The Investment Climate in the Commonwealth of Independent States

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Introduction

The dissolution of the Soviet Union left the successor states with numerous economic problems. In comparison with other developed countries, the Soviet Union had a large industrial sector that was biased toward heavy industry. Light industry was relatively underdeveloped, while the service sector was virtually non-existent. Furthermore, the economic activities of the Soviet Union had developed with little reference to criteria of economic efficiency. To facilitate planning, industries were often highly concentrated in a single area and were of a large scale. There were hardly any small and medium-sized enterprises. To settle the vast Siberian expanse and to put industries out of reach of German forces during World War II, heavy industries were often located east of the Ural Mountains. The light industries, producing consumer goods, were concentrated in the western parts of the empire. Washing machines for the entire Soviet Union, for example, were mostly produced in Belarus. The republics on the southern rim of the Soviet Union had relatively little industry. As transport and energy costs were kept low, this uneven economic structure could be sustained.

The break-up of the Soviet Union signified the end of central planning. Supply chains were broken and enterprises henceforth had to find their own suppliers and customers, and were confronted with (foreign) competitors. As the system of central planning had discouraged the introduction of technological progress, most production facilities were economically obsolete in the new market environment. Both heavy and light industry needed to be modernized to become competitive in the world market, and a service sector needed to be developed.

The restructuring of the economies of the successor states to the Soviet Union required high levels of investment. However, the economic crisis that followed the dissolution of the Soviet Union wiped out the savings that could have been used to finance these investments. The governments of the CIS countries did not have sufficient means available to compensate for the lack of savings by financing investments out of their budgets. Moreover, the new owners of privatized firms proved to be more...
creative in transferring capital out of the CIS than in raising and using capital to finance the restructuring of production processes. As a result, investments in fixed assets remained low in the CIS countries throughout the first decade and a half after the dissolution of the Soviet Union.

In this contribution, we will examine the investment climate of the successor states and discuss what is being done and what needs to be done to successfully attract investments to restructure these states’ economies. We will concentrate on the conditions for attracting foreign investment. An alternative route would be to study what needs to be done to prevent capital from flowing out of the country. But, arguably, if a country is attractive for foreign investment, it is also attractive for domestic investment. A practical argument is that conditions to attract foreign investment are more widely discussed in the literature than those for domestic investments. Furthermore, it is likely that domestic investment will increase before foreign investment, as domestic investors have better knowledge of the local situation and thus see opportunities before foreign investors do.³

In the first section, we will briefly review how, historically, Russia overcame the lack of domestic savings to finance investments. As is the case today, domestic savings in the 19th century were insufficient to finance the required levels of investment, and Russia was critically dependent on foreign investment for its economic development. The tsarist regime, however, maintained a firm grip on economic development and was reluctant to allow foreign ownership of the means of production. It did, however, attract foreign investments, mostly bonds, to Russia. During the communist regime, foreign investments were not solicited at all. Industrialization was financed by so-called forced savings.

This section will also discuss the present levels of foreign investments in the countries of the CIS. The second section will focus on the strategic factors that foreign investors distinguish in their investment decisions and will argue that most of the CIS countries do not meet these requirements. It can be argued that the CIS countries are not very attractive destinations for foreign investment and do not attract much of it. The third section expands on the actual investment climate and discusses, in more detail, what type of institutional environment investors encounter and what type of policy making investors have to deal with. This section

Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan. The Baltic states—Estonia, Latvia, and Lithuania—followed a markedly different track from the other states and aspired toward EU membership, which they attained in 2004.

³ Another way of increasing domestic investment would be to close the border for (outgoing) capital flows.