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How to improve the investment climate in the CIS?

by Alina Kudina

Private capital flows and foreign direct investment (FDI) to developing and transition economies has soared throughout most of this decade. In 2008 net private sector capital flows reached an estimated $619 billion (from a record $900 billion in 2007) while FDI accounted for an estimated $580 billion. Some of this capital has headed to the Commonwealth of Independent States (CIS), a region whose prospects have improved considerably since the 1998 Russian financial crisis. Although the amount of capital flows into the CIS has been largely insignificant prior to and shortly after the crisis, currently their share of global private capital flows has averaged a more impressive 13%. Attracted by the region's decade long growth, international investors began investing in the CIS to exploit potentially lucrative investment opportunities.

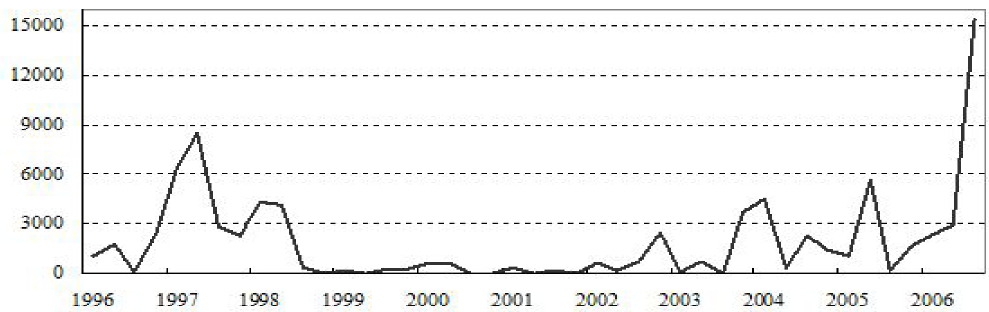
Nevertheless, the economies of the CIS are not immune to external shocks or loss of investor confidence. An abrupt withdrawal of capital may have severe consequences given the relative small size of their economies and low market capitalization. Recent turmoil in the financial and credit markets along with a general deterioration in the global investment climate has created an increasingly challenging environment for the CIS. Given that the financial sector accounts for a greater portion of each economy it is crucial that the CIS improve its investment climate. Policy-makers in the region can assist in attracting additional portfolio capital and FDI by supporting stronger macroeconomic fundamentals, promoting greater integration with regional and global trading blocs, and reforming domestic financial, regulatory, and political institutions. All of these policies can significantly improve the CIS's image as an attractive investment destination.

Portfolio Flows into the CIS

Since their independence from the Soviet Union and subsequent integration with the global economy, the economies of the CIS have experienced volatile swings in their short-term capital flows. Since 2005, however, CIS portfolio flows have picked up considerably as a result of stronger regional economic growth and financial market development. The amount of capital inflows into the CIS between 1995 and 2006 totalled $83.2 billion. However, the CIS are still highly vulnerable as was demonstrated during the second half of 2008. An abrupt withdrawal of capital from the region triggered by the global financial crisis has brought severe consequences and exposed many investment challenges, especially within its largest markets: Russia, Ukraine and Kazakhstan. Up until recently these countries had experienced substantial inflows of equity capital thanks to robust activity within the region's stock markets and IPO (initial public offering) deals. That said, major economic and political challenges remain, including initiating additional market liberalization as well as strengthening legal and regulatory reforms. Consequently, future portfolio flows into the CIS will continue to be volatile and susceptible to global financial fluctuations.

A recent CASE study[1] identified key factors that drive portfolio flows into the CIS countries. The determinants of portfolio inflows are divided into four external categories[2] based on the Tobin-Markowitz framework: (i) investment return in home country relative to abroad, (ii) perceived risk of investments, (iii) degree of co-movement between international returns, and (iv) diversification motive. This set of factors enables a comprehensive analysis of the main determinants of portfolio flows into the CIS. However, it was domestic factors that helped to determine the size and scope of country portfolio flows including restrictions on cross-border capital movements, political stability, financial market development, and exchange rate as well as financial risk.

Figure 1. Portfolio investment inflows in the CIS countries, million USD



Source: International Financial Statistics

A domestic factor that has heavily influenced capital flows into the CIS has been the restriction on cross-border capital movements. The ease of liquidating an investment in the local market tends to be very important for investors. In the CIS, controls on capital flows have not been lifted and explains the relatively modest volumes of portfolios flows coming into the CIS as compared to direct investments.

Another factor that has shaped the pattern of portfolio flows into the CIS has been their shaky political environments. The CIS countries have undergone consistently changing political situations which have had a detrimental impact on their investment climate. Thus, strengthening political stability through institutional reform and greater transparency will have a considerable impact on future investment flows.

1 Kudina, A. and Lozovyi, O. (2007), "Determinants of Portfolio Flows into CIS Countries", *CASE Network Studies and Analyses*, No. 354.
2 Calderon C., Loayza N. and Serven L. (2003), "Do Capital Flows Respond to Risk and Return?" The World Bank, *Policy Research Working Paper*, 3059.

Underdeveloped financial markets are another restrictive factor affecting portfolio flows into the CIS. In the first years of independence the scope of investment opportunities was limited to debt instruments. As a result portfolio flows were dominated by government securities. Improving the financial market infrastructure to attract private capital into the CIS will improve both the quantity and quality of future portfolio flows.

Domestic regional events also play a crucial role in determining the investment climate in the CIS. For instance, the Russian crisis of 1998 is believed to have had the largest impact on portfolio flows into the CIS. Directly following the Russian default portfolio outflows from the CIS amounted to $1.7 billion, $2.7 billion when one includes Russia. The CIS's deep economic, historic, and cultural ties with their former benefactor significantly impact their brand image with investors.

There is also a noteworthy link between the growth in portfolio flows in Central and Eastern Europe (now EU member states) and enhanced capital flows to the CIS. It is likely that some investors expect CIS countries to have economic performances similar to those of the new EU member states. Hence, investment into the CEE and CIS are deemed complementary: the more capital flows into the CEE countries, the more likely capital is to flow into the CIS.

Overall, domestic factors such as success of institutional reforms and improved creditworthiness are the key drivers that will attract capital flows into the CIS. Investor sensitivity to these factors indicates that CIS countries need to pay considerable attention to the development of a healthy economic and political environment in order to improve their investment climates.

Policy Implications for Increasing Capital Flows into the CIS

Policy-makers can assist in attracting more portfolio investment into CIS countries with the following actions:

-1-

Supporting strong macroeconomic performance. As investors link actual investment with country performance, inadequate macro policies may transfer into sudden capital flight in time of distress. Otherwise, negative consequences for the economy and, in particular, the financial sector, may be even more pronounced.

-2-

Positive economic developments in the CIS region should be accompanied by lowering/abolishing restrictions on the current account, reforming domestic financial sectors and further integrating with the global economy.

-3-

CIS countries must continue to grow, reform and integrate with global trading blocks. This will allow the return of short-term capital and thus contribute to the development of stronger domestic financial markets and allow for the cheaper financing of budget deficits over time.

Foreign Direct Investment (FDI) Flows into the CIS

FDI inflows into the CIS averaged $19 billion a year between 2000 and 2006; half of it went to Russia. Although FDI in the CIS has increased over the last decade, the quality and type of investment is still limited. On average, the CIS economies have been less dependent on FDI than other transitional economies in Central and Southeastern Europe. Moreover, the majority of non-oil multinational enterprises (MNEs) that dominate the investment landscapes of Ukraine, Kyrgyzstan, Moldova and Georgia operate as "isolated players", serving local markets through strong links with parent companies, rather than cooperating with local firms or exporting finished products to markets outside the region. Most foreign firms site volatility in the economic and political environment, ambiguity of the legal system, and high levels of corruption as the greatest operational barriers in the region.

The success and failure of FDI in the CIS is highly dependent on investor type (market-, resource- and efficiency-seeking) as well as their investment motives and operating model. A recent report by CASE[3], based on a survey of 120 foreign-owned companies, examined the motives behind FDI in the four aforementioned countries in addition to tangible ways of improving their investment climates.

Up until the early 2000s, the abundance of natural resources in several CIS economies had been one of the most important determinants of FDI. The majority of these investments were related to resource/energy extraction, construction of transport pipelines, large privatizations, and debt/equity swaps to pay for energy supplies.

However, the dominant motive for investment in the four non-oil producing CIS countries has been driven by market expansion. According to investors the opportunity to supply products and services to local domestic markets as well as proximity to the European Community were the main drivers of investment. Foreign firms' share of recipient country markets range from 20 to 47 percent and so choosing to serve the local market has been shown to be the most profitable strategy for past investors.

It is expected that together with closer integration with the global economy (particularly with the EU) and the fall in overall protection, low-cost CIS labour will attract new waves of investments, similar to those experienced in CEE and SEE countries at the beginning of the decade. However, the growing threat of protectionism and general downturn in FDI towards developing countries will present major challenges for the CIS's labour markets. Also, access to CIS research and technological expertise is not a leading factor in attracting FDI, suggesting that investors have yet to view the region's domestic suppliers as possessing the necessary skill-sets or efficiency capabilities to export CIS made products to outside markets. Therefore, the influence of technological spillover onto domestic firms is still quite limited.

In light of current economic realities competition for increasingly scarce investment capital will become steeper in the years to come. In order to attract future investments CIS economies need to quickly address some of the major impediments that are holding back economic development.

The most urgent problems facing the CIS include volatility of the political environment, growing economic uncertainty, ambiguity of the legal system, and high levels of corruption. Political and economic instability, along with an inadequate physical infrastructure, deter many investors from Georgia and Kyrgyzstan. Last August's war between Russia and Georgia only undermined Georgia's credibility as a stable investment destination. Ukraine and Moldova may appear to be more stable, but investors continue to perceive bureaucracy, corruption, and domestic legislative uncertainties as the main obstacles to successful business operations. Ukraine's recent gas crisis, which cut-off both domestic and EU-wide energy supplies, severely tarnished its image as a secure energy provider. In addition, all of these countries need to take bold steps to curb both petty and institutional corruption. The majority of CIS countries, with the exception of Georgia (ranked 67 of 163 countries), placed in the bottom third of Transparency

3 Kudina, A. and Jakubiak, M. (2008), "The Motives and Impediments to FDI in the CIS", *CASE Network Studies and Analyses*, No. 370.

International's 2008 Corruption Perception Index.

An ambiguous legal system and lack of clear property rights continue to be major concerns for investors seeking cheap factors of production in the CIS, whereas the uncertainty of the economic environment is most harmful for investors seeking skilled labour or use of local R&D. Thus improving macroeconomic stability should be of primary importance for governments hoping to attract skilled labour- and R&D-seeking FDI. Interestingly, these two types of investments bring the greatest economic benefits and development to the host country. Improving the legal system will also help foreign companies to develop their operations and build links with domestic businesses, thus helping them to make a development impact much sooner.

Table 1. Assessment of problems faced by foreign investors in the CIS

Problem	Ukraine	Moldova	Kyrgyzstan	Georgia	Total average
Volatility of the political environment	3.4	3.3	4.5	2.8	3.5
Uncertainty about the economic environment	3.3	3.4	4.4	2.9	3.5
Ambiguity of the legal system	3.9	3.5	3.5	2.7	3.4
Corruption	4.0	3.9	3.1	2.1	3.3
Bureaucracy	3.9	3.9	3.1	2.0	3.2
Lack of physical infrastructure	2.5	2.8	3.9	2.9	3.0
Backward technology	2.4	2.9	3.1	2.4	2.7
Lack of business skills	2.4	2.6	3.1	2.7	2.7
Finding a suitable partner	2.5	2.9	2.3	2.8	2.6
Problems in establishing clear ownership conditions	3.2	2.9	1.7	2.4	2.6

Source: survey results (CASE Network Studies and Analyses No. 370)
Note: higher number indicates that a given impediment is more important. Numbers are simple averages.

Policy Implications for attracting additional and higher quality FDI into the CIS

Policy-makers can assist in attracting higher quality FDI into the CIS by doing the following:

-1-
Securing greater macroeconomic and political stability, and reducing the ambiguity of the legal system.

-2-
Removing legal deficiencies to stimulate more active interaction between foreign companies and local businesses, as well as the development of infrastructure (transport, industrial).

-3-
Fighting corruption in order to attract efficiency-seeking (R&D) investment. Political willingness is the key and will define the effectiveness of actions taken.

In the long-term promoting linkages with the domestic economy (through business incubators, information clearing houses) and/ or building local technological capabilities via R&D, high tech industrial parks, and training institutions. More immediately an improvement in intellectual property rights would go a long way in attracting greater amounts of higher quality FDI.

Conclusions

Institutional investors notice positive developments in the CIS and tend to react to them. If positive economic developments in the CIS are accompanied by bold action, including reform of the domestic financial sector, further integration within the region and global economy, and strengthening of legal, political, and regulatory institutions, an upsurge in portfolio flows and FDI into the region is sure to be expected.

However, the majority of future investments, at least in the short-term, will be focused mostly on market-seeking and low-cost production and labour investment strategies. Current analysis suggests rather pessimistic implications for the influence of technological spillovers from FDI on the productivity of domestic firms in the CIS. In studies examining CEE data, it was apparent that the highest productivity-increasing gain for local firms took place when foreign-owned and technologically superior firms bought local supplies, taught suppliers and made them acquire new technologies. In the case of the CIS it seemed that potential spillovers from FDI were rather limited to certain firms and/or sectors of economic activity. Foreign firms in the CIS seem to buy supplies locally only when necessary, and prefer to concentrate on capturing domestic demand.

Although the economies of the CIS are still in the process of maturing and developing, taking the necessary steps to improve their investment climate, sooner rather than later, will help them secure a greater chance of more diverse and longer-term investment in the future.

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