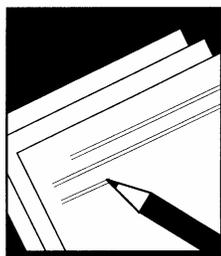


# Policy Discussion Paper



# IMF Policy Discussion Paper

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## FDI and the Investment Climate in the CIS Countries

*Clinton R. Shiells*

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### **FDI and the Investment Climate in the CIS Countries**

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#### **Abstract**

The views expressed in this Policy Discussion Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Policy Discussion Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

In view of disappointing levels of inward foreign direct investment (FDI), this paper examines capital flows into the Commonwealth of Independent States (CIS) countries and investigates the main impediments to a more favorable investment climate. Direct investment inflows have generally been related to natural resource extraction or energy transportation infrastructure projects, large privatization transactions, and debt/equity swaps to pay for energy supplies. Low FDI inflows despite strengthening macroeconomic performance has reflected a weak investment climate particularly owing to incomplete structural reforms. IMF staff working on the countries concerned cited burdensome tax systems, widespread corruption, extensive state intervention coupled with weak legal and regulatory frameworks, and incomplete structural reforms as the main impediments.

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	Contents	Page
I.	Introduction.....	<a href="#">3</a>
II.	Foreign Direct Investment (FDI) .....	<a href="#">7</a>
	A. Energy Exporting Countries .....	<a href="#">8</a>
	B. Reforming Energy Importers .....	<a href="#">12</a>
	C. Other Energy Importers .....	<a href="#">14</a>
	D. Motivation for FDI.....	<a href="#">15</a>
III.	Investment Climate .....	<a href="#">16</a>
	A. Energy Exporting Countries .....	<a href="#">17</a>
	B. Reforming Energy Importers .....	<a href="#">20</a>
	C. Other Energy Importers .....	<a href="#">23</a>
	D. Comparison with Other Regions.....	<a href="#">23</a>
IV.	Conclusions and Policy Implications.....	<a href="#">26</a>
	References .....	<a href="#">32</a>
 Text Table		
1.	Correlations Between Regions in the Rankings of Investment Obstacles.....	<a href="#">25</a>
 Boxes		
1.	The Role of Privatization .....	<a href="#">29</a>
2.	Net Capital Flows .....	<a href="#">30</a>
 Figure		
1.	Commonwealth of Independent States (CIS) and Central and Eastern Europe and the Baltic States (CEB): Net FDI Inflows, 1989–2001 .....	<a href="#">31</a>

## I. INTRODUCTION

Foreign direct investment (FDI) has an important role to play in filling the gap between domestic savings and the high levels of investment needed to support economic growth in the Commonwealth of Independent States (CIS)<sup>2</sup> countries over the medium term. Moreover, it provides external financing often (though not exclusively) in the form of equity rather than debt, frequently in the export or import–competing sectors, all of which contributes to an improved external position. The literature stresses the importance of FDI as a source of technology and management expertise.<sup>3</sup> Investment may involve creation of new firms or expansion/restructuring of existing firms. De novo firms are particularly important for growth in transition countries. However, creation of de novo firms in the CIS countries has thus far been low, reflecting entry barriers.<sup>4</sup>

Aggregate investment in the CIS countries contracted sharply following the breakup of the Soviet Union (see De Broeck and Koen (2000) and Campos and Coricelli (2002)). More efficient use of existing investment could undoubtedly be made, for instance through better governance. Nevertheless, FDI generally has fallen dramatically short of levels needed to

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<sup>2</sup> These are Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

<sup>3</sup> See, for instance, Borensztein and others (1998).

<sup>4</sup> For evidence concerning the creation of de novo firms in the CIS countries, see Havrylyshyn and McGettigan (2000) and Vandycke (2003).

offset the low domestic investment rates.<sup>5</sup> There is a huge gap between the levels of cumulative net FDI inflows per capita into some of the transition economies of Central and Eastern Europe and the Baltic states (CEB),<sup>6</sup> on the one hand, and the CIS countries, on the other. Average annual levels of net FDI inflows, relative to GDP, also fall short of levels in the CEB countries, although the shortfall is smaller (see Figure 1).<sup>7</sup>

The weakness in investment levels, including especially FDI, has given rise to a concern with the quality of the “investment climate” in the CIS countries, which depends on both policies and institutions.<sup>8</sup> Even energy-abundant countries, such as Azerbaijan, Kazakhstan, and particularly Russia, have not succeeded in attracting levels of cumulative net FDI inflows per capita comparable to those into the CEB countries.

This paper analyzes the trends in capital flows, particularly FDI flows, into each of the CIS countries, which adds to previous studies that generally considered the CIS countries only on an aggregate basis. The paper shows that capital flows into some countries were adversely

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<sup>5</sup> Exceptions include Azerbaijan, Kazakhstan, and Uzbekistan. In the case of Uzbekistan, estimates of inward FDI flows provided by the authorities differ from their balance of payments figures and should therefore be viewed with caution.

<sup>6</sup> The paper uses the European Bank for Reconstruction and Development’s (EBRD’s) CEB country grouping, which includes Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia.

<sup>7</sup> EBRD (1994, 2000), Lankes and Venables (1996, 1997), Garibaldi and others (2001), Zinnes and others (2001), Havrylyshyn (2003), and Kinoshita and Campos (2003) analyze the determinants of foreign direct investment.

<sup>8</sup> Garibaldi and others (2001) considers the role of institutional quality in attracting foreign direct investment. Havrylyshyn and van Rooden (2000) estimates the effect of institutional quality on economic growth, drawing upon measures available in Freedom House (2001) and Heritage Foundation (2003).

affected by the Russian crisis but drops in capital flows into others were coincidental. Improved macroeconomic and growth performance since 1999 generally led to only a very modest pick-up in capital flows, reflecting a weak overall investment climate in the region. Total net private capital inflows consisted mainly of direct investment. Some countries were more successful than others in attracting FDI, mostly owing to investment in resource extraction or energy transportation infrastructure. Other spikes in FDI accompanied large privatization transactions (see Box 1) or settlement of energy debts.

The paper subsequently considers the main obstacles to a more supportive investment climate in the CIS countries. IMF country teams<sup>9</sup> were asked to identify the factors which had influenced, either favorably or adversely, the country's investment climate, guided by surveys of investors if available. The responses show that the investment climate depends on a wide array of factors including burdensome taxation, widespread corruption and poor governance, weak legal and regulatory frameworks (including property rights violations) accompanied in many instances by pervasive state involvement in the economy, and the need to follow through with (or in some instances to initiate) structural reform programs.<sup>10</sup> Underlying the weak investment climate is the need to build institutions appropriate to a market economy.

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<sup>9</sup> These teams consist of IMF area and functional department staff assigned to conduct program and surveillance review missions.

<sup>10</sup> EBRD (2000) argues that there is a close link between FDI per capita and progress in transition. In particular, Chart 4.9 in EBRD (2000) shows that there is a positive correlation between the average EBRD transition indicator and average net FDI inflows per capita in the transition economies.

EBRD (2002b) took a different approach to assessing the quality of the business environment, relying on the results of the joint EBRD/World Bank Business Environment and Enterprise Performance Surveys (BEEPS) in 1999 and 2002 (see Chapter 2, EBRD (2002b)).<sup>11</sup> Although these surveys provide a useful set of qualitative and quantitative indicators which summarize the quality of the business environment, it is not always easy to pinpoint country-specific weaknesses in the investment climate using the BEEPS indicators.

In contrast to EBRD (2002b), the present paper attempts to identify the specific obstacles to a more supportive investment environment in each of the CIS countries, providing stylized case studies of how the actions of governments and incumbent firms may have impaired or aided the investment climate, and sketching common themes across the region. It should be noted, however, that key factors identified by one country team (e.g., a distorted exchange rate system in Uzbekistan), though not identified by other country teams, may be present in one or more additional CIS countries (e.g., Turkmenistan).

The paper is organized as follows. Section II analyzes the level and composition of inward FDI flows into the CIS countries over the last decade, including the role of privatization, and FDI in energy-abundant CIS countries. Section III evaluates the investment climate. Finally, Section IV offers some conclusions and policy implications.

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<sup>11</sup> The BEEPS asked firms to assess the functioning of the state in each of the following seven areas: (i) access to financing; (ii) quality of infrastructure; (iii) taxes; (iv) regulation; (v) quality of judiciary; (vi) crime; and (vii) corruption. In particular, firms were asked to rate, on a four-point scale, how problematic each of these factors were for the operation and growth of their business. Notably, these indicators show an overall improvement, on average, in the quality of the business environment in the CIS countries, even after controlling for the effects of improved macroeconomic performance. The survey also asked respondents to  
(continued...)

## II. FOREIGN DIRECT INVESTMENT (FDI)

As noted above, international comparisons indicate that cumulative net FDI inflows per capita remain very low in the CIS countries, compared to the CEB countries, despite progress in achieving macroeconomic stability and attaining relatively high growth rates. While levels of net FDI inflows prior to the Russian crisis in August 1998 were low in the wake of the 1997 Asian crisis, net FDI inflows generally fell further following the 1998 crisis. As economic activity in the region recovered starting especially in 2000, it had been hoped this would lead to a surge in foreign direct investment. Unfortunately, data for 1999–2001 do not show a significant upturn in inflows.<sup>12</sup>

This section accordingly describes the trends in the *inward FDI* flows<sup>13</sup> (except where specially noted) into the CIS countries and their sectoral and source country composition. Given the diversity of the CIS region, it is useful to form country groupings to highlight common themes. Foreign direct investment into energy-exporting countries (which will be

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provide quantitative indicators such underreporting of sales by firms for tax purposes, average time spent by managers dealing with public officials, and payment of bribes.

<sup>12</sup> In the last few years, the weakness in industrial country markets (including due to financial misreporting scandals) has put pressure on enterprise balance sheets and therefore reduced the supply of investment funds in emerging markets. For instance, the financial troubles of AES—a significant investor in emerging-market energy assets—appears to have had an impact on FDI in the CIS utility sectors.

<sup>13</sup> Box 2 describes trends in net capital flows into the CIS countries, including *net FDI inflows*. These net FDI inflows are defined in this paper (following the presentation in the IMF *Balance of Payments Statistics Yearbook*) as the difference between *inward FDI* (a positive number) and *FDI abroad* (a negative number). (It should be noted that inward FDI and FDI abroad are in turn also net data concepts.) In contrast to Box 2 and Figure 1, this section focuses on inward FDI flows (unless specially noted), based on data provided by national authorities. It should also be stressed that the poor quality of balance of payments data in many countries introduce some noise into measured FDI flows.

referred to as “Group A” countries) has a very different character than investment into the other CIS countries. Energy sector projects are driven by special considerations such as the size, quality, and location of energy reserves, with less weight placed on the overall investment climate in the country than for other investments.<sup>14</sup> Also, the petroleum sector is often subject to a separate tax regime which may alter investment incentives. Moreover, multinational energy companies have a lot of expertise in dealing with poor governance, including corrupt regimes. Of the energy–importing countries, it is useful to distinguish between countries that have pursued market-oriented economic reforms (Group B), which would be expected to stimulate FDI, and countries that have not undertaken such reforms (Group C). With these considerations in mind, the section utilizes the following three country groups: (Group A) energy exporters (Azerbaijan, Kazakhstan, Russia, and Turkmenistan); (Group B) energy importers pursuing market-oriented reforms (Armenia, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Ukraine); and (Group C) other energy importers (Belarus and Uzbekistan). The section concludes with some observations on investor motives based on the literature and international comparisons.

### **A. Energy Exporting Countries**

Foreign direct investment into the energy exporting countries has generally been limited to the energy sector, with the notable exception of Russia. While the set of energy–exporting countries is heterogeneous, it must be stressed that the considerations driving inward FDI

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<sup>14</sup> It could be argued that investment in gold mining is driven by resource availability rather than primarily the overall investment climate, which would imply that the Kyrgyz Republic and Tajikistan be added to Group A. In addition, it could be noted that Uzbekistan has significant natural gas export potential. The country groupings are made purely for expositional purposes.

into the energy sectors of energy-abundant economies may not generalize to other sectors of the economy. Nevertheless, as illustrated especially by recent developments in Kazakhstan and Russia, while FDI into the energy sectors of the CIS countries are based on long-term considerations, they also depend to some extent on aspects of the overall investment climate such as the rule of law, transparency, and corporate governance.

**Azerbaijan** has been one of the most successful CIS countries in attracting FDI mainly due to its significant oil and gas reserves, with inward FDI flows averaging about \$900 million per year during 1997–2001 (equivalent to about 20 percent of average annual GDP).<sup>15</sup> Inward FDI flows, mostly into the oil sector, accounted for about 70 percent of gross capital formation during this period. With the sanctioning of the Baku–Tbilisi–Ceyhan (BTC) pipeline project and the first phase of full field development of the Azeri–Chirag–Guneshi (ACG) fields, oil sector inward investment increased substantially in 2002. Net FDI inflows in Azerbaijan were 26 percent of GDP in 2002 and are expected to rise further in 2003. Further growth in investment in these two projects, as well as the Shah Deniz gas field and associated South Caucasus Gas Pipeline are expected in 2003 and 2004.

In **Kazakhstan**, which had the highest cumulative net FDI inflows per capita during 1989–2001 of any CIS country (see Figure 1), the major portion of FDI occurred in the oil and gas sectors, driven by a desire to have access to world class petroleum opportunities in the Caspian basin. In 1999–2001, three quarters of inward FDI flows went into the oil and gas

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<sup>15</sup> Azerbaijan ranked second among CIS countries, behind Kazakhstan, in cumulative net FDI inflows per capita during 1989–2001 (see Figure 1). Inward FDI flows into Azerbaijan increased sharply in 1997 and 1998, amounting to over \$1 billion in each of these two years. This was due to the start of important new oil projects. There was some decline in inward FDI flows from 1999 onwards but this had little to do with the Russian crisis.

sectors. Petroleum output has accordingly grown at around 15 percent per year and now accounts for roughly 25 percent of GDP. Foreign direct investment in other sectors is small owing to the small size of the domestic market, its distance from world markets, and a poor investment climate (see Section III below).

The majority of FDI was supplied by the United States, Canada, and Western Europe, reflecting the activities of multinational oil companies. Inward FDI flows are only partly explained by large privatization transactions including the sale of a large operating stake in the Tengiz field to Chevron in 1993, an additional small 5 percent share in 2000 (\$450 million), a 25 percent stake in Tengiz to Mobil in 1998 for \$1.1 billion, and sale of a stake in the Kashagan offshore exploration and development consortium to Phillips and Inpex in 1998 (\$500 million).

In **Russia**, the very low levels of inward FDI flows reflect the slow pace of reforms. Inward FDI flows into Russia grew from \$2.1 billion in 1995 to \$4.8 billion in 1997, fell to \$2.5 billion in 1998 reflecting the financial crisis, and were roughly \$3 billion in 1999–2001, implying that inward FDI flows have not reached their pre-crisis level. In the 1999–2001 period, following the Russian crisis, inward FDI flows accounted for less than 10 percent of gross fixed investment, and FDI's contribution to economic growth was correspondingly limited. On a per capita basis, cumulative inward FDI flows in 1999–2001 amounted to about \$20 per person, a small fraction of levels in the CEB countries (again, Figure 1 shows net FDI inflows rather than inward FDI flows; see footnote 13 above).

On a stock basis, cumulative inward FDI flows in 1995–2001 were \$19.6 billion, the bulk of which was done by industrialized countries (notably, Germany, the United States, and the

United Kingdom). Cyprus was a leading source of FDI but this most likely reflects Russian offshore companies operating in Cyprus and may accordingly be considered domestic investment.<sup>16</sup>

While private domestic investment has been concentrated in the natural resource sectors in Russia, food processing accounted for the largest share of inward FDI flows and the oil extraction sector for the second largest. More than half of inward FDI flows in the oil and gas sectors (\$1.5 billion) were invested in the Sakhalin I and II projects in Russia's Far East. British Petroleum (BP) announced in February that it plans to acquire a 50 percent share in a company to be formed with TNK International, Russia's fourth-largest oil firm, for \$6.15 billion. The agreement reportedly involves BP paying \$2.4 billion in cash on completion of the deal, scheduled for this summer, and three subsequent annual tranches of \$1.25 billion to be paid in BP shares.

Inward FDI flows into **Turkmenistan**, which averaged around \$125 million during 1999–2001,<sup>17</sup> were mainly in the form of production sharing arrangements (PSAs) in the oil sector and joint ventures in the non-oil sector, although the latter were very modest due mainly to non-supportive government policies (see Section III below). In the oil sector, inflows were well below those needed to achieve the government's annual production targets, apparently due to disappointing results of recent Caspian Sea oil exploration efforts and the persistence

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<sup>16</sup> Funds are sent offshore to avoid paying taxes, transport proceeds of criminal activity, evade capital controls, or in response to political uncertainty. See Loungani and Mauro (2000) for further discussion.

<sup>17</sup> Inward FDI flows into Turkmenistan dropped from \$108 million in 1997 to \$62 million in 1998 in an apparent response to the Russian crisis. This drop was short lived and inward FDI flows rebounded to \$125 million per annum in 1999 and 2000 and \$133 million in 2001.

of territorial disputes between Turkmenistan and Azerbaijan concerning their respective exploration blocks.

### **B. Reforming Energy Importers**

The countries in Group B—Armenia, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Ukraine—are very diverse. Nevertheless, common themes emerge in their experiences with foreign direct investment. In Armenia, Georgia, and Moldova, energy sector privatization or oil pipeline construction projects accounted for the majority of inward FDI flows. The experiences of the Kyrgyz Republic and Tajikistan with inward FDI flows were confined mainly to one large gold mine project in each country with limited inward FDI flows elsewhere in the economy. Ukraine's inward FDI flows have been more diversified reflecting its industrial structure.

In the Caucasus countries, **Armenian** inward FDI flows were equivalent to nearly 7 percent of GDP on average during 1998–2001, although these tailed off following progress with privatization. The main sectors receiving this FDI were energy, telecommunications, and food, with the principal source countries being Russia, Greece, the United States, and France. It should be noted that the Russian firm Gazprom acquired shares in an Armenian gas company, Armgas, in 1998. Moreover, in 2002, the Armenian and Russian governments agreed on a debt/equity swap involving cancellation of \$94 million in debt for 100 percent of equity in the Hrazdan thermal power plant, Mars control systems plant, and three research institutes.

**Georgian** inward FDI flows fluctuated between \$80–236 million in the 1997–2001 period (on average equivalent to about 4½ percent of annual GDP) reflecting mainly a large oil

pipeline construction project as well as some significant power sector privatization transactions. In particular, high inward FDI flows in 1997 and 1998 were attributable to the construction of the Baku–Supsa oil pipeline and terminal in Supsa. Sale of a 75 percent stake in Telasi, the Tbilisi electricity distribution company, to the U.S. company AES also contributed to high inward FDI flows in 1998. In 2000, AES purchased part of the Gardabani thermal power station.

In **Moldova**, inward FDI flows declined from \$76–78 million per annum in 1997–1998 to \$39 million in 1999 reflecting the Russian crisis, and picked up to \$128 million in 2000 and \$149 million in 2001. About half of the recent inward FDI flows have been in the electricity, gas, and water sectors. Foreign direct equity investments relative to total fixed capital formation increased sharply in 2000, jumping from 17 percent in 1999 to 45 percent in 2000 and 44 percent in 2001. Recovery from the Russian crisis provided an important stimulus. Moreover, there were significant privatization transactions in the energy sector in 2000 and Gazprom acquired a share of the Moldovan firm Moldova–Gaz in 2001. Re–investments from abroad by local businessmen, perhaps for tax purposes, may also explain some of the FDI, owing to the importance of investment in offshore zones. Russia, the United States, Spain, United Kingdom, and France accounted for three fourths of all inward FDI flows since 1995.

Despite its efforts to implement market–oriented reforms, the **Kyrgyz Republic** received inward FDI flows of about 7 percent of GDP (and net FDI inflows of only 3 percent of GDP) on average in 1996–2001, related in large part to the Canadian firm Cameco’s investment in the Kumtor gold mine. Two other large investments include U.S. investment in the Hyatt Regency Hotel and German cigarette manufacture Reemtsma’s investment in the Bishkek

tobacco factory.<sup>18</sup> In **Tajikistan**, inward FDI flows accounted for less than 2 percent of GDP on average during 1998–2001, the majority of which was provided by a British company investing in a gold mine.

In **Ukraine**, inward FDI flows have remained very weak, accounting for a mere 4 percent of domestic fixed capital investment, or about 2½ percent of GDP, in 2001. With gradual macroeconomic stabilization, inward FDI flows grew from \$267 million in 1995 to a peak of \$743 million in 1998, dropping by 33 percent in 1999 to \$496 million reflecting the effects of the Russian crisis (balance of payments data). There was a moderate pick up, to \$595 million and \$792 million in 2000 and 2001, respectively. The two leading sectors were food and processing of agricultural products and domestic trade. The leading source countries, which accounted for three fourths of the inward FDI stock at end-June 2002, were (in decreasing order of importance) the United States, Cyprus, United Kingdom, Netherlands, Russia, British Virgin Islands, Germany, Switzerland, and Austria. The bulk of the stock of inward FDI from Cyprus and other offshore centers probably reflected the activity of domestic and Russian investors.

### **C. Other Energy Importers**

The countries in Group C—Belarus and Uzbekistan—have not yet implemented fundamental market-oriented reforms. Not surprisingly, inward FDI flows into these two countries have been extremely limited, with the exception of investment related to the construction of the

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<sup>18</sup> Inward FDI flows into the Kyrgyz Republic were mainly related to a few large projects and do not show a significant impact of the Russian crisis. However, it is possible that inward FDI flows might have been higher absent the general economic uncertainty in the region which followed in the wake of the Russian crisis.

Yamal pipeline in **Belarus**. This pipeline, which is owned by Gazprom, has started operating, although not yet at its full planned capacity. In **Uzbekistan**, net FDI inflows accounted for around 1 percent of GDP in 2001 (balance of payments data).

#### **D. Motivation for FDI**

Lankes and Venables (1996, 1997) and EBRD (1994) considered in greater depth the motivations of foreign firms seeking direct investments into the Eastern European, Baltic, and CIS countries. Direct investment into the CIS countries has been mainly “resource seeking,” whereas FDI into countries that are more advanced in the transition process has been more often “efficiency seeking,” i.e., oriented toward export processing based on low (productivity–adjusted) labor costs. A strategy of increasing labor productivity, coupled with competitive labor cost, might help to increase the economic growth rates of the CIS countries and attract more efficiency–seeking FDI. For CIS countries with large domestic markets, such as Russia and Ukraine, there may also be potential for market seeking FDI oriented toward production for sale in the domestic market in the future but this would appear to require significant improvements in the investment climate.

Investors reportedly view smaller countries in a regional context as potential hosts for market-seeking investment. While formal trade barriers are generally low in the region (except for Uzbekistan), lowering the very significant trade and transport impediments within the region could help stimulate investor interest by increasing the effective market size.<sup>19</sup> In

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<sup>19</sup> The Capital Markets Consultative Group (CMCG) found that, inter alia, the size of the domestic market and potential for growth were key factors influencing investment location decisions (see IMF (2003)). Investors noted that a number of emerging market countries were  
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the Caucasus or Central Asian sub regions, notwithstanding the political obstacles, the likelihood of attracting market-seeking investment might be enhanced by strenuous efforts to remove trade and transport impediments within these sub regions to provide for the degree of goods and factor mobility that would be needed by investors to operate effectively in a regional market. Regional efforts to remove trade and transport impediments are underway in the context of the CIS-7 Initiative.

### III. INVESTMENT CLIMATE

The investment climate in the CIS countries is dominated by a complex set of relationships between the still-pervasive public sector and incumbent firms, as well as the public sector's interference in private sector activity.<sup>20</sup> Extensive government regulation in the form of business licensing, inspections, and certification, combined with low civil service salaries and more generally weak public administration, provide incentives for rent-seeking by public officials. In turn, barriers to entry, impediments to competition (including weaknesses in domestic competition policy and trade barriers), ineffective bankruptcy procedures, and weak corporate governance allow inefficient incumbent enterprises to remain in operation.

Financial intermediation to finance investment, especially by small and medium sized

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small and therefore free trade agreements and regional trade integration schemes were often important in influencing investment decisions.

<sup>20</sup> In Russia, many of these impediments are particularly severe at sub-national levels of government (see Broadman (2002)). Vandycke (2003) describes deficiencies in the environment for private sector development in the CIS-7 countries (Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan).

enterprises (SMEs), is limited by underdeveloped banking systems and capital markets.<sup>21</sup> In turn, weak property rights, contract enforcement, and bankruptcy procedures present obstacles to further strengthening of the banks.<sup>22</sup> Pricing of key inputs including energy (and in some cases water or rail transportation) serves as an implicit subsidy especially to energy-intensive enterprises. The remainder of this section describes the main factors influencing the quality of the investment climate in the CIS countries based on information supplied by country teams. To facilitate presentation, countries will be grouped as described in Section II.

### **A. Energy Exporting Countries**

It is important to stress that the overall favorable macroeconomic situation in Azerbaijan, Kazakhstan, and Russia has had a significant positive influence on the investment climate, quite apart from any structural reform progress. The business environment faced by private investors in **Azerbaijan** is a dual one, with a transparent and efficient environment for the oil sector regulated by PSAs with foreign investors ratified by the parliament and a weak and poorly enforced one for the rest of the economy. The IFC Foreign Investment Advisory Service's (FIAS's) 2002 (unpublished) report on Azerbaijan indicates that the main factors adversely affecting the non-oil economy were: (i) weak infrastructure (especially electricity supply disruptions); (ii) poor financial intermediation; (iii) weak legal and regulatory systems; (iv) complicated licensing requirements; and (v) corrupt tax and customs

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<sup>21</sup> Financial intermediation in poorer, smaller countries may also be impeded by low savings of the poor population and lack of large-scale investment opportunities.

<sup>22</sup> Broadman (1999) considered how to improve competition, strengthen corporate governance and bankruptcy procedures, reduce barter and other non-cash transactions, and more generally foster enterprise restructuring, in Russia. Shleifer (1994) considers how to establish secure property rights in transition economies.

administrations. To address these problems, the number of businesses requiring licenses has been cut by about 85 percent, with the validity of licenses extended from as little as 6 months to 5 years, the central bank has closed banks that failed to meet prudential regulations, and there are ongoing and comprehensive programs to improve tax and customs administration.

The results of several surveys of the investment climate in **Kazakhstan** undertaken by the IFIs (including a 2002 FIAS study) cited corruption in the provision of basic government services (health, education, police, judiciary, and customs). While the legal framework for a market economy has improved steadily and notably a modern tax code is in place, investor surveys found overlapping and excessive regulation and inspection, especially for small businesses. Moreover, there was a heavy presence of large industrial-financial conglomerates. A number of policy initiatives complicated the investment climate, including: (i) an investment law that appeared to limit the right of appeal to international arbitration; (ii) a transfer pricing law with stringent provisions; (iii) a rigid quota system on foreign employees (including limits administered at the local level); (iv) domestic content requirements; and (v) a public campaign by the government in favor of a renegotiation of the contracts of foreign oil companies. The result is that FDI in the service and SME sectors was extremely limited as small service and industrial firms were not able to fend off predators and abusive practices with the same vigor as large multinational oil firms were. Kazakhstan has also advanced very strongly in financial sector reform and some FDI has been recorded in this sector. Finally, it should be noted that Kazakhstan attracted the minimum investment grade level from international rating agencies in 2002–2003.

According to the FIAS survey of foreign business managers in 2001, the main reasons for not doing business in **Russia** were: an unstable tax environment; regulation; legal vulnerability;

lack of a level playing field; crime; unreliable supply; and corruption (police, courts, and government generally). While there was significant progress across a wide range of structural reform areas during 2001–2002, these reforms have not yet had a major impact. The reforms have had a positive impact on investor sentiment in asset markets but key reforms to ensure an increase in economic investment still need to be implemented.<sup>23</sup> Tax reforms are an exception. Prior to recent reforms (including of the income and profits taxes), the tax regime was cited as the biggest impediment to investment and entrepreneurship. Tax reform has contributed to an improvement in the investment climate. Other key supporting reforms (civil service and public administration, banking, judicial, and energy sector reforms, as well as WTO accession) are at an early stage and will take a long time to implement effectively (see Owen and Robinson (2003), Chapter 3).

**Turkmenistan's** legal and regulatory environment was characterized by a 2001 EBRD study as inadequate for supporting investment and other commercial activities. Its weaknesses include unclear laws that depend heavily on missing implementing regulations, burdensome business regulations, and the non-implementation of international accounting standards. The lack of a coherent institutional framework to implement privatization policy has been a major obstacle to attracting foreign investment. The slow progress with privatization may be attributed to a number of factors including the limited set of enterprises eligible for privatization and the fact that those offered for sale are loss-making or non-operating units with obsolete technologies or small enterprises mainly in the trade and catering businesses. In addition, the government has remained reluctant to privatize industrial enterprises. In those

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<sup>23</sup> While equity investments in Russian companies remain low for the reasons discussed, corporate borrowing from abroad has picked up considerably, albeit from a low base.

cases where industrial enterprises have been privatized, it has insisted on maintaining a controlling share.

## **B. Reforming Energy Importers**

In **Armenia**, surveys indicate that the investment climate has been hindered by a broad array of factors including a small domestic market, weak governance, and deficiencies in the legal system. Enterprise surveys conducted in 1996–1999 (including by the World Bank) identified taxes and tax regulations, political and policy uncertainty, lack of financing, anti-competitive practices, corruption, crime, infrastructure, and the functioning of the judiciary, as the main impediments to doing business in Armenia.

In **Georgia**, a liberal foreign investment policy (including unlimited tax-free repatriation of capital and profits, no currency controls, access of foreign investors to all but a few strategically significant sectors), membership in the WTO, and stable foreign exchange and inflation rates (except for a temporary surge following the Russian crisis) have favorably affected the investment climate, as have Georgia's strategic location as a conduit for Caspian oil exports to the west and relatively favorable conditions for tourism and agricultural development. However, several factors were perceived as having negatively affected Georgia's investment climate. Foreign investors involved in disputes with local partners after their enterprises achieved profitability have been, in some cases, subject to arbitrary court decisions favoring local investors, signaling inadequate protection of investors' rights. The unstable border area with Russia and kidnapping of foreign businessmen have reportedly also adversely affected investor confidence. Moreover, the Georgian government's anti-corruption measures are perceived to have been inadequate. Georgia extracts nearly 3 percent

of annual company revenue in bribes, nearly twice as high as in Russia (EBRD (2002b), Table 2.2, p. 28). Tax officials often demand bribes and advance tax payments from foreign companies. Finally, infrastructure is reported to be poor, particularly disruptions in electricity supply to the industrial sector.

While the existence of gold reserves helped attract foreign investment from Cameco,<sup>24</sup> the main factor limiting FDI into the **Kyrgyz Republic** has been excessive red tape and perceived corruption. Investment laws were amended following WTO accession in 1998 with a view to making the country more “investor friendly.” Measures adopted included the streamlining of the registration process for joint ventures, allowing foreign insurance firms to offer brokerage and other services, and annulling the 49 percent ceiling on foreign ownership in aviation services and insurance. However, licensing remains an area in need of further reform. Foreign investors in the four Free Economic Zones (FEZs) are exempt from several taxes and duties, such as duties on capital imports and customs duties on exported goods. Although the Bishkek FEZ has had some success in attracting FDI, two other zones (Naryn and Maimak) have performed very poorly.<sup>25</sup>

The investment climate in **Moldova** has benefited from its WTO membership and an open trade regime with low import tariffs, and effective banking supervision. However, Moldova is lagging in some important structural reform areas. Notably, there are deficiencies in the legal system. Several important laws have been passed to improve the legal framework and

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<sup>24</sup> Kumtor, Cameco’s Kyrgyz subsidiary, was given special tax concessions as an incentive to invest.

<sup>25</sup> See EBRD (2001), Box 3.1, p. 54, for a discussion of the costs and benefits of investment incentives in transition economies.

corporate governance, including a new insolvency law, a pledge and collateral law, and a new civil code. Effective implementation of these laws will be crucial for improving the investment climate. Important privatization projects have been delayed and there have been only limited sales to strategic investors. Finally, conflict of interest and corruption were perceived as key impediments to investment in Moldova.

While no investor surveys are available for **Tajikistan**, discussions with investors in the cotton sector indicated frustration with the informal legal environment, political interference, and lack of payments discipline.

Despite some positive factors and signs of improvement in the investment climate, FDI in **Ukraine** remains very low and investors cite many impediments. Positive factors include favorable macroeconomic performance, a switch to cash-based privatization through tenders, and a dramatic decline in barter trade with a corresponding increase in cash collections particularly for electricity and gas. A survey of foreign investors in 2000, conducted by the International Center for Policy Studies in Kyiv, indicated that the main deterrents to FDI in Ukraine were: (i) instability and complexity of government regulations; (ii) ambiguity of the legal system; (iii) uncertainty in the economic environment; (iv) corruption (particularly at the local level); and (v) a high tax burden. Moreover, 95 percent all foreign companies surveyed believed that proper privatization policies (in particular, transparent procedures) could significantly improve the business climate.<sup>26</sup> A more recent survey (conducted in 2002 by the American Chamber of Commerce) obtained similar results but also noted delays in

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<sup>26</sup> Elborgh–Woytek and Lewis (2002) examined the recent privatization experience in Ukraine and analyzed the shift in IMF conditionality, from quantitative targets, to conditionality aimed at strengthening privatization procedures.

VAT refunds and the impossibility of land pledges as having adversely affected the investment climate. Finally, a number of FEZs and Territories of Priority Development, offering significant tax breaks for capital investment in underdeveloped and depressed areas, began to operate.

### **C. Other Energy Importers**

A 2001 IFC regulatory cost assessment survey of SMEs in **Belarus** showed that the existing regulatory environment and excessive state involvement in economic activities of private entities constituted major obstacles to investment and growth. The survey showed that businesses in Belarus faced a much higher cost of regulatory compliance than similar businesses in neighboring countries.

In **Uzbekistan**, according to the IMF country team, the discretionary implementation of pervasive regulations constraining almost every aspect of economic activity, and the establishment of a non-transparent system of privileges and tax exemptions, have reportedly discouraged investment. The imposition of multiple exchange rates in 1997, accompanied by the rationing of foreign currency on the formal market (until recently performed by an explicit system of quotas and licenses), including constraints on the repatriation of profits, has been a major constraint on FDI. Investors have been discouraged by delays in the implementation of a program for liberalization of the foreign exchange market, which was scheduled for end-2000.

### **D. Comparison with Other Regions**

As a rough attempt to cross-check the responses of IMF country teams and to compare the results with other regions, the ranking of obstacles to doing business in the 1997 World

Development Report (see Box 3.1, World Bank (1997)) was compared with the ranking of impediments to investment cited by IMF country teams, in the following eight areas: (1) corruption; (2) crime and theft; (3) regulation; (4) taxes; (5) financing; (6) inflation; (7) policy instability; and (8) poor infrastructure. The method used was to count the number of times each of these eight factors was cited by the IMF country teams—since there are 12 CIS countries, the maximum number of times each factor could be cited was 12. For the 12 CIS countries, corruption and regulation were each cited as impediments in the responses by country teams for 10 countries; crime and theft, financing, and policy instability were each cited for 5 countries, taxes and poor infrastructure were cited for 3 countries, and inflation was not cited for any of the countries. These results suggest that inadequate property rights protection (in the form of corruption, crime and theft, and regulation) is a key impediment to further investment in the CIS countries.

The ranking of investment impediments based on these eight categories was either uncorrelated or negatively correlated with the rankings of obstacles to doing business presented in World Bank (1997), although none of these correlations is significantly different from zero:

Table 1. Correlations Between Regions in the Rankings of Investment Obstacles

	Rank Correlation Coefficient	Test Statistic 1/
Sub-Saharan Africa	-0.33	-0.87
Latin America and Caribbean	0.15	0.37
East and South Asia	-0.52	-1.48
Middle East and Africa	-0.17	-0.43
CIS 2/	0.01	0.03
CEE 3/	-0.36	-0.94
High-Income OECD 4/	0.06	0.14

**Sources:** IMF staff; and Box 3.1, World Bank (1997).

**Notes:**

1/ The null hypothesis is that the rank correlation coefficient is zero; the critical value at the 5 percent level is 2.45 for a two-tailed test.

2/ This corresponds to the correlation between rankings based on IMF country teams and rankings for the Commonwealth of Independent States (CIS) countries based on the World Bank (1997) survey.

3/ CEE denotes Central and Eastern Europe.

4/ OECD denotes the Organization for Economic Cooperation and Development.

Notwithstanding the low or negative correlations,<sup>27</sup> obstacles associated with property rights protection ranked among the top three both in CIS and non-CIS countries, except for the high-income countries of the OECD. These results confirm that tackling corruption is of first-order importance in improving the investment climate, and that corruption is a widespread problem internationally.

<sup>27</sup> The near zero correlation between rankings based on the responses of IMF country teams and those based on World Bank (1997) for the CIS countries reflects differences in methodology and timing. In World Bank (1997), for instance, taxes and policy instability ranked first and second as obstacles to doing business in the CIS countries. These factors have arguably become somewhat less important over time as tax rates have started to come down in some CIS countries (e.g., payroll tax rates) and macroeconomic stability has broadly been attained.

The presence of corruption may reduce the quality of foreign direct investment. Firms with valuable technological and other knowledge capital are less likely to invest in countries with governance problems and if they do will tend to avoid joint ventures. The same is true for export-oriented investment, which is less bound to a particular location than market- or resource-seeking investment.

#### **IV. CONCLUSIONS AND POLICY IMPLICATIONS**

This paper has examined capital flows into the CIS countries and their investment climate. Private capital inflows consisted mainly of direct investment and were concentrated in a few energy-abundant countries. Cumulative net FDI inflows per capita in the CIS countries accounted for only a small fraction of inflows received by the CEB countries.<sup>28</sup> Reflecting this, net FDI inflows fell drastically short of levels needed to support high, sustainable growth. These inflows were generally related to natural resource extraction or energy transportation infrastructure projects, large privatization transactions, and debt/equity swaps to pay for energy supplies.

Greatly disappointing levels of FDI despite strengthening macroeconomic performance reflected a weak investment climate in the region, particularly owing to incomplete structural reforms. Country teams surveyed cited burdensome tax systems, widespread corruption, extensive state intervention coupled with weak legal and regulatory frameworks, and incomplete structural reforms (including banking system, civil service, and energy sector reforms), as the main impediments to a healthier investment climate. Further institution

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<sup>28</sup> This refers to Central and Eastern Europe and the Baltic states, which are listed in footnote 6.

building is needed to underpin structural reform efforts. The paper described the main factors influencing the investment climate in each of the CIS countries, providing a rich picture that complements existing summary indicators. Lack of property rights protection—in the form of corruption, crime, and excessive regulation—was cited most frequently as a significant investment impediment, a pattern consistent with experience in other regions.

Measures to improve the investment climate should be carefully sequenced. The CEB countries attracted FDI through privatization, but thus far this has yielded only limited revenues and efficiency gains in the CIS countries. Opportunities for further sales are now somewhat circumscribed. Moreover, experience with regional electricity sector reform suggests that privatization may not succeed unless appropriate legal and regulatory frameworks and a competitive environment are already in place, which would also help lower entry barriers for de novo firms.

Previous studies indicate that the levels of FDI attracted by the CIS countries depend on more than the country's economic policies—natural resource abundance, institutional quality, and prospects for European Union (EU) accession also appear to have played significant roles. Some of the smaller, poorer CIS countries—which have limited domestic markets, are located far from the EU, and are not likely to be candidates for EU accession—are unlikely to reap the benefits from the implementation of good policies in the form of higher net FDI inflows in the near term or possibly even the medium term (notwithstanding other benefits of good policies, including more effective use of domestic investment). The international community will need to continue to support these countries over the longer term if they are making best efforts to implement good policies.

The situation in the energy-abundant and larger, more highly diversified CIS countries is somewhat more favorable. In Russia, for instance, investors have already begun to respond to the authorities' efforts to implement structural reform policies, although there is a risk that reform efforts may stall in the run-up to elections. In other countries, such as Ukraine, improved macroeconomic performance has provided an opportunity to follow through with the implementation of structural reforms.

The literature also suggests that investors view especially smaller countries in a regional context as potential hosts for market-seeking FDI (which is oriented toward selling in the domestic or regional market). Regional cooperation aimed at removing trade and transport impediments could help raise the attractiveness of the smaller CIS markets as potential destinations for investment. A strategy of improving labor productivity could also contribute to increased economic growth rates and help attract more efficiency-seeking FDI (which is oriented toward production for export based on low productivity-adjusted labor costs).

### **Box 1. The Role of Privatization**

Levels of FDI inflows into transition economies are closely related to the size of privatization receipts (EBRD (2000), Chart 4.5, p. 84). EBRD (2002a) found that privatization in the CIS countries generally has not yielded large-scale foreign investment. In contrast, FDI into the CEB countries was motivated to some degree by their proximity to the EU and the prospect of EU accession.

Djankov and Murrell (2002) showed, based on a “meta-analysis” using a large number of empirical studies, that privatization was strongly associated with improved enterprise performance for the transition economies as a whole but this effect was not statistically significant for the CIS countries:

- This finding was attributed to the higher share of less effective categories of owners (in particular, owners in the “worker” and “diffuse individual ownership” categories were more prevalent) in the CIS countries than in transition countries as a whole;
- The owners most effective in improving enterprise performance were foreign investors in results which aggregate CIS and non-CIS transition countries, although there were some significant regional differences;
- In the CIS countries, bank and concentrated individual ownership were significantly more effective than in the non-CIS countries, while workers and outsiders (including foreign investors) were significantly less effective in the CIS countries; and
- This latter finding was at least partly due to poor corporate governance institutions in the CIS countries.

Supporting reforms need to be in place to support privatization:

- Havrylyshyn and McGettigan (2000) highlighted the importance of ensuring that an accommodating market environment is in place to support privatization, including macroeconomic stability, enforcement of hard budget constraints, and a properly functioning system of property rights;
- Zinnes and others (2001) stressed the need to implement policies to strengthen a country’s legal, regulatory, and institutional environment as a complement to privatization;
- Krishnaswamy and Stuggins (2003), which studied privatization of the electricity sector in the Europe and Central Asia (ECA) region, suggested that it would have been better to focus initially on legal, tariff, and regulatory reform, and commercialization of operations, prior to unbundling, the introduction of competition, and privatization; and
- Vandycke (2003) described how the growth of private sector activity in the CIS-7 countries mainly reflected transfer of state assets having little economic value and with weak management and poor governance, a form of privatization that is unlikely to induce the emergence of a dynamic, efficient private sector.

The EBRD indicated that the process of privatization in the CIS countries is largely over but had not attracted large-scale foreign investment or knowledge (EBRD (2002a), Box 1.3, p. 15). However, the EBRD’s indicator of progress in large-scale privatization ranges from 1 to 3+ (out of a possible 4+) in the CIS countries with a median of 3, suggesting an intermediate level of progress with large-scale privatization.

## Box 2. Net Capital Inflows

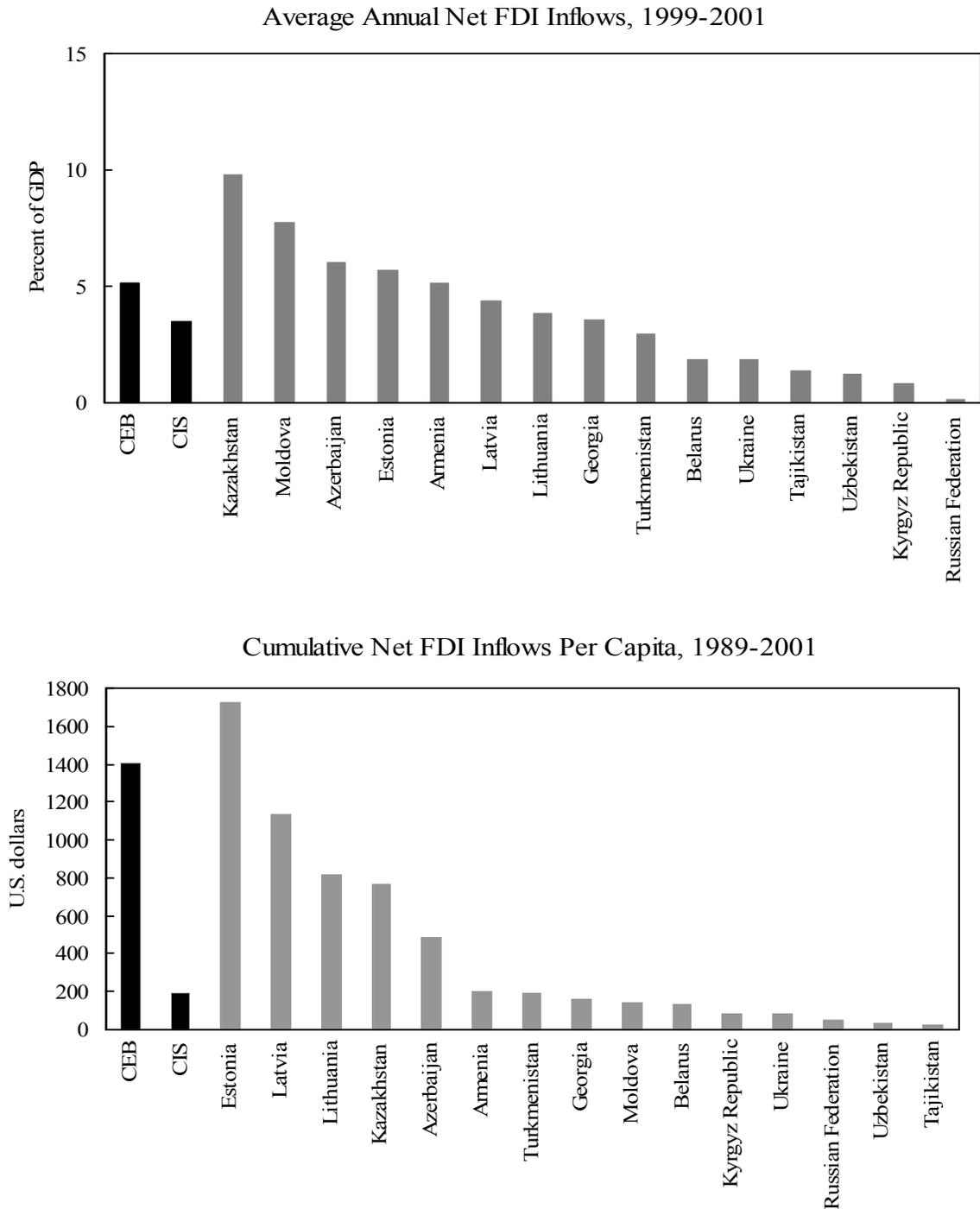
Net capital inflows consist of direct investment, portfolio investment, other investment, use of IMF credit and loans, and exceptional financing. Previous studies (Garibaldi and others (2001), EBRD (2000), and EBRD (2002a)) have analyzed the trends and composition of total net capital flows into the CIS countries on an aggregate basis:

- Notwithstanding the low levels of cumulative net FDI inflows on a per capita basis shown in Figure 1, Garibaldi and others (2001) found that net capital inflows as a percent of annual GDP into transition economies (with the important exception of Russia) were consistently above both the overall developing country average and the averages for Latin America and Southeast Asia during 1995–1999;
- Within the set of transition economies, total net private capital flows as a percent of annual GDP into the CIS countries (excluding notably Russia) were higher on average during 1995–1999 than in the CEB countries (but excluding the Baltics) and selected Southeast European countries during 1993–1999;
- Within the CIS countries (excluding Russia), total net *private* capital inflows consisted almost entirely of direct investment; and
- Russia experienced net capital outflows during this period reflecting capital flight (see Loungani and Mauro (2000) for further discussion of Russian capital flight).

Concerning the composition of total net capital inflows by country:

- Some countries have been more successful in attracting FDI than others, often due to investment in energy and other resource extraction or energy transportation infrastructure (Azerbaijan, Belarus, Georgia, and Kazakhstan);
- Other spikes in capital inflows accompanied privatization programs (Armenia, Lithuania, and Ukraine; see Box 1), or settlement of energy debts to Russia (Armenia and Moldova);
- Total capital flows into some countries (Moldova, Russia, Turkmenistan, and Ukraine) were adversely affected by the 1998 Russian financial crisis (as well as developments in world financial markets) but the coincident drops in total capital flows into others were largely unrelated to the Russian crisis (Azerbaijan and Kyrgyz Republic);
- While there has been a pick-up in capital inflows starting in 1999, consistent with the strengthening of macroeconomic performance, the increase has not been dramatic; and
- Russia continued to experience sizeable net capital outflows despite strong macroeconomic performance and efforts to accelerate structural reforms.

Figure 1. Commonwealth of Independent States (CIS) and Central and Eastern Europe and the Baltic States (CEB): Net FDI Inflows, 1989–2001



Sources: EBRD, *Transition Report 2002*; national authorities; and IMF staff estimates.

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