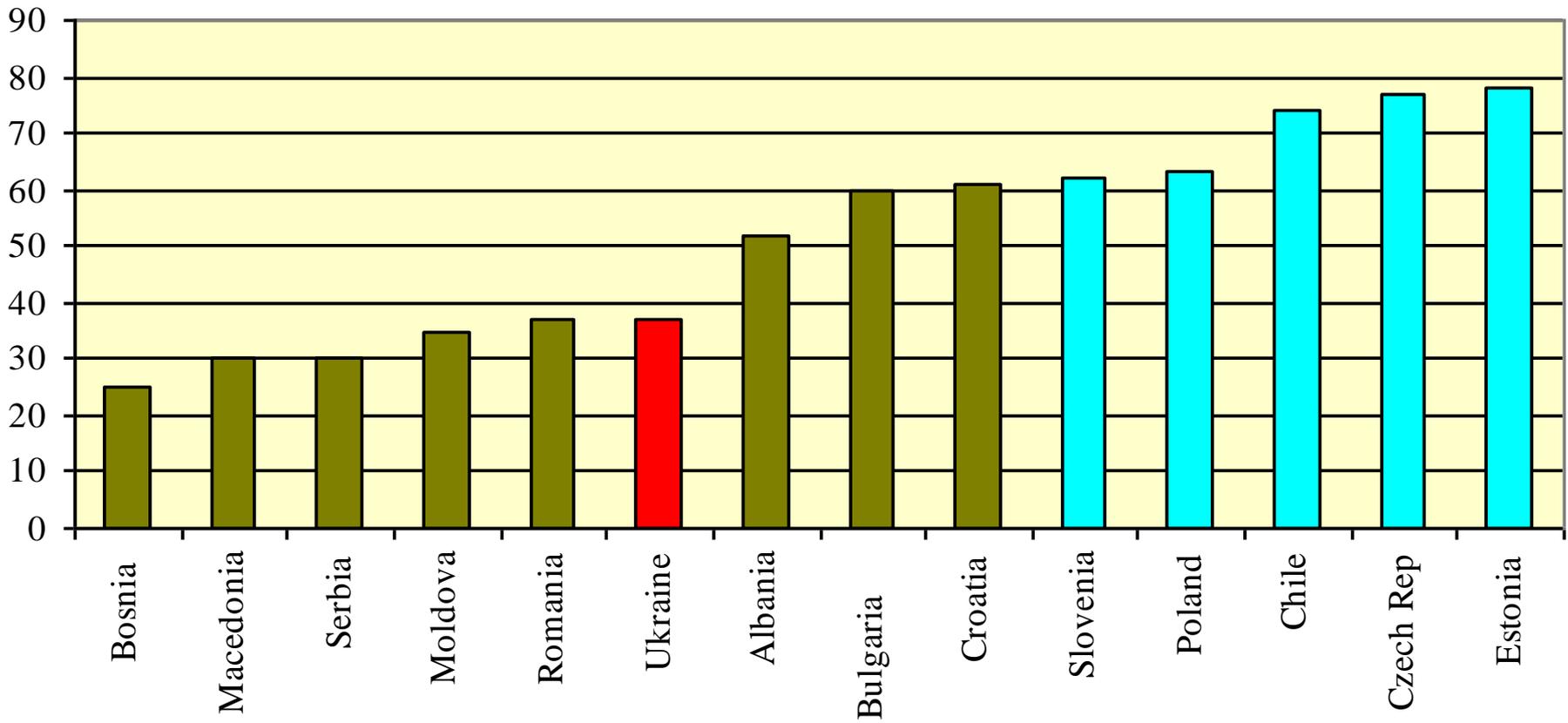


## **Driver #6: Financial Sector Development**

In order to develop a **healthy financial sector** capable of meeting financial needs of growing businesses it is necessary:

- (1) To further improve banking supervision, including stronger prudential regulations (capital adequacy, lending to related companies, etc.);
- (2) Encourage stock market transactions to be made on the organized market;
- (3) To facilitate the development of private pension funds.

# Driver #6: Financial Sector Development

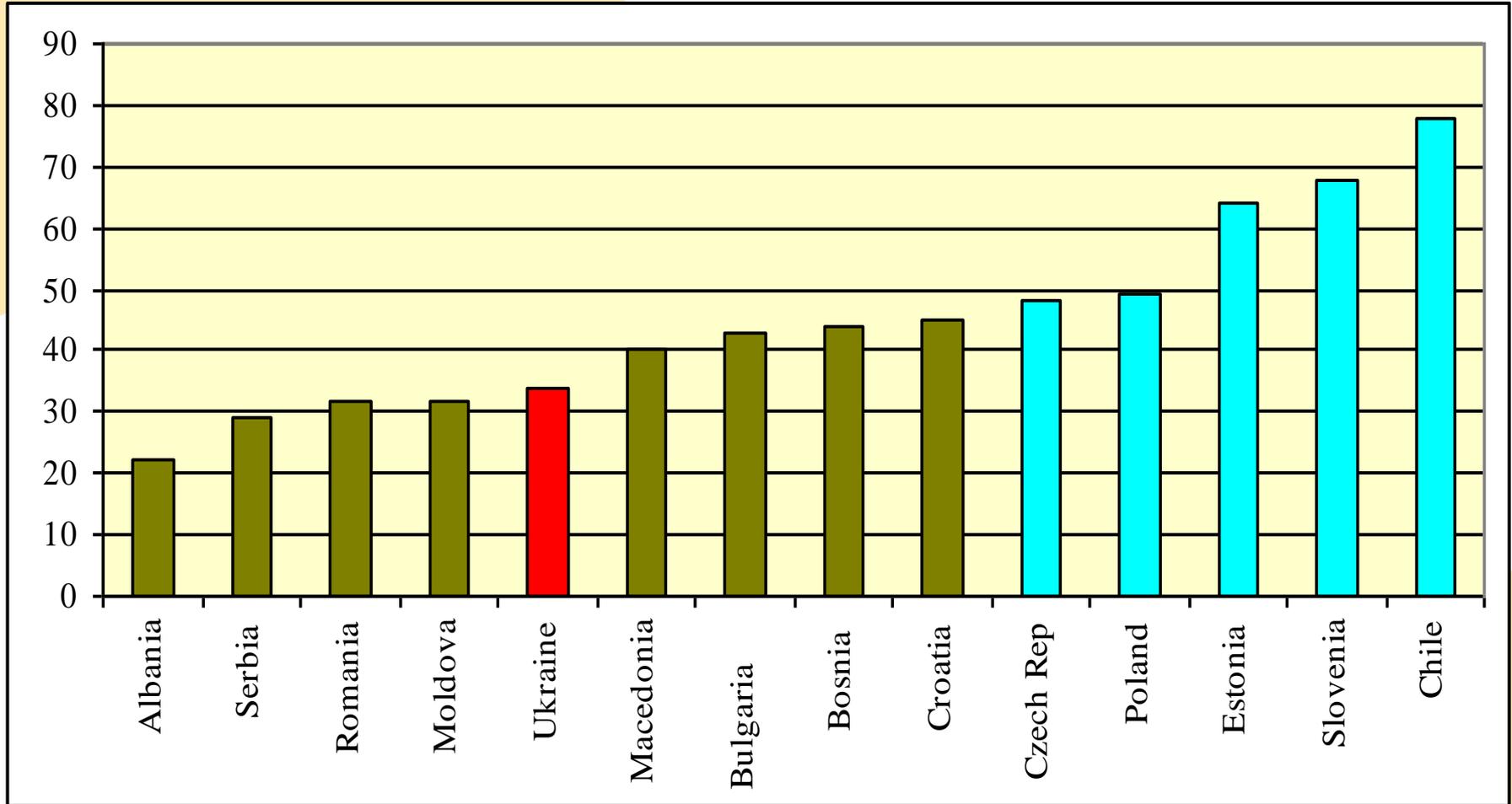


## **Driver #7: Corruption**

Important measures to prevent **corruption** are:

- (1) to continue with the public administration reform to improve transparency of decision-making process;
- (2) to reduce the ambiguity of government regulations and raise accountability of the public servants for their decisions;
- (3) strengthen the internal audit office.

# Driver #7: Corruption (100 – no corruption)

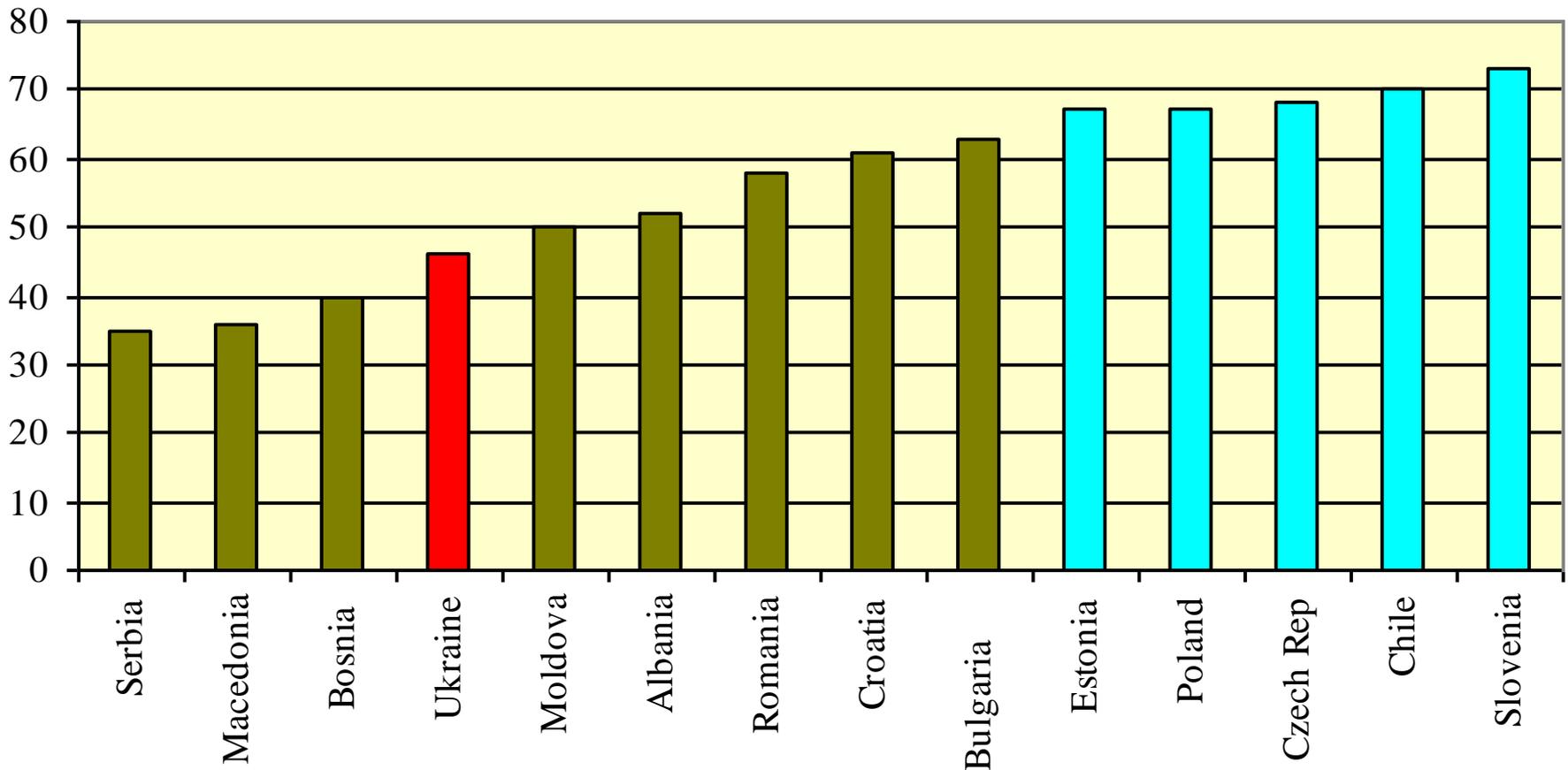


## **Driver 8: Political Risks**

In order to minimize the **political risks** for business activities it is important:

- (1) to strive for governmental stability, including longevity of key officials;
- (2) to take measures to eliminate power abuses at different levels of the authorities.

# Driver #8: Political Risks (100 – no risk)

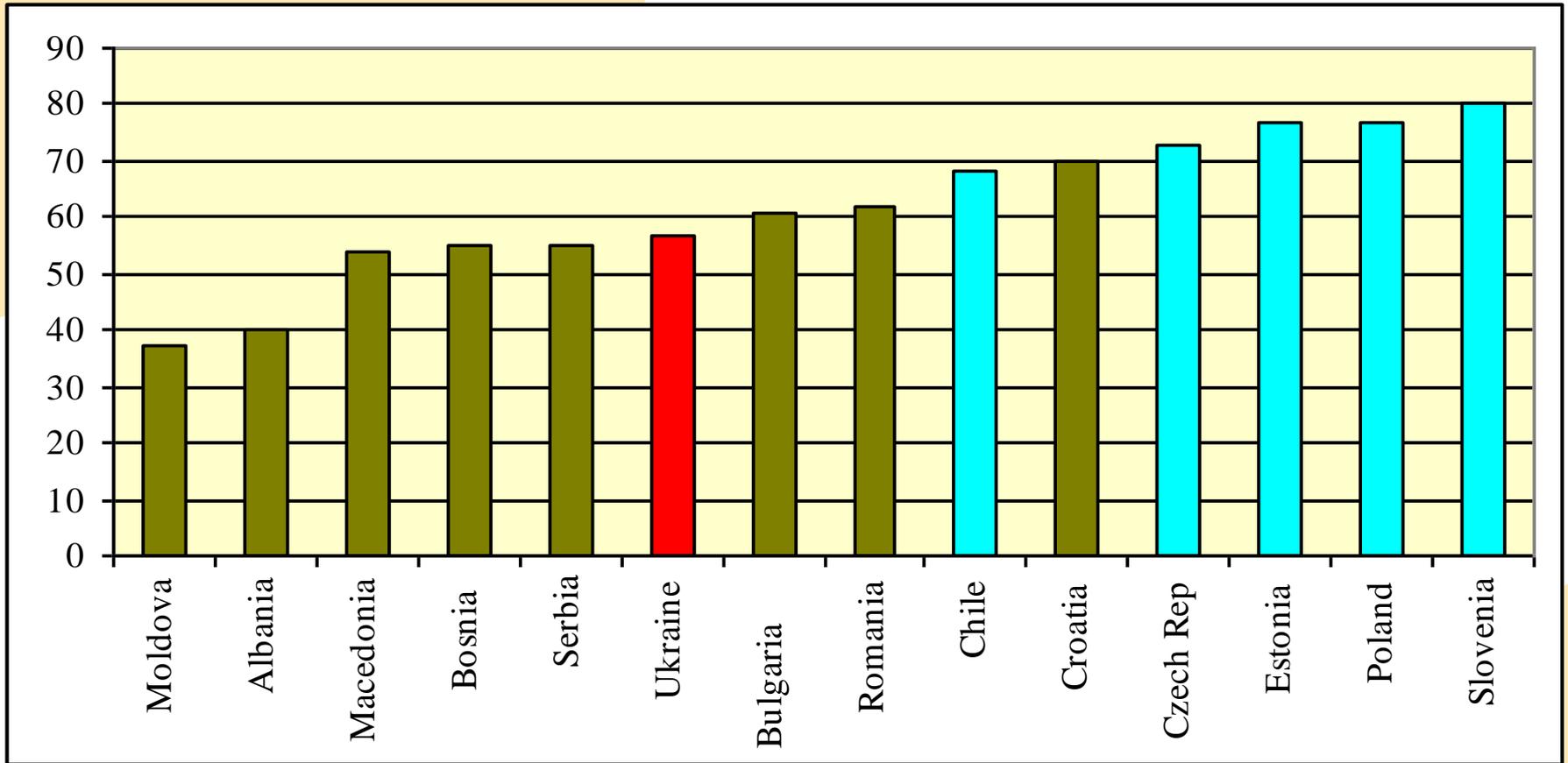


## **Driver 9: Country Promotion and Image**

Among priority actions to **promote and inform investors about business opportunities in the country** are:

- (1) To ensure effective functioning of the investment promotion agency;
- (2) Continuously interact with representatives of the private sector in Ukraine to learn the problems they are facing and provide feedback on dealing with those problems.

# Driver 9: Country Promotion and Image



- Experience across many transition economies show 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.
- This policy could be accompanied by more concrete efforts to attract large foreign investors to the country.
- But without a liberalized business environment, stable legal system and good public and corporate government, these efforts will not yield results.