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Business Opportunities in Eurasia

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Introduction

I have been asked to comment on the business climate and investment opportunities in the Eurasia region. For the purposes of this presentation, I include in the region all of the Former Soviet Union, Turkey, as well as Central and South Eastern Europe (hence excluding Western Europe, Iran, Iraq and Afghanistan).

The first point to remember is that this region encompasses a population of about 500 million, and recently has been one of the most dynamic regions of the world in terms of economic growth. With an average annual per capita income growth rate of about 4-5% over the last four years, even as recession gripped much of the rest of the world, the potential business opportunities in this region have rapidly expanded. Prospects for continued economic growth in the region remain also strong.

Of course, the region is highly heterogeneous, and hence it is useful to look briefly at individual countries and sub-regions to get a better sense of what the opportunities are for business and investment.

Russia

Russia's economic recovery since the financial crisis in 1998 has been buoyed by persistently high oil prices, but also by the cumulative impact of 15 years of economic reforms and recent political stability. Business surveys (such as the so-called BEEPS surveys conducted by EBRD and the World Bank) show a notable improvement in the perception of the investment climate in Russia since 1999, which helps explain the reflow of capital (80 percent of this represents portfolio flows which have the potential to be easily reversed) and a recent revival of investment (albeit still heavily concentrated in the natural resource industries). With personal income growth even outstripping sustained high economic growth, per capita consumption is now estimated be exceed its 1990 level by 20% and a new middle income class is emerging rapidly.

Continued reforms are needed, if Russia is to maintain its strong economic performance of recent years. Continued improvements in the business climate through civil service reform and improved governance at the federal, provincial and local levels are essential, as are reforms of the banking sector, infrastructure rehabilitation (including IT infrastructure) and modernization of education and health services. Early accession to the WTO is another important factor. Following the slogan “It’s the economy, stupid!” I expect that Mr. Putin will want to maintain strong economic growth, both for his own domestic political standing and to enhance Russia’s international clout. I would therefore expect him to revive economic reforms my mid-2004, after the imminent parliamentary and presidential election cycle is completed. For the potential investor, the key indicator of a serious government commitment to create a better investment climate will be civil service and sub-national government reforms.

With continued economic growth and reforms, Russia will offer many investment opportunities in the coming years, especially in the natural resource sectors, but increasingly also in retail and consumer products, infrastructure investment and services, and in the area of IT and software development.

Ukraine

Ukraine is, in some respects, the miracle performer of the last four years in the region. With a sustained economic growth of 5% or more, in the absence of large energy resources and despite still low ratings on most comparative governance scales, Ukraine shows a surprising turn-around in economic fortunes. Among the reasons for this unexpectedly good performance are the strong Russian economic growth, the cumulative impact of domestic economic reforms, increasing political stability and predictability in economic management (even as the domestic political situation remains often murky for the outsider), and Ukraine’s increasingly solid orientation towards the EU. One much under-appreciated fact about Ukraine is that Kiev has become one of the most attractive cities in Europe!

The economic prospects for Ukraine are good, if continued and essential economic reforms (including WTO accession, improvements in governance and investment climate, and continued orientation towards the EU) are combined with political stability in the run-up to and following the presidential elections in 2004. As for Russia, I would see increasing investment opportunities especially in the areas of agro-business, retail and consumer products, possibly traditional heavy industries and mining (including steel and coal), and in IT and software. Of course, there are risks that need to be watched: The weak agricultural performance in 2003 due to bad weather, compounded by a bad policy response of the government, is a reminder of the vulnerabilities Ukraine faces.

Other CIS Countries

Many of the smaller CIS countries were especially hard hit by the disintegration of the Soviet Union and by the collapse of the Russian economy in the wake of the financial crisis of 1998. But most have also shared in the economic recovery of the Eurasia region over the last four years, partly because of Russia's revival, but also because of their own economic reforms and their gradual integration with the world economy. However, future prospects for these countries are decidedly mixed.

Among the positive surprises are Armenia, Azerbaijan, Kazakhstan and Tajikistan, where economic reforms and political stability have combined with improved regional economic conditions to produce significant economic turn-around and reasonable prospects. Among the more disappointing performers for varying reasons are Georgia, Moldova, Uzbekistan and, of course, the continuing outliers and non-reformers, Belarus and Turkmenistan. A number of cross-cutting factors will determine the medium term outlook of these countries:

- Settlement of regional conflicts: Central Asia's prospects would be much enhanced by peace in Afghanistan and Iraq and by normalization of the international relations of Iran, as well as by improved cooperation among the Central Asian countries themselves. Settlement of the Armenia-Azerbaijan conflict over Ngorno-Karabakh and of the division of Georgia with Abkhazia would help regional development in the South Caucasus. Settlement of the Transdnistria conflict would help Moldova's development and regional integration with Urkaine. International political support for the settlement of these conflicts will be essential.
- Economic and governance reforms: Continued improvements in economic management and especially improvements in governance (including transparency in the management of natural resources) are critical. The recent introduction of oil funds in Azerbaijan and Kazakhstan are positive development. For Central Asia, economic reforms in Uzbekistan are key, given the size and central location of Uzbekistan, and the fact that its current restrictive economic policies inhibit regional trade and cooperation.
- Access to world markets: Most of the smaller CIS countries are still isolated from world markets by a combination of land-locked and remote location, poor domestic policies, lack of transport infrastructure and regional cooperation, and lack of access to industrial country markets, esp. the EU. EU trade policies remain unfavorable towards these countries, esp. as regards agricultural trade, although poor quality and difficult transport access are also very important barriers to expanded trade with the EU (as for among themselves) for many small and poor CIS countries.

The current fragmentation of regional markets and limited access to international markets, combined with continuing problems of security and of the domestic investment climate in many of the smaller CIS countries, will limit investment opportunities for some time to come. However, there are some opportunities worth considering, such as oil, gas and mining and related investments in transport infrastructure (e.g., pipelines, such as the BTC pipeline now under construction in the South Caucasus), agro-business, tourism and increasingly also here retail and consumer products (Central Asia, for example, represents a potential market for 50 million people).

Turkey

During the last 12 months Turkey has been able to overcome many of the symptoms of its economic and financial crisis that have plagued the country in recent years. Economic growth has revived, inflation and real interest rates have declined, and the prospects of peace in Iraq and an enhanced domestic political stability since the national elections in late 2002 have improved the outlook for continued financial stabilization and economic growth. However, the country still faces major challenges that, if not addressed, may yet derail the recovery and improved prospects.

- Iraq: As long as the security and economic situation in Iraq remains unsettled, Turkey will not be able to normalize its trade with this important neighbor, and there will remain the perceptions and the reality of security risks, as well as risks of continued confrontations over the issue of the Kurdish minority and of possible frictions with the US and the EU.
- Economic and financial risks: Turkey has a long history of stop-go reforms and of recurrent economic and financial crises. Only persistent fiscal, structural, social and governance reforms will address the underlying causes of this instability. The program of the current government is generally pointing in the right direction, and with its clear majority in parliament it has in principle the political clout to implement reforms quickly and effectively, but progress with key reforms has so far been uneven, because of apparent internal differences and diverging interests within the governing AK party and because of the lack of a strong cohesive leadership in the economic sphere.
- EU accession: The prospects of eventual EU accession have been much enhanced by the decisions taken at the EU summit in Copenhagen late in 2002 and by the government's fast pace of domestic political reforms since. However, the lack of a settlement in Cyprus, uneven progress in the economic domain, an unfinished political reform agenda, and continuing deep divisions within the current EU about the prospects of Turkish accession, mean that the prospects for a positive decision about the start of negotiations in late 2004 remain uncertain for now.
- FDI: Turkey has an extraordinarily poor track record in attracting FDI, considering its favorable location relative to European markets and its well developed private sector. This has many causes, not least the investor perception of regional security risks, of poor governance and high corruption, and of an inhospitable local business community. The current government has vowed to change the reality underlying these perceptions and open up the country to foreign investors. Progress in this area will be a major indicator of progress with economic reforms and EU integration.

In principle, Turkey offers many investment opportunities, including in tourism, agro-business, manufacturing and consumer products and retail, and could well be a prime location for the more footloose of European investors as they move east from Central Europe and as a staging area for US and Japanese investors who want to serve

EU and FSU markets. The question will be whether the investment climate will sufficiently improve with economic and governance reforms and an improve regional security situation to attract potential investors in these and related areas.

The Balkans

Compared to 3-4 years ago the political and economic outlook in the Balkans has greatly improved. The political changes and ensuing economic reforms in Serbia and in Croatia in particular have led to a quantum leap in the prospects of the region, reinforced by the salutary effects of the South East Europe Stability Pact. The decision of the EU to offer the Balkan countries a long-term perspective of eventual EU membership provides an essential umbrella of political stability and an incentive for economic and governance reforms that will, as elsewhere in Central Europe in the last decade, help propel governments in the right direction of regional cooperation and improving the business climate. This eventually will make the region attractive for foreign investors.

There are, however, still substantial risks in the short-term: The unsettled territorial and political status of Kosovo, the continuing domestic political uncertainties in Serbia (and the as yet uncertain prospects of the union of Serbia and Montenegro), and the legacy of the Bosnia conflict and of the Dayton Agreement which has burdened Bosnia and Herzegovina with a huge liability of unresolved governance problems – these are key issues yet to be addressed by each country and by the international community, the sooner the better! Additional challenges arise out of the unfinished economic and governance reform agenda in the region, which needs to be addressed if the investment climate is to improve significantly.

As long as these risks and challenges hang over the region, regional security and cooperation and integration with European markets will remain uncertain and investors will understandably question the long-term prospects. Risks aside, however, the region does offer substantial investment opportunities, including in agro-business, tourism, infrastructure and related services, and eventually consumer products and retail services.

The EU Accession Countries of Central Europe

Although by now taken for granted, it is an extraordinary historical development that eight Central European countries, including three former republics of the FSU, will joint the European Union in 2004, with all referenda now affirmatively completed. If one further considers that Bulgaria and Romania probably, and Croatia possibly, will accede to the EU by 2007, and this within less than 20 years after the Iron Curtain fell, one can only be stunned by the extraordinary progress and success of the transition from command to market economy, and from dictatorship to democracy in Central Europe.

Of course, foreign investors have already grasped the opportunities which this transition has offered them, with FDI rates in recent years in this region exceeding those in most other emerging markets. It was only natural for investors to take advantage of the rapid improvements in these countries' business climate and in their financial institutions, of their highly educated, but still relatively cheap labor force, and of the ease of access to Western markets and the prospects of early integration into the unified EU markets.

Looking forward, however, Central European countries face big challenges, each of which also represents an opportunity. Depending on whether or not Central European countries, their governments and their people can respond effectively to these challenges and opportunities over the next ten years or so, they will be able to replicate the extraordinary successes of Finland and Ireland – relatively recent members of the EU that have been able to convert their rather backward economies into highly dynamic and successful modern knowledge economies. Alternatively, if Central European countries fail to respond, they will stagnate, at least in relative terms, and stay behind the pack, as have Greece and East Germany in the recent past.

Briefly, the challenges – and opportunities – are the following:

- EU constitutional reform: The new member countries have an opportunity to influence the expected new constitution of the EU and to ensure that the decision making processes and institutions of the new, enlarged EU function effectively and credibly.
- EU economic performance: The new member countries will be much affected by the overall economic performance of the EU. To a significant extent this will be determined by the ability of the larger members of the EU, esp. Germany, to carry out much-needed structural reforms and to maintain a prudent fiscal and monetary policy mix that limits undue indebtedness and keeps interest rates low.
- Continued economic transformation in the new member countries: Many of the new member countries, esp. the larger ones, are burdened by old industries and relatively large rural sectors, by high unemployment and inflexible labor markets, by high and rising social spending requirements for an aging population, by significant infrastructure investment requirements and by potentially huge environmental liabilities. Making the structural, social and environmental reforms and investments, while also maintaining a prudent fiscal stance, will be difficult and politically challenging. The influx of large financial transfers from the rest of the EU to the new and poorer members will help in making the needed investments, but this also requires the creation of the institutional capacity needed to absorb these funds effectively, a capacity which so far remains underdeveloped.
- EU external economic policies: The new member countries have an important opportunity to influence the approach of the EU towards "Wider Europe" – as the neighbors to the East and South of the enlarged EU are now increasingly referred to – and towards important global economic issues, such as the WTO negotiations (and especially the EU's agricultural policy), the international debate on the global financial architecture, and international support for the economic and social transformation of the developing world with a view to reducing global poverty and disparities.

This is a daunting list of challenges for the Central European countries and their governments. However, for potential investors in the region these countries offer excellent opportunities, not least also as a staging post for investments further east.

Concluding observations

Looking back over the last 10-15 years of political, economic and social transformation in Eurasia, one must be grateful for the overall progress and success that are now becoming apparent, after the painful and difficult political disintegration and transition recession which gripped the entire region during the early years – and for some countries during much of the 1990s. Investors have begun to take advantage of the many opportunities which the emergence of strong economies have offered, especially in Central Europe.

Of course, progress and prospects are not uniform across the region, as the preceding detailed discussion has explained. And most of the CIS countries have not yet returned to their pre-1990 levels of income, despite recent sustained recovery. Moreover, at a time when the world now understandably focuses on Afghanistan, Iran and Iraq, it is important to remember that the belt of countries from the Balkans through the South Caucasus and Central Asia still represents major challenges, as a number of temporarily "frozen" regional conflicts and a number of potential failed states may turn into major sources of regional and global instability very quickly.

In sum, many challenges remain for the countries of the region and for the international community. Among these challenges two stand out:

- First, the need for each country to ensure the appropriate fundamentals of economic policy and governance and to foster regional economic cooperation, so as to create a favorable business environment for foreign and domestic investors alike.
- Second, the need for the international community to provide appropriate support, especially to the smaller, and economically weaker countries, to help ensure an early settlement of still potent regional conflicts and to support the economic and social recovery of these countries, many of which are still among the poorest of the world, especially in the Balkans, the South Caucasus and Central Asia.

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