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**Eurasian Economic Union:
investment climate and FDI
overview**

The article examined the investment climate of Eurasian economic union (EEU) countries and dynamics of foreign direct investment (FDI) flows in the region. Most theoretical and empirical studies refer to the positive impact of integration on economic performance, trade and foreign direct investment. The FDI flows to the Eurasian economic union members follow an increasing tendency, with an exception for Russia, which experiences a downturn in FDI inflows from the European countries. In the intraregional aspect, Kazakhstan obtained more FDI since the adoption of Customs union, which partially verifies the positive impact of intraregional cooperation and liberalizing reforms on FDI. The investment climate characteristics are relatively satisfactory for all three countries; however, some institutional reforms are required for more favorable conditions of establishing a foreign firm, additionally the allowed shares of foreign ownership in such sectors as: media, telecommunication, insurance, transportation and electricity can be increased for expanding investment opportunities in the EEU region.

Key words: Eurasian economic union, FDI (foreign direct investment), investment climate.

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**Еуразиялық экономикалық
одақ: инвестициялық климат
және тікелей шетелдік
инвестициялар**

Мақалада Еуразиялық экономикалық одақ (ЕЭО) елдерінің тікелей шетелдік инвестициялары (ТШИ) мен инвестициялық климаты қарастырылған. Интеграцияның экономикалық көрсеткіштерге, сауда және тікелей шетелдік инвестицияларға әсері жағымды екендігін көптеген теориялық және эмпирикалық зерттеулер дәлелдейді. Еуразиялық экономикалық одақ мүшелеріндегі жалпы тікелей шетелдік инвестициялары артқанымен, Еуропа елдерінен Ресейге келетін ТШИ ағымы қысқарды. Реформалар ырықтандыру мен ішінара ынтымақтастық өңірдегі тікелей шетелдік инвестицияларға жағымды әсер етті – Кеден одағының құрылуынан кейін Қазақстанға келетін ТШИ саны арта түсті. Үш елдің инвестициялық климат сипаттамалары қанағаттанарлық; алайда, шетелдік фирманы құруға жағдайларды жақсарту үшін кейбір институционалдық реформалар қажет, ЕЭО өңіріндегі инвестициялық мүмкіндіктерді көбейту үшін медиа, телекоммуникация, сақтандыру, тасымалдау және электр салаларындағы шетелдік фирмалардың меншігіндегі акциялар үлесін арттыру қажет.

Түйін сөздер: Еуразиялық экономикалық одақ, ТШИ (тікелей шетелдік инвестициялар), инвестициялық климат.

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**Евразийский экономический
союз: инвестиционный климат
и обзор прямых иностранных
инвестиций**

В статье рассмотрен инвестиционный климат стран Евразийского экономического союза и динамика прямых иностранных инвестиций (ПИИ) в регионе. Большинство теоретических и эмпирических исследований свидетельствует о положительном влиянии интеграции на экономические показатели, торговлю и прямые иностранные инвестиции. В странах Евразийского экономического союза наблюдается возрастающая тенденция прямых иностранных инвестиций, за исключением России, которая переживает спад объемов ПИИ из европейских стран. Во внутрирегиональном аспекте Казахстан привлек большее количество прямых иностранных инвестиций после принятия Таможенного союза, что частично подтверждает благоприятное воздействие внутрирегионального сотрудничества и либерализации реформ на ПИИ. Характеристика инвестиционного климата трех стран относительно удовлетворительна, однако, некоторые институциональные реформы необходимы с целью создания более благоприятных условий для открытия иностранной фирмы; вместе с тем, для расширения инвестиционных возможностей в регионе ЕЭС необходимо разрешение на владение большей доли акций иностранной собственности в следующих секторах: медиа, телекоммуникация, страхование, транспорт и электричество.

Ключевые слова: Евразийский экономический союз, ПИИ (прямые иностранные инвестиции), инвестиционный климат.

**EURASIAN ECONOMIC
UNION: INVESTMENT
CLIMATE AND FDI
OVERVIEW**

Integration and its impact: the Eurasian Economic Union

In 2010 the Customs Union (CU) started its work on the territory of Belarus, Kazakhstan and Russia with an adoption of Unified Customs Code, under which the common regulations on import duties, procedures of assessing the imported goods' value and introducing the country of origin became effective. The introduced regulations refer to the indirect taxes that are collected from mutual trade on the territory of Customs Union. According to the agreement on the import, the common import duties are to be paid to the unified account of the CU country, which afterwards will be transferred to the country budgets following the ratio: Russia – 87.8 percent, Kazakhstan – 7.3 percent, Belarus – 4.7 percent [1].

In January 2015 the Eurasian Economic Union (EEU) was officially launched on the territory of the three mentioned member countries. Integration is expected to re-enforce the existing trade relations by excluding tariffs, likewise allowing for free capital flows and labor migration among countries. It is also to be noted that Eurasian Economic Union regulations have abolished the customs control, phytosanitary and veterinary control which will decrease the expenses for the local business; additionally, producers will be able to get a unified certification of their product's quality and origin.

The Eurasian Development Bank's Integration Research Center reported that by 2030 the future total economic effect of further integration will be approximately 900 bn. USD. The estimated results of enhanced trade relations, production cooperation and leveling the technology development among the EEU countries will lead to a long-term annual GDP growth of 2.5 percent for each of the EEU members [2].

In addition to mentioned economic benefits, the consumers will be better off by having more choices of higher quality products on the market; also the prices are expected to decrease due to more imported goods and higher competition among importers and the local producers. New workplaces, anticipated to occur on the local market due to future enhancing production and launching the joint firms, are most likely to help the unemployed and improve welfare of some part of citizens.

The Customs Union adoption may lead to an overall economic growth of member countries, anticipated trade creation or trade di-

version, moreover to the attraction of investment flows from outside the integration region as well as allocation of higher amounts of FDI within the region. In his study Clausing neglected the gravity model results due to difficulty of differentiation in trade volumes between US and Canada before and after the Canada-United States Free Trade Agreement (CUSFTA) adoption. Instead, Clausing used the supply and demand equations in order to derive the relationship equation of the imports' fluctuation with changes in tariffs and share of imports from Canada before the CUSFTA adoption while capturing the unstable periods by the time dummy variable. The author's estimation outcome suggests a large import growth from Canada which implies a strong evidence of trade creation and additionally, the results indicate a less trade diversion of imports from other countries [3].

A large strand of literature is aimed at research of integration impact on trade and overall economic performance, however, fewer papers are devoted to the effect of foreign direct investment and change in investment patterns as a result of launching a free-trade area. A research by Guerin examines FDI directed to developing economies from developed countries during 1992-2004; the outcome strongly supports the positive effect of economic integration on FDI [4].

Likewise, Jaumotte argues that a financially stable economy with a better level of education, which adopted a regional trade agreement (RTA), will get higher volumes of FDI than the other RTA members. Additionally, the author provided results on diversion of foreign investments from non-member countries to member countries of RTA which clearly points to additional advantage of adopting such an agreement. Jaumotte deployed the GLS model and corrected the heteroskedasticity problem, the findings of which reveal that FDI is not significantly correlated with a domestic market size, on the contrary the regional market size of RTA is found to be positively correlated with FDI. Further, the sensitivity tests determined that population variable also exerts some positive impact on FDI attraction, therefore Jaumotte concluded that it is most likely FDI will be directed in accordance with the higher labor supply in a country [5].

Berger et al. used the gravity model, incorporating a large sample of FDI bilateral flows in developing and developed countries as a dependent variable. Apart from the traditional independent variables of gravity model, Berger et al. added the detailed variables on the presence of liberalizing and dispute settlement provisions in RTA or bilateral investment

treatment and dummy variables (double-taxation, common currency) and a control variable (political constraint). The study results show that liberalizing admission mechanisms using the national treatment and MFN (most favored nation) clause have a strong positive effect on FDI flows, in contrast the dispute settlement provisions are found to be of little importance for FDI [6].

In order to deal with the serial correlation and heteroskedasticity, Medvedev used the feasible generalized least squares (FGLS) method, which allows estimation in the presence of mentioned problems. Some new dependent variables incorporated in the model are: the GNI per capita, a consumer price index, a common market for the preferential trade agreement (PTA) countries, the trade-weighted real effective exchange rate. The outcomes are in line with the traditional view that the preferential trade agreements lead to a higher FDI inflows, while the distance increase to PTA members by 1 percent will lead to decrease of the net FDI inflows to a host country by 0.18 percent. Moreover, most FDI were allocated in developing countries implying a prevailing tendency of the North-South or the South-South trade patterns [7].

Although the regional integration's impact on FDI patterns might be very complex and different depending on the level of the member countries' economic development, available natural resources, population and other factors, the effect of liberalizing reforms and enhancing cooperation among countries is expected to be positive.

Investment characteristics in EEU

The investment climate characteristics that may considerably affect the multinational enterprises' investment decisions are: an allowed share of foreign equity ownership in Greenfield FDI, foreign merger and acquisition, the «easiness» of doing business, the arbitrating process and access to industrial land. Investing Across Borders (IAB) report is the World Bank's indicators of foreign direct investment regulations, which presents the quantitative estimation of the aforementioned characteristics for 104 countries.

The manufacturing and primary sectors such as: agriculture, mining oil and gas, banking, construction and healthcare management are allowed for maximum share of foreign ownership in Greenfield as well as merger and acquisition in Russia, Belarus and Kazakhstan. Kazakhstan has the highest indicators for almost all sectors except for the telecommunication and media, in which only 49 and 20 percent stakes of foreign participation are allowed. Russia restricts the foreign owner-

ship, merger and acquisition in international and domestic air transportation, insurance sectors to a less than 50 percent, while television broadcasting to – 50 percent stake. Among the EEU economies Belarus has the most restrictive regulative rules, which prohibit the Greenfield projects, merger and

acquisition in the fixed-line telephony services, the electric power transmission and distribution and the railway freight transportation sectors. Also the Belarus government restricts the insurance and media sectors' foreign ownership to 49 and 30 percent respectively (Table 1) [8].

Table 1 – Investing across sectors. Investing Across Borders, the World Bank Group

Sector Group	Belarus	Kazakhstan	Russia	Regional Average	Global Average
Mining, oil & gas	100	100	100	96,2	92
Agriculture & forestry	100	100	100	97,5	95,9
Light manufacturing	100	100	100	98,5	96,6
Telecom	75	49	100	96,2	88
Electricity	64,3	100	100	96,4	87,6
Banking	100	100	100	100	91
Insurance	49	100	49	94,9	91,2
Transport	80	100	79,6	84	78,5
Media	30	20	75	73,1	68
Construction, tourism & retail	100	100	100	100	98,1
Health care & waste management	100	100	100	100	96

On the other hand, Belarus is the country with a higher regional and global index of starting a foreign business – 78.9; it is required to complete only 6 procedures and it takes 7 days for establishing a foreign firm. In Russia and Kazakhstan the number of necessary procedures is increased up to 10, and it will take considerably longer time to start a new business – 31-34 days [9].

The «strength of ownership rights» index is high in Belarus and Russia (100), whereas in Kazakhstan it equals 66.7 which is lower than the regional and global average levels. The longest leasing time for public and private lands is permitted in Russia -239 and 62 days respectively. In Kazakhstan time to lease is shorter: 159 days for public and 37 days for private lands, in Belarus the allowed time equals – 97 and 34 days. The leasing contracts' limitation for public land in Belarus is 99 years, for Kazakhstan and Russia – 49 years. The access to land information in Russia and Kazakhstan is rather low – 44 and 37 respectively, the availability of land information is poorer in Belarus (60), in contrast for Russia and Kazakhstan the

latter index equals – 90 and 95, relatively better than the regional level -78.9 [10].

The «strength of laws» index is the highest in Belarus – 78, but still lower than the regional average (Eastern Europe and Central Asia) of 82.5 and the world average of 85.2. The extent of judicial assistance for Belarus reaches 85, while the regional result is 64.4 [11]. The «easiness of doing business» index given by the World Bank database indicates a relative improvement for all three countries during 2010-2014 time period [12].

The IAB report indicates that Kazakhstan and Russia need the reforms in institutional procedures, mainly aimed at organizing the process of the foreign business establishment and reducing bureaucracy so that the registration process will be simplified and less time-consuming. For Belarus allowing a foreign ownership in all segments of the telephony, transportation and electricity sectors will expand the investment opportunities for foreign firms.

FDI inflows to Kazakhstan, Russia and Belarus

Total amount of net FDI during 2005-2014 allocated in Russia equals 461 292 mln. USD, in Kazakhstan – 105 634 mln. USD, in Belarus – 17 503 mln. USD. A huge amount of FDI from Germany, Netherlands, Ireland, Luxemburg, Cyprus, United Kingdom, Swiss and Austria were directed to Russian Federation. Largest FDI attracted to Kazakhstan are from Netherlands, France, USA, China, Switzerland, Great Britain, Russia, Italy and Cana-

da. In case of Belarus the largest investors are: Russia, Cyprus, Turkey, Germany, Austria, Netherlands, Great Britain and Iran. The FDI patterns to Kazakhstan and Belarus have followed an increasing trend, without any dramatic peaks or downfalls, whereas Russia is experiencing a decreasing tendency of foreign investments starting from 2014, which appears to be the part of an overall economic slowdown in Russia (Figure 1) [13].

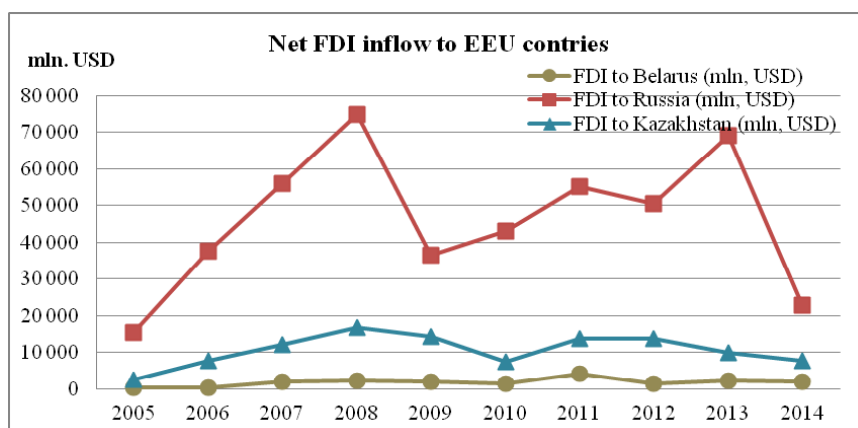


Figure 1 – FDI inflow to Eurasian economic union countries

In the EEU intraregional aspect, Russia is one of the main FDI investors, in 2010-2014 Russia has invested nearly 43 bn. USD in Belarus, and 5.9 bn. USD in Kazakhstan. During the same period gross FDI flows from Russia to Kazakhstan increased to 40 percent, from Belarus investment flows augmented to

80 percent (Figure 2) [14]. Total gross FDI outflow from Kazakhstan to Russia amounted 703.8 mln. USD, to Belarus – 1.8 mln. USD (Figure 3) [15]. For the case of Belarus and Russia we need more credible data on mutual FDI flows between two countries, currently the available data is not sufficient.

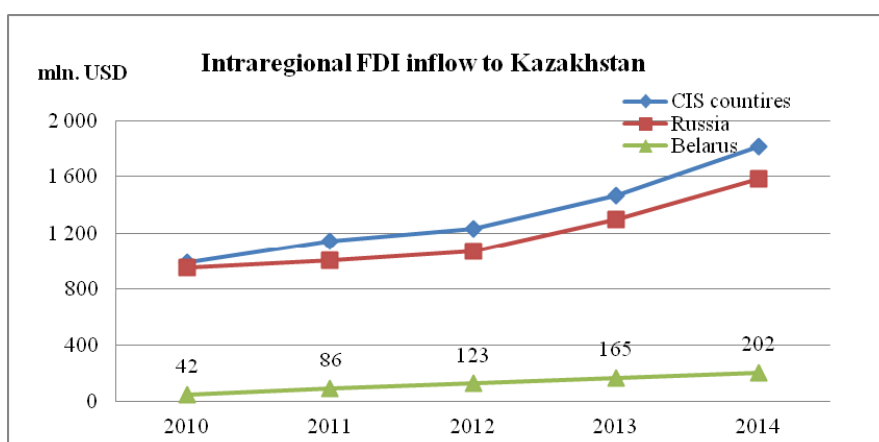


Figure 2 – Intraregional FDI inflow to Kazakhstan

Conclusion

The dynamics of foreign capital flows to Kazakhstan and Belarus is increasing, whereas for the case of Russia, FDI follows a declining trend due to less amount of FDI from European countries. During 2010-2014 the intraregional FDI flows from Russia to Kazakhstan have grown to 40 percent and from Belarus to 80 percent, which may serve as an

evidence of integration's positive influence on foreign direct investment flows.

Investment climate of the three countries can be improved by implementing the organizational reforms aimed at bureaucracy reduction, also allowing more shares in foreign ownership stakes, merger and acquisition in media, telecommunication, insurance, transportation and electricity sectors.

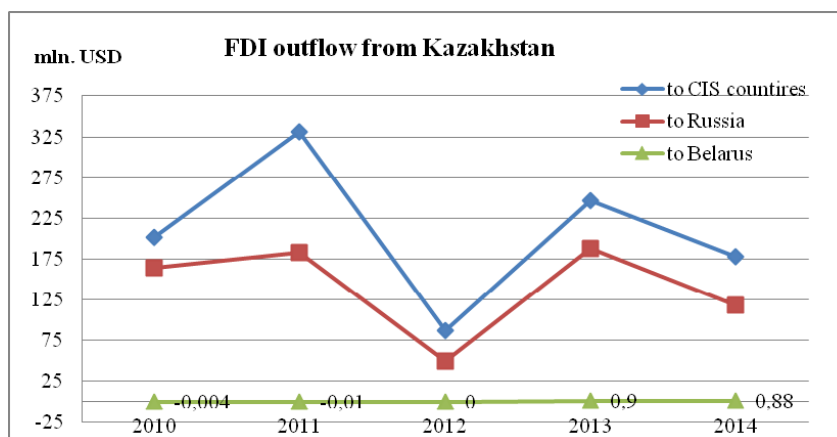


Figure 3 – FDI outflow from Kazakhstan

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