THREE ESSAYS ON TRANSITION OF POST-COMMUNIST SOVEREIGNS

by

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This dissertation is dedicated to my late father who valued my education over his health.

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by

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THREE ESSAYS ON TRANSITION OF POST-COMMUNIST SOVERIGNS

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The Berlin Wall and the Iron Curtain crumbled, resulting in the end of the Warsaw Pact (8 members) and the collapse of the Soviet Union. Hence, the European Bank for Reconstruction and Development (EBRD) was founded to assist these (newly) sovereigns to become pluralistic democracies with a functioning market economy. Capital was scarce in these post-communist nations, and funding was needed to implement costly reforms. The EBRD played a catalytic role by guiding, providing funds, advising governments to transition faster while attracting further investment to member nations. These involvements with member nations provide an opportunity to the EBRD to reduce information asymmetry about sovereigns for foreign investors. The first paper analyses the role of the EBRD in attracting foreign direct investment to savings-deprived post-communist sovereigns. This paper utilizes traditional political risk scores and the EBRD transition scores and their effect on the attraction of investment from abroad. Evidence suggests that if member nations can secure funds from the EBRD, investment risk decreases. Moreover, transition indicators of the EBRD are significant in attracting foreign investment to host nations. The second paper sheds light on the EBRD's role in developing the financial sector and bringing financial greenfield FDI to member nations. As a lender in record or with guarantees to

investors, the Bank has a significant role in introducing new markets to international financial institutions with alleviated risk. These investments had a positive and significant effect on the growth of those economies and credits provided to the private sector. The last paper focuses on the transition experience of three energy-rich nations in Central Asia. The international significance of these counties is lower than other post-communist states and have no aspirations to join the EU due to geographical distance. Without public push, executives of these nations played a significant if not sole role in deciding the pace of transition to market-oriented economy. Kazakhstan fared better in economic change compared to its neighbors because President Nazarbayev cooperated with international institutions and implemented policies to transition the economy despite lagging in the democratization of country or institutions. Turkmenistan and Uzbekistan executives adopted gradual transition, and those economies still show features of a controlled economy rather than a free market one after more than aquarter-century.

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CHAPTER 1

INTRODUCTION

The world was polarized during the Cold War as countries chose their allies according to geographical or ideological proximity to two superpowers. With the fall of the Berlin Wall and the collapse of the Soviet Union, members of the USSR started to declare their independence and intention to transit from controlled to a market economy. Since Soviet ideology could not deliver the promised wealth and prosperity via public ownership, the fall of ideology triggered the need for a better and more proven system. Therefore, the Warsaw Pact members and former Yugoslavia Republics intended to transition from past to future.

Although, all transition economies started with similar institutions, ended up with very different economic and political achievements after more than quarter century. According to World Bank classification, certain economies such as Poland, Latvia, and Croatia have finalized their transitions and now belong in high-income brackets. However, Moldova and Uzbekistan were still in the lower-middle-income bracket, while Tajikistan has recently moved up from a low-income bracket to join the next lower middle-income level. Russia, Serbia, Romania, and many more countries are in the upper-middle-income bracket. Heterogeneity among former communist states apparent and how they became so different after a quarter-century is puzzling. Similar, if not same, economic and political tools were available to all governments in power, albeit they chose different paths. This discrepancy is not only in economics but also in the democratization of these countries. Polity scores of these countries range from 10 to -9. While Lithuania received highest value of 10 immediately in 1991,

countries like Uzbekistan still have a flat line of -9 since the independence in 1991. All economic and political indicators show diverse patterns for the transition. For instance, Armenia attracted $178 million in 2015 while neighboring Azerbaijan secured more than $4 billion. The same year, Croatia attracted $160 million in Foreign Direct Investment (FDI)[1] , while neighboring Serbia had $2.3 billion[2].

International institutions such as the World Bank and the IMF raced to assist in transition to these nations prescribing policies that will complete the economic integration as fast as possible. Hence, the most common advised policy was adopting shock-therapy while providing much-needed funds to support adoption of the policies. However, these institutions' focus were too broad and they had to deal with other global issues simultaneously. Therefore, a new institution, the European Bank for Reconstruction and Development (EBRD) was founded to guide, fund and assist to resolve the issues of post-communist sovereigns.

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[1] Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate).2 FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated. FDI may be undertaken by individuals as well as business entities. (Source: UNCTAD)

[2] http://data.worldbank.org/

CHAPTER 2

THE EBRD AND DETERMINANTS OF FDI IN POST-COMMUNIST SOVEREIGNS

2.1 Introduction

This paper will analyze all post-communist regions with traditional political risk scores and later replace them with six transition scores assigned by the EBRD. Using traditional political risk scores will assist the reader in comparing the results with other studies and compare them with the one that utilizes the EBRD scores. Additionally, the reader will have the ability to see if scores produce consistent results or not. Furthermore, the reader will have an opportunity to understand the region in detail and how some countries fared better than others in transitioning their economy and attracting foreign investment.

The layout of the paper is as follows. Section 2 summarizes the literature on the importance of financial institutions to economic growth and the signaling effect of an international institution. Section 3 provides a brief history of the EBRD as an institution since it is relatively new and not well known. Section 4 provides a theory employed in this paper with hypotheses. Section 5 discusses the data and methodology utilized in this paper with panel evidence on the effect of the EBRD on the financial sector of the transition economies and its contribution to economic growth. Section 6 offers concluding remarks.

2.2 Literature Review

FDI has a potential to boost the economy by creating jobs, increasing competition, bringing new capital, and introducing new technology to new markets. Hence, a study of FDI inflow to post-communist countries will hint at how those countries attracted the investment individually, and we will look for similar characteristics that draw the investment funds. In contrast, some countries failed to attract the same amount of investment. The academic literature is heavily focused on developing countries. Still, not much scholarly work has been done to understand the diversity of paths and outcomes both in economy and politics from the former Soviet bloc.

There is a growing interest in the characteristics of a country that affect the multinational company investment decisions operating in emerging markets and the developing world. The students of this field try to understand or analyze the link between political institutions and political risks faced by multinational companies. The pervasive wave of nationalization between the 1960s and 1970s forced scholars to claim the uniqueness of the term because, after 1975, there was no nationalization (Kobrin, 1984). However, the largest political insurance claim occurred when the financial crisis hit Argentina in 2002 (Moran, 2003). Recent implications of nationalization in Russia forced scholars to rethink the previous findings of the impact of political risk on the FDI. This study will analyze the relationship between political risk and FDI in light of several indicators and the effects of the indicators on the FDI inflow to the transition economies since the collapse of the Soviet Union and, as a result, the dissolution of the Warsaw Pact.

It is challenging to pinpoint the causal factor for explaining the possible causes of specific events in the political economy. The reason lying beyond this bundle is the complexity of the issues and their multiparty structure. It turns out to be an excellent example of this dilemma when explaining the relations between the FDI and the political risk. Jensen (2008) mainly focuses on the impact of democratic institutions and the constraints on executives, and he states that democratic institutions create a lower level of political risks for the FDI. He also mentions that the restrictions on the executives contribute to the stability of the countries and create a more democratic regime.

On the other hand, reviewing the previous implications reveals that multinational firms are always prone to nationalization and to operate under the expropriation threat, even in democratic regimes. Vernon (1971) coined the famous phrase, "obsolescing bargaining," which refers to the idea that multinational investors lose their superiority once they invest in a country and become more prone to the external threats by national governments when they increase their investments in the country. Governments may openly expropriate assets (Kobrin 1979) or renegotiate contracts (Gatignon and Anderson 1988; Williamson 1996). Learning from the experiences, the multinational firms began to utilize arbitration clauses in their investment contracts; however, even the arbitration clauses became useless since they harmed the hosting governments as they could negatively affect the states' reputation (Jensen, 2008). Moreover, some states have preferred not to comply with arbitration clauses and ignored the rulings of the third parties to defend their national priorities. Even if these arbitration clauses are fully enforced, they prove difficult to specify given the complexity of writing a contract about assets

that have yet to be created and the uncertainty of the pace and scope of technological innovation (Freeman 1982; Mowery and Rosenberg 1989; Oxley 1997).

Reviewing the literature reveals that scholars of the political economy have divided into two main streams of ideas on the impact of democracy on the FDI level in a country. Some scholars have mainly focused on the idea that democratization levels of the countries affect the FDI rates. In contrast, others assert that democratization negatively impacts the FDI level since it increases political risks.

Tsebellis (1995, 2002) summarizes the main arguments of the first group into four points and claims that democratization decreases the political risk and the FDI rate increases as a result of this process. He claims that the first reason for reducing political risk in a democracy lies in its stabilization effect on policies. That is to say, since democratic regimes distribute the sources of power to various institutions and utilize a kind of checks and balances, this distribution reduces the risks of drastic changes in the policy-making process. Therefore, the system creates a protection mechanism against harming multinational firms' interests and assures them that they can integrate themselves into the internal markets without any hesitation.

The second factor that leads to reduction of the political risk lies on the path that democratic regimes allow the private sector, no matter foreign or domestic, to lobby for tailoring friendlier policies affecting their industries. According to Li and Resnick (2003), Multi-National Enterprises (MNEs) may exploit and enhance their monopolistic or oligopolistic positions in the market by bribing the politicians, where politicians presumably encourage inward FDI. Jensen argues that the vulnerability of democratic institutions does not mean that

the private sector is not influential in authoritarian regimes but that democratic regimes locate more transparent ways to influence the policies using legal instruments.

The third factor contributing to lessening the political risk is the transparency of the policy-making process in democratic regimes. Scholars agree that democratic regimes use transparency in the policy-making process. This transparency leads multinational firms to foresee future developments and use their sources more efficiently (Rosendorff and Vreeland, 2006). Therefore, multinational firms prefer to invest in democratic regimes more than those operating under authoritarian rule.

The last factor that decreases the political risk in democratic regimes is the issue of reputation costs. Jensen (2003, 2008) argues that countries enacting harmful policies against multinational companies will suffer from a low level of investment in the future. Consequently, this leads to "audience cost," which refers to the idea that politicians pay for the price of low-level investments at the polls and tarnish their reputation. As a result, voters replace politicians who have bad reputations with multinational firms with better ones.

As stated before, some scholars take a different approach and claim that democracy increases the political risk, negatively affecting the country's FDI level. In contrast with the first group, the second group focuses on the side effects of democratic institutions and claims that democratic institutions can easily be exploited by manipulating several factors.

The main argument that the second group highlighted may be classified into two parts: the policy instability and the chaos created by the competing interest groups to enact their

priorities. The first instrument refers to the idea that democratic institutions are prone to be exploited by politicians with several motives. Since the politicians' preference is getting re-elected, their prescribed policies will change to easily win the election rather than keeping the MNCs in the country. When politicians change their approach according to the preferences of the electors, it may endanger future investments from multinational firms. Hence, governments may change policies even though they will result in poor macroeconomic outcomes in the future. (Rodrik 1991; Alesina and Tabellini 1990; Persson and Svensson 1989). When electoral survival becomes more important than the other issues, it may lead politicians to imply contrasting policies of their successors.

The second argument focuses on the idea that although democratic institutions give a chance to multinational firms to influence the government's policies, it may turn to a disadvantage when the interest of the local business firms conflict with multinational firms. Since the local business owners are more experienced in local politics, they can utilize several ways and means to influence the policies and easily harm foreign investors' interests when a conflict occurs between the sides (Henisz 2002a).

Consequently, democratic political institutions allow government policy to be responsive to the policy preferences of both firms and voters. However, if voters outweigh the MNCs, voters' preferences will be a priority for the government. Still, if MNCs can lobby and influence the government policy, then politicians will protect the interest of the MNCs if they can win the election despite their support for MNCs (Jensen 2008).

Post-communist transition economies may be analyzed from a democratization point of view to test how the theory works in this particular case. However, it will not explain the attraction of FDI to less democratic countries such as Russia and Kazakhstan. Moreover, Kyrgyzstan is the most democratic in post-Soviet Central Asia but attracts the least among regional neighbors.

Many studied the transition of post-Soviet countries heavily (Aslund, 2007, Stone 2002, Balcerowics, 2000, Cameron, 2009), but those studies mostly lack quantitative results to support their arguments. That may be because there was not enough observation to obtain reliable results. However, that does not lessen their contribution to the literature. It has been more than twenty-five years since the fall of the Union; hence there is enough data to analyze. Data may not be very reliable since most international institutions rely on individual governments to report.

In his book, Aslund (2007) argues that countries that adopted radical reforms produced better and more durable economic performance than those reformed gradually. Also, the shock therapy resulted in better political institutions despite the pain of the initial post-reform phase. The radical reform adopters were Central and Eastern European countries that were seeking accession to European Union (EU). Cameron (2009) explains the reason behind those radical reforms as a push from the EU rather than voluntary reform by the governments of the particular countries. The aspiration to enter the EU influenced the timing and pattern of

reforms.[3]. However, Cameron fails to identify determinants of reforms adopted by the Russian Federation, Kazakhstan, Armenia, and Kyrgyzstan. In his book, Stone (2002) argues that the IMF successfully prescribes "shock therapy" style reforms to Poland and other post-communist states except for Ukraine and Russia. Poland signed three programs with IMF in 1991, 1993, and 1994. Stone argues that when Polish politicians missed the target, IMF suspended the program. Hence, Poland had to go through painful reforms despite opposition from the public. Moreover, Bulgaria was another example of success in transitioning economy with a prescribed program of IMF. However, that was not the case with Russia, where the author blames the United States for intervening with an independent IMF program. IMF was not able to suspend the program, although Russia missed the targets. As a result, Russia could not adopt shock therapy as prescribed by the IMF. Stone (2002) argues that Russia has an unequal income distribution than its arch-nemesis, the United States. As a result of failed policies of IMF, Stone argues that Russia is still corrupt and still with unreformed industry, agriculture, and service sectors.

Since Ukraine was a strategically crucial country, the US has intervened with IMF programs in favor of Ukraine as well. Hence, even though the conditions have not been met, IMF bent the rules to continue to support the program. High inflation and unpopular structural reforms were why Ukrainian legislators and Presidents abstain from pushing those reforms.

[3] Cameron uses data, but we can also check with EBRD transition scores

However, Ukraine may be better with loosely adopted policies rather than abandonment of such policies.

Grigor Pop-Eleches (2008) also studied four post-communist countries (Romania, Moldova, Slovakia, and Bulgaria) and compared them to the other four countries from Latin America. He has focused more on the international and domestic dynamics of IMF programs with countries. According to Pop-Eleches, countries in the program benefited from IMF funding and signaled to third-party lenders to fund projects in their countries (2008, pg. 102). By employing costly signaling, transition economies attempt to attract foreign capital and investments by signing programs with IMF and reforming the command economy. According to Rodrik (1988), policy reforms without sufficient credibility can be aborted or reversed, showing the government's seriousness in adopting reforms. Costless signaling is nothing more than a display of future intentions; hence, governments need to go overboard to indicate that the policy is credible.

2.3 EBRD history

The European Bank for Reconstruction and Development (EBRD) was founded in 1991 in London to assist Central and East European countries to transition to the market economy. Later the Bank encompassed former Soviet Union members as well. Currently, it serves 38 members in three continents, including Europe, Asia, and North Africa. Since its establishment, the Bank has played a historical role and acquired unique expertise in the region. One feature that differs from other international institutions is its ability to respond events

swiftly and decisively. This has been apparent in their response to Arab Spring, financial crises, and of course with the fall of the Soviet Union[4]. The EBRD is owned by 67 countries, the EU, and the European Investment Bank (EIB). Member countries are also shareholders of the Bank. Recent members include China and India as well. As a result of this institution, member nations enjoyed integration into the global economy and continued transitioning to the market economy. Till the end of 2017, total funding by the Bank reached 120 billion Euros in the region. Since the EBRD only funds projects that are not feasible for market financing, this value has an even more significant effect.

This institution has a unique role in guiding members in difficult times and providing much-needed funds for projects that were not appealing to international financiers. Therefore, the Bank has a huge risk appetite while advising nations to reform its institutions and markets. The EBRD evaluated the transition of each member and assigned transition scores from 1991 to 2014. Since then, more sophisticated measures have been introduced to evaluate member sovereigns.

2.4 Theory and Hypotheses

This paper investigates the determinants of FDI inflows into the transition economies and the perceptions of the investment climates in those countries as reflected by their political

[4] https://www.ebrd.com/who-we-are/history-of-the-ebrd.html (Accessed on March 25, 2019)

risk scores determined by the Political Risk Services (PRS) Group and with the EBRD transition scores. One of the most cited works on this field is by Busse and Hefeker (2007), in which they have analyzed the developing 83 countries. In their work, they have utilized FDI data from World Bank. This paper will also use World Bank FDI net inflow[5] data. This paper aims to investigate the effect of EBRD loans and transition scores in the attraction of FDI to post-communist countries. This analysis encompasses the year between 1991 and 2014. The cutoff date in the data is 2014 because the EBRD ceased to publish initial transition scores and started to publish more qualitative in-depth analyses.

The theory employed in this paper is that the EBRD was created to assist post-communist economies to transition members' economies and institutions. Therefore, the Bank's amount of finances to sovereign members and evaluations of these economies, a. k. a. transition scores, should be a credible signal to appeal to international investors and invest in member countries. The EBRD finances are crucial because the Bank finances projects that are not feasible to fund through financial markets due to lower returns or high risk. Moreover, transition scores indicate host governments' credibility and commitment to reform their institutions and to undertake market reforms, which are crucial to a healthy transition to the market economy.

The EBRD loans to member countries are the total loan given to each country from 1991 till 2014 each year. Some countries have received funds from the Bank each year, and

[5] FDI net inflow (in current US $, BOP) is foreign direct investment inflows minus foreign investment leaving the country. Not to be confused with net FDI, FDI inflows minus FDI outflows where domestic investors invest in other countries.

some countries have not. However, total loans are the accumulation of both public and commercial loans to member nations. The EBRD assists with funding when the member country cannot finance a project from the financial markets with favorable rates or cannot finance it at all. Therefore, the EBRD funds should assist countries in financing the projects that are not attractive for international banks but should also solve the financial hurdle of a member country to transition to the market economy and eventually be attractive for further investment. Moreover, these finances by the EBRD will also mean that the member country is serious in transitioning its economy and its institutions. Hence;

H1: the EBRD loan will positively affect the FDI to post-communist countries

While the EBRD is financing projects in member countries, it also evaluates each sovereign annually and publishes those scores in six categories. These categories are small-scale and large-scale privatization, governance and enterprise restructuring, price liberalization, trade, and foreign exchange system and competition policy[6]. Each varies between 1 and 4+, where 1 is the no reform while 4+ shows that the sovereign is performing at the standards of an advanced industrial country. These evaluations are an indicator of how a country is transitioning its economy and institutions. Therefore, the expectation is that these indicators be determinants in attracting FDI to each economy.

H2: the EBRD transition scores will be positive and significant in attracting FDI to member nations

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[6] https://www.ebrd.com/cs/Satellite?c=Content&cid=1395237866249&d=Mobile&pagename=EBRD%2FContent%2FContentLayout

Each transition indicator will be tested separately with the model to prevent collinearity. That is because numbers are close to each other and do not fluctuate much compared to each other.

2.5 Models

Most empirical studies in the literature on FDI analysis used logarithm for FDI and independent variables. In the first estimation, FDI data obtained from World Bank will be used with political risk scores, while the second one will use EBRD transition scores instead of political risk scores. While PRS political risk scores are more commonly used, it only publishes in twenty post-communist countries. However, EBRD transition scores were issued for all from 1991 till 2014. The regression formula will be as follows:

$$\mathbf{lnFDI_{i(t+1)} = \beta_0 + \beta 1 lnGNI_{it} + \beta_2 lnGROWTH_{it} + \beta_3 lnTRADE_{it} + \beta_4 lnINFLATION_{it} + \beta_5 lnEBRDloan_{it} + \beta_6 EU_{it} + \beta_7 PoliticalRiskit + e_{it}} \quad \mathbf{(1)}$$ [7]

where βj are the estimated coefficients, PoliticalRisk stands for one of the 12 indicators for political risk (i for country, t for time), and e_i is an error term. Political risk indicators are used one by one to avoid multicollinearity since those numbers are close to each other. Also, Hausman (1978) test suggests using the fixed-effects model[8].

Model 1 will analyze the period from 1991 till 2014 with commonly used political risk scores. Only seven of the political risk scores will be utilized. Since risk scores are only available for

[7] Harris -Tzavalis unit root test utilized for stationarity.

[8] Chi-square = 16.49 (p = 0.0083). Results do not change even if we add seven political risk or transition scores one at a time.

twenty post-communist countries observation number for the analysis will be lower. However, it is a commonly used indicator to evaluate the risk of foreign investment into a country. Moreover, a dummy variable is included to analyze the effect of EU membership to attract FDI.

$$\mathbf{lnFDI_{i(t+1)} = \beta_0 + \beta 1 lnGNI_{it} + \beta_2 lnGROWTH_{it} + \beta_3 lnTRADE_{it} + \beta_4 lnINFLATION_{it} + \beta_5 - lnEBRDloan_{it} + \beta_6 EU_{it} + \beta_7 EBRDtransition + e_{it}} \quad \mathbf{(2)}$$ [9]

Model 2 includes the EBRD transition scores instead of the political risk scores. The transition scores will increase the number of countries included in the analysis to twenty-eight countries from twenty.

2.6 Data and Variables

This analysis will cover years from 1991 till 2014. The dependent variable will be FDI inflow to post-communist countries. PRS scores cover only twenty transition countries, so that the result would be more restrictive. Moreover, PRS Groups' country risk scores will be utilized and later replaced with EBRD's country scores to compare the results. Once EBRD transition scores are introduced to the model, observation and country numbers should increase.

PRS Group has published risk scores since 1984; however, PRS Group rated only 20 transition economies rather than all. PRS Group provides 12 different risk indicators to each country, but only include the relevant[10] ones.

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[9] Harris -Tzavalis unit root test utilized for stationarity. Stationarity achieved with difference and restested to confirm.

[10] The analyses do not include external and internal conflict, military in politics, religious tensions, and ethnic tensions. There has been some internal and external conflict in the region, but that did not last long. The military does not have an active role in

Each indicator is scaled between 0 and 12; the higher the score lower the political risk. These indicators are widely recognized by scholars and used as high-quality measures of political risk[11]. Only twenty[12] transition economies have been assigned political risk scores from 1991 till 2014. Conflicts across the border in transition economies happened before the turn of the millennia. Only Russia and Georgia experienced short conflict for about ten days in 2006. However, Georgia is not included in the political risk data set. Russia had experienced internal conflict in Northern Caucasus till 2009, and Greenfield investment data was minimal till late 2008. The total investment to the region was 900 million USD, while Russia received more than 300 billion USD from 2003 till 2016. Investment in Northern Caucasus was generally into a heavy industry like construction, machinery, and also warehousing. Also, Azerbaijan and Armenia experienced short-term conflicts over Nagarno-Karabach during the time data covers, but those conflicts were not escalated to war and lasted short. Internal and external conflicts are not counted in our analysis as a dummy or any other kind of variable. The only major cross-border conflict during the dates covered is the annexation of Crimea and which happened in the spring of 2014. Even though that may influence the investments in the Crimea region, it is less likely to affect investments in both Russia and Ukraine. However, Russia has been sanctioned immediately after annexation, which may have caused the decline

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politics throughout the region, and it is not a tradition for a general to become a president. Religious and ethnic tensions are minimal in the

[11] These indicators have been used by Harms and Ursprung (2002), Bolaky and Freund (2004), Rodrik et al(2004), Noguer and Siscart (2005), and Busse and Hefeker (2007).

[12] Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Check Republic, Estonia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Mongolia, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine

in investment in Russia. Unfortunately, our analyses do not include the period after 2014, excluding escalation in the border with Ukraine and Russian Federation. None of the former Warsaw pact members experienced a military coup after the fall of the Soviet Union. Therefore, there is no need to include that indicator as well. Religious tensions were minimal in this region since all were communists before starting to practice their pre-communist religion. Moreover, communist leaders turned into nationalistic roots overnight with the fall of the Soviet Union. Only religious tension was experienced among former members of Yugoslavia.

The EBRD transition indicators will be evaluating each sovereign according to their progress on implementing market reforms. Each indicator will evaluate the progress from 1 to 4+. The lowest indicator, 1, shows no progress in that category. 2 signals that there is little progress toward implementing market reforms, while 3 means that the country made significant reform. 4 indicates that the country has made substantial progress in that category but still room for further reform while 4+ means that nation has a standard and performing like an industrially

Table 2.1. Correlation Matrix (PRS Scores)

	lnGNI	Government Stability	Socio-economic Condition	Investment Profile	Corruption	Law and Order	Democratic Accountability	Bureaucratic Quality
lnGNI	1							
Government Stability	0.0566	1						
Socio-economic condition	0.2892	0.7504	1					
Investment Profile	0.3091	0.4098	0.4915	1				
Corruption	0.102	0.6932	0.815	0.2943	1			
Law and Order	0.1467	0.7374	0.8706	0.48	0.8873	1		
Democratic Accountability	0.2084	0.731	0.7916	0.3841	0.8511	0.828	1	
Bureaucratic Quality	0.4088	0.6022	0.7291	0.3341	0.7715	0.7409	0.7923	1

Table 2.2. Correlation Matrix (EBRD Scores)

	lnGNI	Large-scale Privatization	Small-scale Privatization	Governance and Restructuring	Price Liberalization	Trade and Forex Systems	Competition Policy
lnGNI	1						
Large-scale Privatization	0.4973	1					
Small-scale Privatization	0.482	0.8354	1				
Governance and Restructuring	0.6653	0.8266	0.7977	1			
Price Liberalization	0.3504	0.7288	0.7487	0.6549	1		
Trade and Forex Systems	0.4551	0.7906	0.8338	0.7394	0.8432	1	
Competition Policy	0.643	0.7395	0.6641	0.8394	0.526	0.5983	1

advanced nation[13]. As shown in Table 2.1, all indicators are related to each other with varying degrees. Corruption is highly correlated with law and order, government stability, socio-economic conditions, and democratic accountability, excluding investment profile. Partial 2, governance and restructuring, and competition policy reforms are highly correlated with the size of the economy, whereas the rest is below 0.5 level despite positive correlation. Albeit transition scores are highly correlated with one another where all are above 0.7. Hence, these indicators will also be used individually. As these indicators increase, sovereigns should be more attractive for foreign investors. Therefore, a positive and significant result is expected on both political risk and the transition indicators.

Even though there is no theoretical model for determinants for FDI flows, many variables have been used frequently by scholars (Busse and Hefeker, 2007; Chakrabarti, 2001[14]; Carkovic and Levine, 2005*)*. Those are market size and growth rates. Therefore, FDI should be positively correlated with both variables. The bigger the market size, the more attractive it becomes to foreign investors. Moreover, higher growth of the economy would translate to a higher return on investment. Trade openness is another factor used in scholarly articles that indicate the restrictions on trade by host governments. Asiedu (2002) argues that trade openness determines the kind of investment inflow to a nation. Moreover, if a nation has fewer barriers for imports and exports, investors may choose a sovereign to invest and distribute the good to neighboring nations. However, the sign of correlation with trade and FDI

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[13] https://www.ebrd.com/cs/Satellite?c=Content&cid=1395237866249&d=Mobile&pagename=EBRD%2FContent%2FContentLayout

[14] Even though the dependent variable is not FDI per capita, this analysis will employ GNI (or GDP) per capita.

is not definite in scholarly articles but we should expect a positive relationship between the two (Chakrabarti, 2001).

Many scholars found a positive and significant relation between FDI and market size in Central and Eastern European and former Soviet Union countries (Lankes and Venables, 1996; Estrin et al., 1997; Benacek et al., 2000). Market size is referred to as GDP, but GNP will be utilized instead. GDP (Gross Domestic Product) only includes products in the domestic economy, while GNP (Gross National Product) includes production in foreign subsidiaries of home companies. Therefore, the latter is more encompassing than the former. Moreover, with the turn of the millennia, the significance of market size either diminished or became negative in attracting investment from abroad; however, it is expected to be positive in this paper.

A sound macroeconomic policy with low inflation, low trade deficits, and interest rates is likely to reduce risk in investment returns. Therefore, Aizenman (2003) argues that macroeconomic fluctuation is detrimental in attracting FDI to sovereigns, and consistent policy would make an economy more attractive to investors. Hence, inflation is added to capture volatility in the region.

Following four control variables will be used in cross country panel analyses:

GNI: Gross national income per capita, PPP (current international $) to control market size

GROWTH: GDP per capita growth (annual %) to control market growth

TRADE: the ratio of exports and imports to GDP to control openness of trade

INFLATION: the GDP deflator, a proxy for macroeconomic volatilities

EU: Dummy variable, 1 if the sovereign is an EU member, 0 if not.

EBRD Loan: Total amount of loan given to each member, including funding for public and private projects.

EBRD transition scores encompass the following six categories covering years from 1991 till 2014 for twenty-six nations[15]: large scale privatization, small scale privatization, government and enterprise restructuring, price liberalization and Trade & Forex exchange systems. Range scores are from 1 to 4+ where 1 denotes the robust features of the command economy, whereas 4 means that a substantial part of the transition is accomplished[16]. Whereas 4+ indicates that the sovereign has a standard of an advanced industrial nation. Democratization score, aka Polity scores, is not included in the analysis because the EBRD loans, EU membership, and transition score indirectly indicate the level of democratization in each country.

Large-scale enterprises include the power grids as well as state-owned energy companies such as Gazprom. This category is the crucial indicator since host nations give up their control over the nation's economy. That is to say, a large share of each post-communist economy is dependent upon these large state-owned enterprises. Therefore, higher the indicator means that the host nation is giving up commanding power on its economy and serious in transition to the market economy. Once member sovereign reaches the score of 4, the state gives up at least 50% of the tradable ownership. This score indicates significant progress both with privatization and

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[15] Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Check Republic, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan

[16]. More information regarding scoring and calculation methodology may be obtained from ebrd.com.

corporate governance. When the country scores 4+, then government owns less than a quarter of these large enterprises.

Small-scale state-owned enterprises include small sweatshops or small factories, and their privatization indicates that the state is giving up ownership of these entities. Moreover, this indicator also includes the tradability of the land. Once the highest score of 4+ is reached, the state does not own any share in small-scale enterprises.

The third transition indicator is the governance and enterprise restructuring score. In general, lax budgets and subsidies weaken the discipline in corporate governance at an enterprise level. Hence, credits should be tightened, and bankruptcy legislation should be vigorously enforced to strengthen the competition and corporate governance. The best possible outcome for the transition economies is giving corporate control to domestic financial institutions and markets, which will foster market-based structuring.

The main feature of command economies is the control of prices in the market, both retail and procurement. Score 1 indicates that the government controls or assigns almost all essential prices. For instance, cotton and wheat yields in Central Asian countries were always procured from official prices from collective farms while farmworkers got paid for their labor. Such practice eventually brought the black market to these economies while state-owned stores could not keep products on their shelves with suppressed prices. With the transition, government loosened its grip and started liberalizing the prices in the domestic market on both ends. Once the economy reaches an advanced country level, prices are liberalized except for housing, transportation, and natural monopolies such as public utilities.

Only people allowed to have foreign currency during Soviet times were the ones visiting abroad. Once visitor returns, he should convert it to rubles. Since the state is the only employer, there is no market or need in the domestic market other than saving it. Moreover, exports and imports were highly regulated. State-owned companies allowed to exercise both export and import. Russian Vneshekenom bank operated as an export-import bank of the Soviet Union. With the fall of the Union, some members continued to use such bank for foreign transactions. Once the country completes its liberalization of trade and foreign exchange system, it removes all quantitative and administrative import and export restrictions, including tariffs, except agricultural goods to protect farmers. Additionally, the domestic currency becomes fully convertible to foreign currencies. Eventually, the EBRD aims for the sovereign to become a WTO member.

The last is the competition policy score, where 1 means not even legislated competition policy or established an institution to ensure market competition. Therefore, each member starts by introducing the legislation and reducing restrictions to enter the market or a plan to regulate dominant firms. Countries may further break up conglomerates in the market and further reduce the restriction for new companies to enter. The best possible outcome is effective enforcement of competition policy with unrestricted entry to most markets.

Table 2.3. Panel Data Analysis with fixed-effect (PRS scores)

Dependent variable: FDI inflow (BoP) (1991 - 2014)							
	Government Stability	Socio-economic Condition	Investment Profile	Corruption	Law and Order	Democratic Accountability	Bureaucratic Quality
GNI	1.848***	1.763***	1.788***	1.879***	1.848***	1.835***	1.845***
	(0.14)	(0.14)	(0.15)	(0.14)	(0.14)	(0.14)	(0.14)
Growth	0.329***	0.314***	0.356***	0.347***	0.331***	0.328***	0.358***
	(0.09)	(0.09)	(0.09)	(0.09)	(0.09)	(0.09)	(0.09)
Trade	0.22	0.26	0.17	0.32	0.28	0.19	0.15
	(0.30)	(0.30)	(0.30)	(0.30)	(0.30)	(0.30)	(0.30)
Inflation	-0.11	-0.13	-0.07	-0.13	-0.12	-0.11	-0.12
	(0.09)	(0.08)	(0.09)	(0.09)	(0.09)	(0.08)	(0.09)
Population	0.18	0.02	0.51	0.15	0.12	0.07	0.21
	(1.33)	(1.32)	(1.35)	(1.33)	(1.33)	(1.30)	(1.33)
EU membership	-0.16	-0.21	-0.07	-0.20	-0.19	-0.26	-0.17
	(0.18)	(0.18)	(0.18)	(0.18)	(0.18)	(0.18)	(0.18)
EBRD Loan	0.0857*	0.0859*	0.0798*	0.0889*	0.0847*	0.0823*	0.0832*
	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)	(0.04)
Political Risk	0.0199***	0.0325***	0.0313**	0.0692***	0.0650***	0.0585***	0.160***
	(0.00)	(0.01)	(0.01)	(0.02)	(0.02)	(0.01)	(0.04)
N	328.00	328.00	328.00	328.00	328.00	328.00	328.00
R^2	0.80	0.80	0.80	0.80	0.80	0.80	0.80

Standard errors in parentheses
* p<0.05, ** p<0.01, *** p<0.001

2.7 Empirical Specification and Results

Panel data with fixed effects were employed on both analyses presented in Tables 2.3 and 2.4. Table 2.3 includes political risk scores to analyze their effect in attracting FDI to post-communist economies. Market size and growth are both significant in the attraction of FDI. Namely, according to this analysis, investors view market size and how fast an economy is growing to invest in the host nation. Therefore, economic growth after the fall of the Soviet Union is a significant factor in appealing to foreign investors. Trade and population are not significant factors, but inflation is detrimental, although not significant.

Interestingly EU membership has a negative effect on FDI transition, which needs further investigation. However, that may be due to economies attracting FDI once accession talks start with future members. Kersan-Skabic and Orlic (2007) claimed that EU accession talks are credible signals to foreign investors about the state of the economy in possible host nations. Inflation is negative as expected but was not crucial for this group of countries. From Table 2.3, we can see that the EBRD loans are assisting members to attract further investment to their countries. The number of loans may be signaling as approval for the direction and speed of the transition in a host nation. Once the EBRD is not satisfied with the level of transition in institutions, it ceases to fund public projects in member countries. Article 1 of the Agreement of Establishing the Bank mandates the Bank to further democracy and market reforms hand in hand. Hence, if the country lags in establishing democratic institutions, the Bank ceases funding public projects in member sovereign. For instance, the EBRD only funded two public projects in Turkmenistan, and the rest is private. Still, total funding in Turkmenistan is the lowest compared to other Central Asian nations**.** Therefore, the amount of monetary value is

significant in attracting foreign investment to member nations since it credibly signals to investors that the host nation's government is committed to reforms.

Government stability is positive and significant where foreign investors have a keen interest in how stable the host nation's government is in general but with the least coefficient (0.0199). That may be due to initial instabilities in the region but governments. The socio-economic condition of citizens in host sovereigns is also positive and significant at a 0.01% level, while investment profile is crucial to attracting investment abroad. However, the second-highest coefficient belongs to the corruption indicator (.0692). Investors from abroad highly regard corruption or newly worded integrity systems to enter a market. Investors are also highly sensitive to law and order as well as democratic accountability in host nations. Albeit, the bureaucratic quality of a host nation has the highest coefficient (0.16) in this analysis with positive significance. Overall, all relevant political risk scores are positive and significant in attracting foreign investment to host nations.

Table 2.3 only shows the analysis with political risk scores. However, Table 2.4 includes a column where without both political risk scores and the EBRD transition scores. Without those, inflation becomes detrimental in FDI attraction, but the EBRD loan becomes only significant at the 10% level. However, the number of observations jumped from 328 in Table 2.3 to 555 in Table 2.4. As mentioned above, that is due to the non-availability of political risk scores for countries that are not important enough to foreign investors. Designated political risk scores are all significant at 0.1% level except Investment profile, which is significant at 1% level.

Table 2.4. Panel Data Analysis with fixed effects (EBRD scores)

Dependent variable: FDI inflow (BoP) (1991 - 2014)							
		Large Scale Privatization	Small Scale Privatization	Governance and Enterprise Restructuring	Price Liberalization	Trade and Foreign Exchange System	Competition Policy
GNI	1.883***	1.628***	1.673***	1.675***	1.837***	1.603***	1.784***
	(0.11)	(0.12)	(0.12)	(0.12)	(0.11)	(0.12)	(0.13)
GROWTH	0.387***	0.408***	0.279**	0.370***	0.352***	0.362***	0.401***
	(0.08)	(0.08)	(0.09)	(0.08)	(0.09)	(0.08)	(0.09)
TRADE	0.31	0.05	0.41	0.31	0.25	0.29	0.29
	(0.22)	(0.22)	(0.22)	(0.22)	(0.22)	(0.22)	(0.22)
INFLATION	-0.159**	-0.02	-0.02	-0.05	-0.09	-0.05	-0.150*
	(0.06)	(0.06)	(0.07)	(0.06)	(0.06)	(0.06)	(0.06)
Population	0.11	1.38	0.55	0.92	0.69	0.10	0.67
	(0.82)	(0.83)	(0.81)	(0.82)	(0.83)	(0.80)	(0.88)
EU membership	-0.27	-0.21	-0.26	-0.413*	-0.25	-0.12	-0.327*
	(0.16)	(0.16)	(0.16)	(0.16)	(0.16)	(0.16)	(0.16)
EBRD Loan	**0.05**	0.02	0.03	0.02	0.04	0.04	0.05
	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)
EBRD Transition Score		0.653***	0.659***	0.856***	0.571***	0.603***	**0.24**
		(0.12)	(0.14)	(0.18)	(0.16)	(0.12)	(0.14)
N	555.00	507.00	507.00	511.00	507.00	511.00	511.00
R^2	0.82	0.83	0.82	0.82	0.80	0.81	0.80

Standard errors in parentheses

* p<0.05, ** p<0.01, *** p<0.001

According to Table 2.3, nations should work with the EBRD and satisfy its transition requirements to secure further funding from the Bank to attract further foreign investment. Therefore, from this analysis, we can conclude that market size, growth of the economy, the EBRD loan, and political risk scores are all significant factors in attracting foreign investors to the host nation and all affect the attraction of investment from abroad positively.

Table 2.4[17] analyzes the attraction of FDI to post-communist countries with EBRD transition scores. The first model in this table is without any EBRD transition indicator and the inflation is detrimental in attracting the FDI, and EBRD loans to members are only significant at the 10% level. That means that the loans slightly effective in attracting further foreign FDI to a nation. However, once transition scores introduced to the model, then the contribution of the EBRD loans further diminishes and becomes nonpredictive. In Table 2.3 EBRD loans were significant and positive in attracting FDI. That may be due to restricted political risk scores assigned to crucial nations rather than covering all post-communist world. Those nations with PRS scores are also the countries with utmost significance the West in early transition days. Therefore, their integration to the world markets were prioritized compared the the rest of the region. With the turn of the millennium, the EBRD started to shift its focus further East and started to prioritize and provide funding diminishing its involvement with nations that has PRS scores. Introduction of all post-Soviet nations with transition scores to models in Table 2.4 reduces the significance of EBRD loans since the Bank started to evaluate the member nations

[17] I did not utilize selection models for the EBRD loan and it needs further research with introduction of such technique to this model.

in 1991. Further research is necessary with control over EBRD loans to understand better why EBRD loans were not significant on Table 2.3.

Large-scale and small-scale privatization is vital in attracting foreign funds with 0.53 and 0.659 coefficients consecutively. The third transition indicator is the governance and enterprise restructuring score, and it has the highest coefficient (0.856) among six indicators while it is positive and significant in attracting FDI to host nations. Price liberalization is also significant at the 0.1% level but with the second-lowest coefficient determining the FDI inflow to host sovereigns. Trade and foreign exchange system indicator is also positive and significant in FDI attraction to the domestic economy with the coefficient of 0.603.Competition policy is only significant at 10% level with the least coefficient (0.24) among six. Intuitively, unrestricted entry and a competitive market may not be too much appealing for foreign investors to seek return for their investments.

Moreover, with competition policy, indicator EU membership becomes detrimental to the attraction of FDI to post-communist economies. This issue needs further research to understand the mechanism behind it. Additionally, the EU was also negative and significant with

governance and enterprise restructuring, which means that EU membership becomes a negative factor if the country succeeds in reforms without EU push. Also, this may mean that EU members already attracted enough funds while accession talks were going on. Hence, eastern markets may become more fertile and attractive to foreign investors.

From these transition indicators, we can conclude that the EBRD's role in assisting with funds and evaluating and guiding member sovereigns is crucial to attracting much-needed foreign funds and investments for sustainable growth and development. Once the sovereign can

secure funds from the market with favorable rates to fund projects, the Banks mission is accomplished. Until that time, the EBRD will continue to work with members to reach a robust market economy.

From the above analyses, trade is not significant in any of the analyses; therefore, we can conclude that companies are not investing for distribution purposes in each sovereign. The total population is of the whole region is estimated at around 400 million altogether in 1990 and Russia would make more than a quarter of it. FDI net inflows are sensitive to political risk factors and also to the EBRD transition scores. However, once transition score is introduced to the model

with political risk scores, both are a significant determinant of FDI but do not contribute to R2.

Market reforms make former communist economies almost impossible to return to a command economy. Hence, it seems highly relevant for countries to enlarge their share of investment from abroad. Another implication would-be host governments by large-scale privatization and liberalizing trade and forex systems will lose control over the domestic economy as it used to. However, some nations still have not adopted full-scale privatizations yet, and they seem to suffer from not doing so, such as Belarus, Uzbekistan, Tajikistan, and Turkmenistan. These findings also support the notion that shock therapies are more prone to success than gradual ones in attracting foreign funds to an economy.

2.8 Conclusion

From the above analyses, it is safe to conclude that the EBRD played a crucial role in assisting member sovereigns in securing much-needed funds from the Bank and guiding

member nations in the transition process. Therefore, its transition indicators are significant in attracting foreign investment to member countries. These investments were salient for sustainable development. Moreover, the Bank is also committed to establishing democratic institutions in member sovereigns as Article 1 declares that democratic and market reforms go hand in hand. Hence, the Bank punished members who adopted market reforms but not democratic ones. Large and small-scale privatization were crucial for the attraction of foreign investment but also significant for market reforms. Governance and enterprise restructuring was also determining factor for investment. This indicator promotes the market-based structure exercised by domestic financial institutions rather than governments. Price liberalization is the basis of market reforms where the state ceases to regulate prices in the market on both supply and demand sides. Trade and Foreign Exchange system reforms indicator measures the extent of reforms to reach for open trade with less possible restrictions and full convertibility of domestic currency.

Moreover, the EBRD aims member nations to be WTO members and use its platforms to facilitate trade negotiations or disputes. The last indicator is the competition policy, where the host government ensures all markets are open to new entrants and actively enforces competition policy against conglomerates in the market as well. The government may also break up market-dominant companies to ensure the market is competitive enough for all new enterprises.

These two analyses provide a similar picture regarding determining factors in the attraction of foreign direct investment to transition economies. The most common determinant

is market size and growth as a percentage of GDP. Market size is positively correlated in every analysis and only statistically significant. Political risk scores are significant in attracting FDI.

These results advise the EBRD's member sovereigns to complete market and democratic reforms and make their economy appealing to foreign investors. The more governments cooperate with the EBRD, the more likely sovereigns' political risk scores will improve as well as transition indicators.

CHAPTER 3

THE ROLE OF THE EBRD IN ATTRACTING AN FDI TO THE FINANCIAL SECTOR AND ALLEVIATING THE POLITICAL RISK IN POST-COMMUNIST ECONOMIES

3.1. Introduction

The role of financial institutions on economic growth have been analyzed extensively, and many concluded that they are a prerequisite for accelerated economic growth (Levine, 1997, 2003, 2005; Levine et al., 2000; Beck et al.; 2000; Guiso et al., 2004; Watchel, 2001; Caporale, 2015; Fu et al., 2018; Madsen et al., 2018; Bitzenis 2006). Therefore, the development of financial intermediaries is crucial in post-communist countries to foster economic growth. However, money played a limited role in the command economy. Central banks were the main player in the market, which controlled monetary policies and acted as commercial banks. Moreover, banks were segmented into specific industries such as export/import, agriculture, or food industry (Caporale, 2015). Additionally, financial institutions in post-communist countries needed both injections of funds and guidance to transition to market-oriented institutions. Meanwhile countries also needed to signal to investors that their commited to transition.

This paper investigates the assistance of the European Bank of Reconstruction and Development (EBRD) in funding local financial institutions and the role of the Bank in attracting greenfield investment to the financial sector of the controlled economies. After analyzing how the Bank operates differently compared to the IMF and the World Bank, this paper examines how the Bank alleviates the political risk by introducing international financial institutions to new markets and signaling with transition scores published by the Bank in

attracting foreign financial institutions to invest in these economies. After establishing the empirical link that the Bank has positively contributed to the development of local financial intermediaries, this paper further empirically analyzes the domestic, commercial credits (as a percentage of GDP) by incorporating greenfield investment and the EBRD credits to the financial sector of post-communist economies. Initially, panel data analysis was utilized, but a generalized method of moments will be used to control for endogeneity, measurement errors and obtain efficient estimates in the last analysis.

The layout of the paper is as follows. Section 2 summarizes the literature on the importance of financial institutions to economic growth and the signaling effect of an international institution. Section 3 provides a brief history of the EBRD as an institution since it is relatively new and less known. Section 4 provides the causal mechanism employed in this paper with hypotheses. Section 5 discusses the data and methodology utilized in this paper with panel evidence on the effect of the EBRD on the financial sector of transition economies and its contribution to economic growth. Section 6 offers some concluding remarks.

3.2. Literature Review

The relationship between economic and financial development has been argued by many hence it is controversial. Many consider financial intermediaries a crucial institution for economic growth (citations are on Caporale et al. 2015. pg 49), while others argue that their importance has been overstressed (Robinson, 1952; Lucas, 1988 from Caporale et al. 2015 pg. 49). Joseph Schumpeter argues that financial intermediaries play a crucial role in economic

development because they decide which companies to use in society's savings (Schumpeter, 1934). Financial sector institutions alter the path of economic progress by utilizing societal savings. Also, vast development literature iterates that capital accumulation is the key factor in economic growth (Levine et al., 2000). Therefore, financial intermediaries have a significant and positive impact on total productivity growth that feeds the growth of a country's economy (Beck et al., 2000). Beck et al. further find a robust link between the development of financial intermediaries and real per capita growth and total factor productivity. Therefore, financial institutions are crucial for a country despite its command-economy background, but those institutions were either weak or non-existent during and immediately after the fall of the Union.

The domestic financial sector development is crucial since cross-country comparisons have shown that financial sector development has a stronger impact on growth in low and middle than in high-income countries (Aghion et al., 2005). Also, literature re-iterates the significance of financial development for economic growth (Levine 1999). Quantity (Hiskian) of financial institutions is crucial for developing countries to boost their growth, but institutions' quality is more significant for developed nations. Any policy that aims to minimize the cost of financial transactions in an economy boosts the economy and leads to greater capital accumulation (Fu et al., 2018).

Many pursued the development of financial intermediaries in post-communist economies, and only certain made it to the other side by the end of the 1990s. The basic financial architectures of frontrunners in financial development were similar; foreign-owned commercial banks dominate the market by lending mainly to the government. Those countries

are the Baltic States[18], Hungary, Poland, Slovenia, and the Czech Republic. Mainly these funds were generated internally, and also, a bulk of external funding was coming from foreign direct investment. These countries were able to transform their financial system due to their geographic proximity to Europe. Accession talks to European Union was also a crucial incentive to governments to transition their financial system. Therefore, their policies were fiscally and monetarily disciplined compared to other transitioning countries. Most commercial banks in Russia and Ukraine were private, but almost all those banks were insolvent despite many attempts to rejuvenate them (Berglof and Bolton, 2002). Therefore, up to the 2000s, financial development could not produce economic growth in transition economies except those trying to access the EU.

Rodrik (1988) argues that policies adopted by countries can be aborted or reversed if they lack sufficient credibility. With the fall of the Berlin wall, the intention to transition did not cost anything to governments. Therefore, these countries needed a seal of approval from international institutions such as the IMF, the EU, or the EBRD. Pop-Eleches (2008) found that post-communist countries not only benefited from funds from the IMF but also signaled to international financial institutions to fund projects in their country. While Gray (2009) argues these countries send a strong signal to financial markets once they get approval for accession from the EU. Closing domestic economic policy chapters with the EU shows the future trajectory and reduces the default risk for those particular countries.

[18] Estonia, Latvia, and Lithuania

3.3. Financial sector and the EBRD

International organizations such as the World Bank and IMF and their role in developing countries have been analyzed extensively by scholars of the field. However, one institution which was built to assist in transition, development, integration to capital markets, and alleviation of the political risk in post-communist economies, the European Bank of Reconstruction and Development (EBRD), has received much less scholarly attention despite its central role in integrating the economies to the world market.

The World Bank Group works with developing countries to assist them in financing projects by partnering with the private sector, advising in policies, and providing technical assistance to governments in the developing world. In contrast, the IMF partners with governments only and are more concerned with the stability of both markets and exchange rates rather than financing projects. However, the EBRD was built only to assist in the transition of the centrally-planned economies to the market one by advising the governments and providing much-needed funds to the economies to overcome the shortage of financial savings with the Warsaw Pact dissolvement.

With the fall of the Berlin wall, Baltic countries did not hide their intention to become independent, and Lithuania unilaterally declared its independence on March 11, 1990. There was a failed resistance by the Soviets to the declaration, but crumbling politics and economy did not allow to overturn the decision of Lithuania. Such lapse by the Soviets was followed later by Estonia and Latvia on August 20 of the following year. After those three other republics of the union also followed the path and Kazakhstan was the last to declare its

independence on December 16 of 1991. The hammer and sickle flag was lowered the last time from over the Kremlin on December 25, 1991.

With the demise of the Union, fifteen new countries emerged, including Russian Federation, and all lacked any financial savings that are vital to the growth of the economy. However, these scarce financial resources were not specific for the Union members, but also other members of the Warsaw Pact suffered from similar scarcity, including Albania. These newly independent countries presented a unique challenge to developed nations: how to transition these economies to the market economy and integrate them into the world markets. International institutions such as World Bank and IMF were ready to assist, but they did not have a magic wand to transition overnight, and there was no consensus on how to approach and solve the problem in those institutions. In the meantime, a brand new international institution emerged to assist in the transition to a market economy by providing much-needed access to financial resources with tailored policy advice and integration of post-communist countries to the world markets; the European Bank of Reconstruction and Development (EBRD).

The idea for the EBRD first came from President of France François Mitterrand in 1989 to meet the challenge of extraordinary changes in Eastern and Central Europe. In April 1991, the institution opened its headquarters in London to help build a new post-Cold War era.

The EBRD was set up to cope with the historical challenges of assisting the controlled Eastern and Central European economies to transition to the market economies. Due to a lack of funds and redundant profile compared to the institutions like the World Bank and the European Investment Bank, the EBRD struggled to assume an independent role in transforming member economies to the market one while being a controversial institution (Jakobeit 1992).

Although there are similarities with other institutions such as the World Bank Group and the EIB (European Investment Bank), the regional focus and operation of the EBRD are different. The EBRD initially was created only to assist the transition of Eastern and Central Europe, but with the fall of the Union, the Commonwealth of Independent States (CIS) countries were also included.[19] The EBRD simultaneously can deal with both the private and public projects without any state guarantee, unlike World Bank, while IFC[20] deals with only private projects. The EBRD has to commit 60% of loans to private projects or sectors in the process of being privatized. Moreover, the EBRD remains the lender on record, which is not affected by the sovereign debt rescheduling and remains a preferred creditor status even in default (Vuylsteke 1995).

Since EBRD is the lender on record, it facilitates investment, loans from financial institutions to partner with the EBRD in the post-communist countries, which otherwise would be too risky to invest alone for third-party financiers. Namely, the EBRD has a working relationship with individual host governments; therefore, it is very unlikely that the host would attempt to curtail the business of the Bank that provides much-needed funds and know-how for the transition and growth of the economy. Moreover, the EBRD has a strong appetite for risk to offer an extensive range of risk-sharing structures that provide additional commercial and political comfort[21] for third-party financiers. Hence, the EBRD plays a pivotal role in attracting

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[19] Commonwealth of Independent States includes Azerbaijan, Armenia, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Uzbekistan, and Ukraine.

[20] (International Finance Corporation, member of World Bank Group)

[21] www.ebrd.com

new funds and assisting financial institutions opening to new markets with alleviated risk. By the end of 1994, more than 50 international banks had joined in funding projects with EBRD loans to Eastern Europe (Vuylsteke 1995). Additionally, the EBRD provides advising to commercial, investment, and merchant bank investors in countries of its operation. The Bank also works with export credit agencies, investment insurers, development banks, and bilateral donors to develop and provide much-needed capital sources for investments. The EBRD is also participating in co-financing by loan syndications where a group of banks provides the loans, but the EBRD remains the lender of record for the entire loan. Up to 2010, every Euro invested by the EBRD mobilized 1.8 Euro from private institutions in investment projects (Antoneta, 2012). However, the massive capital needs of the transition economies can only be satisfied by local resources since every capital need for projects cannot be financed from abroad via the EBRD or foreign financiers. Therefore, the EBRD's tailored approaches to specific needs for each market resolve the problems in the long run, such as funding local banks by equity and loans, working with the venture and capital funds, and assisting international financiers to access the market by the mediation of the EBRD. Moreover, the Bank has assisted in the creation of new financial intermediaries and has helped privatize banks as a core investor with private placement or offering public shares (Vuylsteke 1995).

One of the main objectives of the Bank is to provide and develop capital resources for projects. The EBRD started financing in late 1991. In that year, the Bank only financed two projects, one was a depository bank in Poland, and the other was a manufacturing company in Hungary. Following year the EBRD has funded thirty four projects ranging from agribusiness to telecom companies worth more than half a billion euros. In 1993 the EBRD passed the one

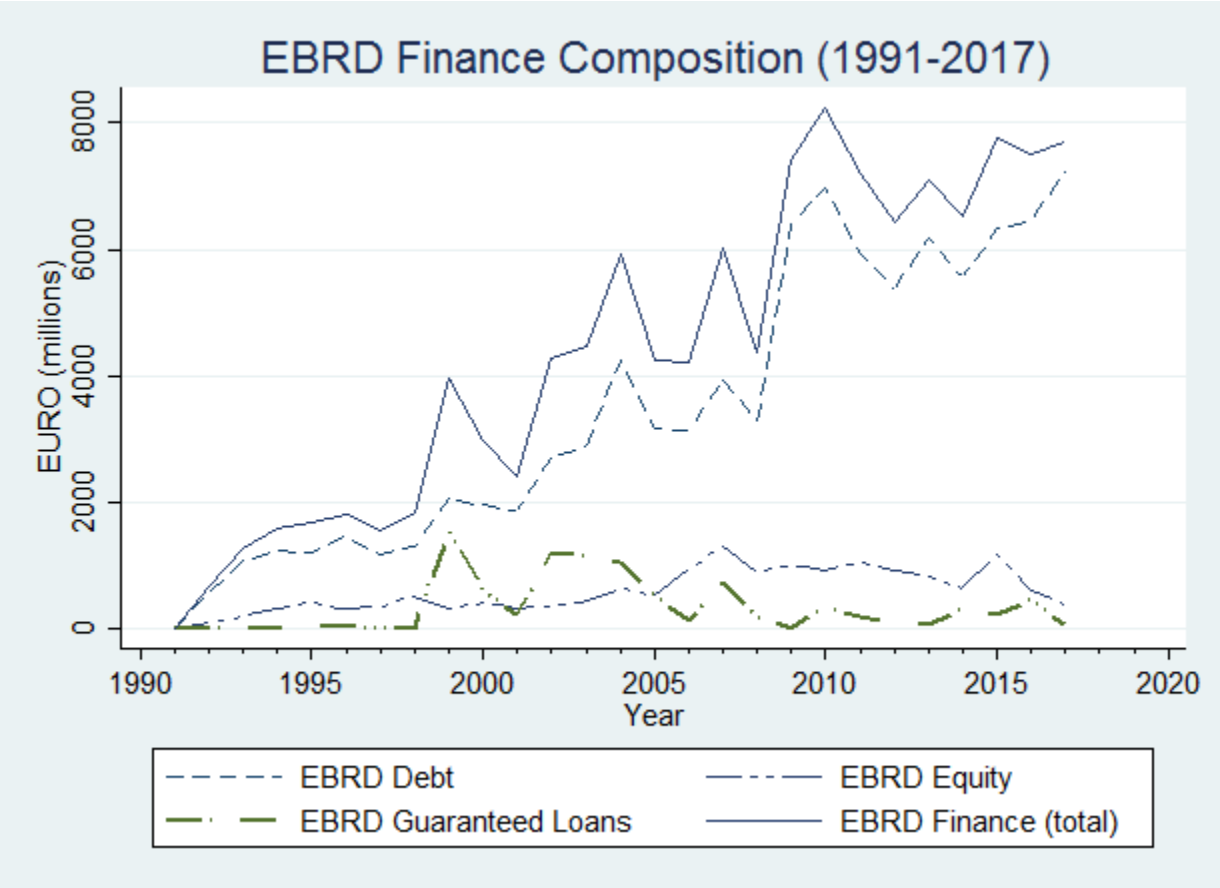

Figure 3.1. The EBRD Finance Composition

billion euros threshold and committed to finance seventy eight projects in the post-communist economies. The growth of the financing was exponential. For the first time in May of 1994, the EBRD guaranteed a loan by a third party, and that was given to a bank in Macedonia for the amount of 5 million euros. Until then, all funds were agreed to disburse from the institution's funds or were not guaranteed. In 1995, the annual guaranteed loans reached more than 68 million euros. Figure 3.1 shows total financing by the EBRD to recipient countries from 1991 till 2017. Despite fluctuations in year-to-year amounts, the increase in financing is substantial. Figure 3.1 also shows the amount guaranteed by the Bank but disbursed by third-party financial

institutions. Unfortunately, the names of those institutions are still not public.[22] Therefore, we cannot verify whether the same financing institutions ended up opening a branch in that particular country after being introduced to the market by the Bank.

The maximum financing amount reached its peak in the year 2010 with a total value of more than 8 billion Euros by the EBRD, but that amount declined sharply and still has not recovered to that level till the end of 2017. By the end of 2017, the EBRD has financed more than six thousand projects worth 120 billion[23] Euros, where 93 billion Euros were financed by the EBRD, other 16 billion euros were EBRD equity, and private partnership funded the remaining 10 billion euros with an EBRD guarantee as shown in Table 3.1. That makes more than 7% of projects funded by a third party with the Bank guarantee. From Table 3.1, we can see a spike around the turn of the millennium, where guaranteed loans comprised almost 40% of total finances. However, that has decreased in the following years and stayed below the 5% threshold (except for 2016). Despite an increase in the EBRD's total funding, guaranteed loans have not recovered after the 2000s. That might be because financial institutions had no demand for such a guarantee to access the market.

As discussed previously, with the turn of the millennia, investors had confidence that post-communist countries made commitments that would make them very costly to return to communism (Tokunaga and Iwasaki, 2017). The EBRD has been a trailblazer for financial institutions in introducing them to new markets with shared risk, and those institutions

[22] It was not public on October 12, 2018.

[23] This value includes the total amount financed by EBRD to all recipients other than post-communist countries such as Egypt, Greece, Jordan, Turkey, and Tunisia.

Table 3.1. Composition of the EBRD Finances

Year	EBRD Debt (%)	EBRD Equity (%)	Guaranteed Loans (%)	Total (million Euro)
1991	100.00	0.00	0.00	6.41
1992	85.21	14.79	0.00	683.19
1993	84.66	15.34	0.00	1,270.43
1994	78.46	21.23	0.32	1,575.74
1995	70.97	24.99	4.04	1,693.62
1996	79.89	17.31	2.80	1,822.34
1997	76.55	23.19	0.27	1,549.43
1998	70.60	28.48	0.93	1,847.10
1999	52.18	8.32	39.50	3,974.14
2000	65.48	13.96	20.55	2,985.88
2001	77.38	13.58	9.04	2,416.15
2002	63.33	8.59	28.09	4,280.96
2003	64.41	9.90	25.69	4,479.92
2004	71.55	10.91	17.54	5,918.56
2005	74.94	12.58	12.48	4,237.77
2006	74.30	22.65	3.04	4,206.27
2007	65.70	21.84	12.46	6,005.96
2008	74.91	20.74	4.35	4,369.71
2009	86.02	13.64	0.33	7,419.32
2010	84.68	11.42	3.90	8,228.03
2011	82.50	14.65	2.86	7,189.28
2012	83.75	14.49	1.76	6,425.89
2013	87.15	11.78	1.07	7,084.37
2014	85.21	10.03	4.76	6,527.66
2015	81.62	15.36	3.02	7,747.49
2016	85.85	8.01	6.14	7,514.04
2017	94.05	5.19	0.76	7,687.09
Total	**78.64**	**13.52**	**7.84**	**119,146.75**

are more likely to invest after testing the market. Total guaranteed loan by the EBRD till the end of 2017 was about 9 billion Euros. About 90% of these loans were loaned to private banks in the transition economies, as shown in Table 3.2. The EBRD was not interested in equities in

Table 3.2. EBRD Guaranteed Finances to Depository Banks

Year	EBRD Debt (%)	EBRD Equity (%)	Guaranteed Loan (%)	EBRD Total (million Euros)
1994	0.00	0.00	100.00	5.01
1995	0.33	0.00	99.67	68.61
1996	3.52	0.00	96.48	21.87
1997	0.00	0.00	100.00	4.17
1998	0.05	0.00	99.95	17.10
1999	37.56	0.00	62.44	2,465.80
2000	54.39	0.00	45.61	1,231.86
2001	16.08	0.00	83.92	187.27
2002	23.02	0.00	76.98	1,145.98
2003	18.20	0.00	81.80	1,352.41
2004	56.84	0.00	43.16	2,037.76
2005	43.21	0.00	56.79	928.25
2006	22.87	0.00	77.13	163.85
2007	40.51	0.00	59.49	1,252.54
2008	22.99	0.00	77.01	247.04
2009	56.34	0.00	43.66	49.29
2010	9.30	0.00	90.70	341.29
2011	64.79	0.00	35.21	428.60
2012	0.00	0.00	100.00	24.59
2013	89.18	0.00	10.82	464.22
2014	3.18	0.00	96.82	283.38
2015	55.33	0.00	44.67	494.58
2016	0.00	0.00	100.00	461.46
2017	0.00	0.00	100.00	39.00
Total	**38.88**	**0.00**	**61.12**	**13,715.92**

recipient financial institutions in host countries when third-party financiers were involved. When guaranteed loans were involved, the EBRD financed about 40% of loans, and the rest was covered by third-party financial institutions. Hence, it will be focused on the loans disbursed by the EBRD to the financial sector with a third-party involvement where the EBRD provides the guarantee. Table 3.2 shows that international financial institutions are willing to reach out to new markets by using the EBRD channel. It cannot be tested whether those

international banks ended up buying equity in those banks due to data restrictions. I hypothesize that with more loans given by the EBRD to the recipient county, third-party financial institutions are more likely to make greenfield investments in the financial sector in the post-communist countries (H2) by opening a branch. The question I will be seeking in this article is: "How has EBRD assisted in the growth of the domestic financial sector, which is crucial to the transition, growth, and sustainable development of member countries?" My argument in this paper is that these guaranteed loans introduced the international financial institution to these new markets and allowed them to test the market with alleviated/shared risk, if not without.

3.4. Theory and Hypotheses

Since financial funds are the single most important factor in economic growth, according to Joseph Schumpeter, post-communist economies should not be able to grow due to a shortage of savings with the fall of the Pact. Therefore, the role of the EBRD becomes significant in access to financial resources for these newly independent countries, which otherwise would not be possible. As mentioned above, the IMF can provide access to financial resources upon request by member countries with certain conditions, but IMF does not lend or fund any specific projects[24]. Without such request, the IMF is just advising policies on maintaining the financial stability in the country and evaluates the health of each member country's economy periodically. The EBRD has a different role compared to any other

[24] https://www.imf.org/en/About/Factsheets/IMF-Lending

international institution in the transition of the post-communist countries. Financing of projects provided directly or through financial intermediaries such as local banks. The EBRD does not aim to replace financial institutions but to complement them. The Bank only invests in projects that could not attract financing on similar terms. This practice reduces the information asymmetry regarding the markets that reduces the risk for a potential investor. Following is the assumed causal mechanism regarding the assistance of the EBRD. While the Bank advises each country separately, it also provides financial resources to the member nations for specific projects. Also, the EBRD provides tools to foreign banks to access the market with alleviated risk with syndicated loans as well as guaranteed ones. Once financial institutions access the market via the Bank, they will reduce the information asymmetry and be able to gather more information about opportunities in new post-communist economies and invest directly. As Berglof and Bolton (2002) argue, commercial banks were dominant in the Baltic and Central European countries' post-communist economies in the early 2000s. That is to say, since foreign banks already invested in those economies, they would go further east to access new markets with higher risk compared to Baltic and central European countries. As a result of these foreign direct investments to the financial sector, domestic credits to the private sector should increase relative to GDP (Beck et al., 2000). If we can find evidence to support the argument that FDI to the financial sector increases the commercial credits given by domestic banks, then it should result in an economic growth.

What explains the southward trend in guaranteed loans? Why have guaranteed loans declined? There can be three possible reasons. The first possibility is that financial institutions loaned to the countries via the EBRD guarantee and decided not to continue to work with both

countries and the Bank, which cannot be tested since such data is not publicly available. A second option is that those banks continued to finance via EBRD but did not require a loan guarantee which cannot be verified as well. The final possibility is that those banks trod the water in those countries carefully and decided to invest directly to access the market rather than using EBRD as a guarantor, which can be tested. While financial institutions work with the EBRD, they can only finance projects that the EBRD chooses, and the EBRD is selective on projects it funds.[25] Also, the bank will not finance every project that satisfies its requirement. Therefore, banks will be missing many opportunities in those markets if they decide to finance only through the EBRD. The Bank does not fund any project in defense, tobacco, and gambling industries under any circumstance. To test my argument, I hypothesize that financial institutions invest in transition economies directly rather than using an intermediary, the EBRD, after the 2000s (H1). Even though I cannot pinpoint which financial institution invested in these economies, I can see if there is an increase in greenfield investment in those economies. If investments pour into those economies, it means that the EBRD has reduced the information asymmetry, and also, companies would not want to miss an opportunity to access new markets with alleviated risk.

[25] EBRD does not fund defense-related projects, the tobacco industry, substances banned by international law, and stand-alone gambling facilities. Moreover, each project should satisfy the environmental standards of the Bank and also the host country.

3.5 Data and Methodology

EBRD loan data is publicly available[26] and greenfield FDI to financial sector data is from the Financial Times market dataset. FT greenfield data is the most comprehensive database of cross-border investments available covering all countries and sectors worldwide[27]. Both datasets provide detailed information regarding the investors and the recipient countries. The range of the EBRD loan data is from 1992 till 2017, while the FDI to financial sector data starts at 2003 and covers till 2017[28].

Beck et al. (2000) introduce a database that includes financial structure and financial development indicators across countries and time. This database uniquely identifies the "measure of size, activity, and efficiency of financial intermediaries and markets." Domestic credits to the private sector relative to GDP will be collected from the Beck et al. database that covers the time from the fall of the Union till the end of 2017.

$$\mathbf{lnFDI_{it+1} = \beta_0 + \beta 1 lnGNI_{it} + \beta_2 lnGROWTH_{it} + \beta_3 lnTRADE_{it} + \beta_4 lnINFLATION_{it} + \beta_5 EBRDtransicionscore_{it} + e_{it}} \quad (1)$$ [29]

[26] https://www.ebrd.com

[27] More information can be found at https://www.fdimarkets.com/

[28] The Year 2018 has not concluded during this project.

[29] Harris -Tzavalis unit root test utilized for stationarity.

The dependent variable in the first analysis is FDI[30] inflow to the financial sector is in current US dollars since Financial Times report project values for individual countries. Therefore, data will be used as it is rather than converting it into per capita[31] net inflow data as Busse and Hefeker (2007) utilized.

There is no standard theoretical model for determinants of FDI flows; however, we observe a considerable number of variables that affect FDI (Busse and Hefeker, 2007). Market size (GDP or GNI per capita) is probably the most critical factor in estimating it (Chakrabarti, 2001)[32]. Therefore, there should be a positive relationship between market size and FDI inflow. Market size is crucial because it may attract horizontal or market-seeking FDI to produce for the local market and also markets surrounding the country. Moreover, high growth rates in the local economy may signal a high return on investment, and as a result, the economy will be more attractive for further FDI. However, we may have an endogeneity problem if growth results from previous FDI inflows (Carkovic and Levine, 2005).

Openness to trade, usually measured as a ratio of imports and exports to GDP, is another determinant of FDI inflows. This measure also gives an idea about restrictions on trade in an individual economy. However, Asiedu (2002) argues that the impact of trade openness is linked to the type of investment the economy attracts. For instance, higher trade barriers may attract horizontal FDI for access to the local market. Relatively open economies will attract

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[30] FDI refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor (Washington, D.C., International Monetary Fund, 1993).

[31] Busse and Hefeker (2007) used FDI net inflows per capita in current US dollars. This analysis will not include net inflows since Financial Times does not provide

[32] Even though the dependent variable is not FDI per capita, this analysis will employ GNI (or GDP) per capita.

vertical or export-oriented FDI. Although trade openness may be positively or negatively related to FDI, empirical evidence suggests that we may expect positive relation in general (Chakrabarti, 2001).

Since the early transition period, there has been a broad consensus among scholars that the market size of CEE and FSU is crucial to foreign MNCs in their investment decisions (Lankes and Venables, 1996; Estrin et al., 1997; Benacek et al., 2000). As per literature, market size is generally referred to as GDP (GNI will be used in this analysis), and the population is expected to have a positive and statistically significant effect on FDI[33]Lefilleur (2008), who reviewed the studies of FDI determinants in CEE and FSU, found that market size has a positive and significant effect in determining FDI published earlier than 2000. However, papers published after the turn of millennia either found an insignificant or negative relationship between market size and FDI performance. Since we are measuring the impact of financial investment on a country, the relation between market size and FDI is expected to be positive and significant. Those institutions will be providing service only to the domestic market rather than giving loans to neighboring markets.

A good macroeconomic policy with low trade deficits and low inflation and interest rates is likely to reduce the risk premium in investment returns for both domestic and foreign investments. Aizenman (2003) argues that macroeconomic volatility has a negative effect on MNCs' profits and investment decisions. Hence, consistent macroeconomic policy is likely to make the market more attractive to FDI investments. Moreover, GNI per capita is measured

[33] See Chakrabarti (2001) and Eicher et al. (2012) for estimates of global level FDI determinants.

in current US dollars rather than real US dollars. Therefore, inflation is added to the regressions to indicate market volatility in a country and accurately estimate FDI by taming the GNI variable.

The following five variables will be used in cross-country panel analyses. GNI: Gross national income per capita, PPP (current international $) to control market size for each country. GROWTH: GDP per capita growth (annual %) to control market growth. POP: The population of each country will be utilized, and data will be retrieved from the World Bank. TRADE: the ratio of exports and imports to GDP to control openness of trade. INFLATION: the GDP deflator, a proxy for macroeconomic volatilities. Polity: a score which has a range of -10 to 10, negative 10 denotes full authoritarian whereas 10 means full democracy.

EBRD transition scores encompass the following six categories covering years from 2003 till 2014 for twenty-six nations[34]: large scale privatization, small scale privatization, government and enterprise restructuring, price liberalization and Trade & Forex exchange systems. Range scores are from 1 to 4+ where 1 denotes the robust features of the command economy, whereas 4 or above means that a substantial part of the transition is accomplished.[35].

EBRD Finance is the amount of loan given to each country since the institution's inception up to the end of the year 2017. Also, EBRD credit to the finance sector will be

[34] Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Check Republic, Estonia, Georgia, Hungary, Kazakhstan, Latvia, Lithuania, Moldova, Mongolia, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan

[35] More information regarding scoring and calculation methodology may be obtained from ebrd.com

utilized in the second analysis to see if they influence domestic credit given by financial institutions.

$$\mathbf{lnPrivateCredit_{it+1} = \beta_0 + \beta_1 lnGNI_{it} + \beta_2 lnINFLATION_{it} + \beta_3 TRADE_{it} + \beta_4 lnGROWTH_{it} + \beta_5 ln(greenfieldFDI_{financial\text{-}sector}) + \beta_6 ln(EBRDcreditfinsector_{it}) + e_{it}} \quad (2)$$ [36]

The second analysis will be analyzing the effect of greenfield FDI on the financial sector on private credits given by financial institutions as a percentage of GDP. If we can find a positive and significant effect, we can indirectly ascertain that attracting FDI to the financial sector results in the growth of the overall economy. I will be using the standard GMM technique to estimate the second model. Beck et al. (2000) analyzed whether commercial credits given to domestic businesses positively affect economic growth. They found evidence to their argument and concluded that private credits to businesses impact economic growth positively. They employed the GMM technique to estimate economic growth. This paper will modify their model and estimate the influence of both guaranteed loans by the EBRD and greenfield investment on commercial credits given in the domestic economy.

There are some shortcomings with the pure cross-sectional instrumental variable estimator. The employment of appropriate panel techniques will alleviate some of these problems. Besides cross-country variance, this paper aims to analyze whether a change in investment in the financial sector affects private credits given domestically. By using panel data

[36] Harris -Tzavalis unit root test utilized for stationarity.

set, we gain degrees of freedom by adding a time-series dimension. Besides, in a pure cross-sectional regression, the unobserved country-specific effect is part of the error term. Dynamic panel estimator, however, controls the presence of unobserved country-specific effects. Lastly, a cross-sectional estimator does not control for the endogeneity of all the explanatory variables.

3.6 Empirics

Most of the analysis in the literature uses logarithmic transformation for both dependent and independent variables. Therefore, a natural logarithm will be utilized for all except EBRD transition scores. The regression formula for the greenfield FDI to the financial sector is as follows:

$$\mathbf{lnFDI_{it+1} = \beta_0 + \beta 1 lnGNI_{it} + \beta_2 lnGROWTH_{it} + \beta_3 lnTRADE_{it} + \beta_4 lnINFLATION_{it} + \beta_5 EBRDtransicionscore_{it} + e_{it}} \quad \mathbf{(1)}$$ [37]

where βj are the estimated coefficients, EBRDtransicionscore stands for one of the 6 indicators for transition indicator for an individual country (i for country, t for time), and e_i an error term. Transition indicators are used one by one to avoid multicollinearity throughout the model.

As shown in Table 3.3, market size is a significant predictor in attracting greenfield FDI to the financial sector and positively correlated as expected with all transition scores except the

[37] lnGNI is non-stationary; therefore, all lnGNI variables are differenced to make it stationary

large privatization one. The country's population is also positively correlated with an investment in the industry and is significant in all six models. Growth is only significant in half of the models in Table 3.3, but all are positively correlated. Even though inflation is not statistically significant, it seems like financial investors distaste an inflationary economy. When it comes to transition indicators, large-scale privatization is the most significant among all three. That is because, unless the country privatizes the large state-owned enterprises, investors are not likely to invest in that economy, fearing that the regime may go back to communism (Tokunaga and Iwasaki, 2017). However, once such privatization happens then, that dissipates the risk of regime change in the economy. The second significant transition indicator is small-scale privatization, and it has an interestingly negative coefficient. That seems like foreign investors are not fooled by small-scale privatization by governments unless it results in large-scale ones. If we analyze the Central Asian countries, the picture would be more lucid. Let us start with the worst-performing one and go towards the best-performing one. Turkmenistan scored the lowest possible transition score in large-scale privatization, 1, and there are only two investments to the financial industry during the analysis period, 2003 till 2017. Tajikistan is one of the highest scored countries with small-scale privatization (score of 4); however, they are

Table 3.3. Greenfield Investment to Financial Sector, 2003-2017

Dependent Variable: lnFDI (Greenfield Data)

EBRD Transition Score	Competition Policy	Governance	Large Privatization	Price Liberalization	Small Privatization	Trade and Forex	
	1	2	3	4	5	6	7
Income Per Capita	3.080***	4.006***	1.174	2.155**	4.042***	1.755**	2.341***
	-4.5	-4.23	-1.98	-3.37	-7.01	-2.86	-5.86
Population	3.005***	3.453***	1.909***	2.321***	4.698***	2.141***	2.200***
	-4.81	-5.03	-3.85	-3.83	-6.29	-3.98	-4.57
Growth	0.515*	0.614*	0.313	0.482	0.661**	0.492	0.690**
	-2.1	-2.51	-1.28	-1.84	-2.97	-2.01	-2.71
Inflation	-0.283	-0.281	-0.22	-0.286	-0.2	-0.279	-0.303
	(-1.05)	(-1.06)	(-0.86)	(-1.04)	(-0.82)	(-1.04)	(-1.29)
EBRD Transition Score	-0.759	-2.341	1.623*	0.866	-6.139**	1.151	
	(-1.17)	(-1.82)	-2.67	-0.52	(-3.52)	-1.39	
EBRD Finance							0.380*
							-2.27
N	49	49	49	49	49	49	52
R2	0.6	0.63	0.65	0.6	0.69	0.61	0.6

large-scale privatization score is only 2.3. Only 8 banks invested in Tajikistan's financial industry that amounts to 256.2 million Euros. The most populous country in Central Asia should do better according to our models in Table 3.3 due to their population. Uzbekistan has EBRD scores for both small and large-scale privatization, respectively, 3.3 and 2.7. Uzbekistan attracted 18 institutions to invest in their financial industry that amounts to around 700 million Euros. Kazakhstan's score on privatization is as follows from small to large, respectively, 4.0 and 3.0. As a result of these policy evaluations by EBRD, investors rewarded the country's financial industry with more than 2 billion Euros of investment from 58 different institutions. One caveat regarding the scores, Kyrgyzstan performed much better than Kazakhstan in privatization, with a score of 4 and 3.7 for small and large-scale privatization, but only 3 financial institutions have invested in the economy that amounts to little more than 100 million Euros for 14 years. According to Siwory and Inkles (1990), economic performance in transitioning countries may be adversely affected by democratization due to weak and fragile institutions. Chit (2018) also argues that democracy has a negative effect on the growth of small and medium enterprises in transition economies. Still, further research is needed why Kyrgyzstan is lagging in attracting FDI to its financial industry despite substantial privatization on both large and small scales.

As an institution seen in model 7 from Table 3.3, the EBRD finances to individual economies are positively correlated with the attraction of FDI to the financial sector. Namely, an institution that has been created to assist in the transition of the communist bloc is serving its purpose as allowing countries to access finance when most needed to transition their economy. More finance countries can secure from EBRD is more likely to attract FDI to its financial sector and hope to create more credits to the private sector to sustain their growth.

Table 3.4. Generalized-Method of Moments (GMM) panel estimator

Dependent Variable: Domestic Credit by Banks as % of GDP	
Income per Capita	0.255 (1.41)
Inflation	-0.0899** (-2.63)
Trade Openness	-0.0859 (-0.33)
Growth	0.145*** (3.67)
Population	-0.255 (-1.77)
GF FDI to Finance Sector	0.0755*** (4.92)
EBRD Credit to Finance Sector	0.00549 (1.02)
Sargan test p-value	0.53
N	39

t statistics in parentheses
* p<0.05, ** p<0.01, *** p<0.001

One caveat regarding the financing from the EBRD is that as a country adopts recommended policies and performs better, the EBRD phases out the assistance once it reaches

the target on policies and transition. That means that economies have access to domestic and international funds, and the risk in those markets reduced to a tolerable level.

However, if a country does not follow the policy advice of the institution, then the EBRD ceases to fund public projects in those economies. Turkmenistan scores have not moved much on both privatization and governance. Therefore, the EBRD only funded two public projects in more than a quarter-century in Turkmenistan with fewer than 26 million Euros. All private funding is also one of the lowest in the region, with 227 million Euros with 66 projects in Turkmenistan. The EBRD funded more public projects in low-performing Kyrgyzstan (more than 185 million Euros with 34 projects) and Uzbekistan (more than 264 million Euros with 10 projects) than Turkmenistan. The EBRD funded 34 public projects in the Kyrgyz Republic, which is seven times more than what has been funded closest to Turkmenistan. One may argue that maybe Turkmenistan did not request those funds from the EBRD, but that would not be rational since the institution is funding those projects with the lowest possible market interest rate.

As a percentage of GDP, private credits given in the domestic economy are estimated with a dynamic panel estimator in Table 3.4. According to the table, greenfield FDI to the financial sector has a positive and significant effect on credits given domestically. Even though the EBRD funding is minimal compared to the FDI to the financial sector, it has a positive effect. Although it is not significant, those funds were trailblazers for the investments in the sector. Therefore, it has a magnified effect on future investments rather than the actual value to financial sectors of post-communist countries. GDP per capita growth in the economy has a positive and significant effect on the growth of private credits. However, it is difficult to find the direction of causality;

therefore, the dynamic model alleviates the endogeneity of variables among each other. As expected, private credit growth is negatively influenced by the inflationary economy. One interesting finding is that trade openness. Although it is not statistically significant, trade openness has a negative effect on private credits. As private credits increase as a percentage of GDP, maybe the share of trade in the economy decreases, causing the negative relation between the two. It needs further research for the definitive cause of that relation.

3. Conclusion

This paper aimed to analyze the effect of an international institution, the EBRD, that provided both assistance and guidance through the transition of the former communist countries. Unlike the World Bank and the IMF, the EBRD provides funds or loans to specific public and private projects that otherwise would not be possible without the institution's assistance. Also, the EBRD has an office in each member country, once economies fulfill their transition, the Bank graduates[38] them and closes its office. Countries after graduation can access financial markets with favorable rates since they have accomplished much-needed institutional and market transition. For instance, like contact information for the Czech Republic has a following note on the EBRD website: "The Czech Republic has 'graduated' from EBRD involvement and is no longer a country in which the EBRD works."[39]. However, there is no such "graduation" from the World Bank or the IMF. Hence, this consolidates the position

[38] Only Czech Republic graduated from the EBRD in 2008. Since then, no other country has done so.

[39] https://www.ebrd.com/contacts.html

of the EBRD; the institution is only there when countries struggle with the transition. Initially, the institution was founded only to assist CEE countries. However, with the fall of the Soviet Union, it expanded to include former Soviet countries. However, today it includes countries from Europe like Greece and Turkey and North Africa such as Morocco, Tunisia, and Egypt. Further expansion shows that the Bank has "graduated" from assisting only to post-communist economies but to economies of three continents[40] in need. Even though post-communist countries are far from finalizing their transformation, it is not clear whether the EBRD would be abolished as an institution once all member countries reach their ultimate destination.

As an institution, the EBRD is a lender on the record, which eases the inclusion of financial institutions to invest in transition economies; otherwise, it would be too risky for foreign investors to navigate new waters without guidance. Therefore, the purpose of this paper was to exhibit that the EBRD has played a crucial role in risk-sharing, market access, and providing much-needed funds for post-communist economies. The EBRD is selective regarding which projects to fund, and member countries needed much more funds than provided by the Bank. Therefore, it is of utmost importance to assist in improving domestic financial institutions in each member country to satisfy the future financial needs of their economies. Hence, almost all of the guaranteed loans went to the financial industry in member nations that facilitated the industry's growth, and it can be argued that those funds further attracted FDI to the financial industry.

[40] Europe, Asia, and Africa.

Data of greenfield FDI to the financial industry in post-communist countries started in 2003, while the EBRD funds started to flow in 1991. There is a twelve-year gap. Even though the EBRD[41] published top twenty banks it works with, it is impossible which financial institution funded specific loan or funds to member countries. Therefore, currently, it is not possible to prove the causal mechanism other than arguing it qualitatively. However, the EBRD Finance overall was statistically significant in attracting greenfield investment to post-communist countries. Moreover, the EBRD guaranteed loans had a positive effect on domestically given commercial credits. Newly found financial institutions in transition economies had a very statistically significant effect on the growth of those credit to the private sector as a percentage of GDP.

Whether the EBRD will be abolished or not, we will see it in the future. However, as an institution, the EBRD has played a tremendous role in the transition of the communist economies by guiding and providing funds needed to transform the controlled economies into the market one.

[41] https://www.ebrd.com/work-with-us/loan-syndications/top-20-participating-banks.html

CHAPTER 4

THE ROLE OF A PRESIDENT IN A LIBERALIZATION OF AN ECONOMY: THE CASE OF KAZAKHSTAN, TURKMENISTAN, AND UZBEKISTAN

4.1 Introduction

With the fall of both the Soviet Union and the Warsaw Pact, scholars had a chance to observe post-communist countries' transitions. This transition included both political and economic liberalization and sometimes just the latter to some extent. The experience was not unique and smooth. Central and Eastern European (CEE) countries aimed to liberalize their political, judicial, and economic systems much rapidly compared to eastern neighbors of CEE countries. That may be due to the aspiration to join the EU and EU accession requirements or even geographical proximity to the EU. Citizens have also played a more active role in shaping their country by participating in political debate and politicians promoted the participation. These accession talks and other international institutions such as the IMF, the World Bank, and the EBRD have influenced the transition of those economies. Then some countries were crucial to the Western powers (especially to the US) like the Russian Federation or Ukraine. Since these countries were significant, international institutions paid much closer attention to the reforms in those countries and provided necessary financial assistance even when they failed to achieve necessary preconditions (Stone, 2012).

Former Soviet Union republics located in Central Asia do not have any proximity to the EU nor significance to the Western powers immediately after their independence. These are important for the democratization of nations because while interacting with highly democratic

international organizations, countries tend to become more liberal in economic and political spheres. More interactions with those actors "then the transmission of values and norms about the democratic process is more likely" (Pevehouse, 2002, p. 530). In the case of Central Asia, such interaction would produce liberalization of the economy but not necessarily the domestic political environment. Additionally, people of this geography lacked experience with democracy nor took an active role in political debate. These countries were missing any internal or external pressure to depart from the past for liberalization, transition, or reforms.[42]. Overnight, former leaders of the Communist Party in each country became nationalist democrat and started rebuilding their country. Without any external or internal pressure, former leaders were sole deciders in the future of their country. In the early years of transition, Russia did not pay close attention to reforms in the region due to domestic economic and political turmoil. Therefore, the fate of transition in Central Asian countries lay in the Presidents' hands with inherited strong executive privileges and power from the Soviet Union. This notion is called superpresidentialism. Superpresidentialism inherited from the Soviet Union played a significant role in executive power in Central Asia. Therefore, presidents were the most important if not the only decision-maker in the transition of their countries. Fish (2003) characterizes the superpresidentialism as the following:

An apparatus of executive power that dwarfs all other agencies in terms of size and their sources it consumes; a president who enjoys decree powers; a president who de jure or de-facto

[42] Even though Russian Federation continued its influence in Central Asian nations, immediately after the fall of the Union, the country was busy with re-constructing its economy, institutions, and political system. However, Russia became more actively engaged when Putin came to power at the turn of millennia.

controls most of the powers of the purse; a relatively toothless legislature that cannot repeal presidential decrees and that enjoys scant authority and/or resources to monitor the chief executive; provisions that render impeachment of the president virtually impossible; and a court system that is controlled wholly or mainly by the chief executive and that cannot in practice check presidential prerogatives or even abuse of power. Superpresidentialism is a regime. It may be contrasted with autocracy, insofar as the chief executive does not enjoy total power and is subject to bona fide, periodic challenge in national elections. (p. 22-23)

Fish defines superpresidentialism as subject to election, which is also true in Central Asia; however, the "periodic challenge in national elections" concept is too strong to paint the electoral picture in the region. There was not any significant challenge in the region to incumbent presidents except for Kyrgyzstan. The executive branch in the rest of the region is much closer to autocracy than such a regime. Moreover, these features of the presidential system curtail the development of political parties in these nations (White et al., 1995). Instead, political parties help the executive address governance problems rather than constrain the executive branch, making democratic transitions less likely (Gandhi, 2008). Such power can generally be a curse than a blessing depending on how the executive exercises that privilege. After almost three decades, in the case of Central Asia, the picture is not very promising.

When dictators are dependent on outside support or face more vigorous domestic opposition, institutionalization is the only way to cling to power. However, if there is weak opposition, the ruler has little incentive to cooperate or institutionalize. Moreover, if authoritarian governments depend on the sale of natural resources, the leader needs little or no cooperation from the private sector or labor to generate revenue to fill state coffers (Gandhi,

2008). In the case of the post-Soviet nations in Central Asia, Kazakhstan, Turkmenistan, and Uzbekistan heavily rely on revenues from energy resources, especially with the turn of millennia.

This paper will utilize theory of superpresidentialism and analyze the president's role in the economic transition of energy-rich Central Asian countries; Kazakhstan, Uzbekistan, and Turkmenistan.[43]. That is because these three states are similar with each other economically, ethnically and all are rich in hydrocarbon resources. Furthermore, former first secretaries became presidents with declaration of independence. It will look into how Kazakhstan fared better in transition to the market economy compared to other sovereigns in the region. The next chapter will give background information about the countries in the region regarding their population, crucial international organization memberships, recent property rights, and investor protection scores. Significant economic policies will be divided into two chapters.

4.2 Background

All five Central Asian countries gained their independence in 1991 with the collapse of the Soviet Union. The Kyrgyz Republic became the first to sever its ties with the Soviet Union, and Kazakhstan was the last. While Uzbekistan is the most populous country with over 32 million, Tajikistan is the least 2 million. According to Table 4.1, the Kyrgyz Republic is the one which became a member of the World Trade Organization earliest among Central Asian countries. Even the Russian Federation became a member of the WTO in 2012, while the Kyrgyz Republic secured its membership in 1998. Tajikistan joined the club in 2013, and Kazakhstan followed in

[43] This paper focuses on three energy-rich countries of Central Asia: Kazakhstan, Turkmenistan, and Uzbekistan. The Kyrgyz Republic and Tajikistan were in low-income countries and energy-scarce, so their experience is different from the other three.

2015. Uzbekistan has been an observer in the WTO since 1994, while Turkmenistan is the last from the former Soviet Union (FSU) to become an observer in July of 2020. According to the World Bank[44] categorization, Kazakhstan and Turkmenistan are upper-middle-income countries, whereas the Kyrgyz Republic and Uzbekistan are lower-middle-income countries. The Kyrgyz Republic was a member of the low-income bracket but moved up in 2014.[45] Tajikistan is the only country in the low-income category from the region. Hence, Tajikistan is eligible to access funds from the International Development Association (IDA) with favorable terms. The IDA assists the world's poorest nations by providing credits and grants with concessional terms. While lower-middle-income countries may blend funds from both IDA and International Bank for Reconstruction and Development (IBRD), upper-middle-income countries may only work with the IBRD.

Apart from Tajikistan, Central Asian countries have the same historical and cultural background with similar languages. Tajikistan shares more of a Persian heritage than the Turkic one. However, one thing is shared among all: the Soviet ruling elite continued to reign in the newly independent countries since there was no public pressure for change. Former communists became national elites overnight and continued to rule new sovereigns. Independence was unexpected and unwanted, so there was no public push for change for democratic governments. That is because of these countries[46] joined the USSR in the 1920s, unlike Baltic Countries, where

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[44] Accessed to wto.org on March 26, 2019.

[45] http://www.worldbank.org/en/news/press-release/2014/07/24/kyrgyz-republic-becomes-lower-middle-income-country (accessed on March 2, 2019)

[46] Before, central Asian nations were under the Russian Tsarist regime, and Bolshevik forces reorganized the region accordingly after the October Revolution.

Table 4.1. Vital Information about the Central Asian countries
Source: World Bank

Country	**Independence Day**	**Population (million)**	**WTO Membership**	**World Bank Income Category**
Kazakhstan	16-Dec-91	18.04	November 30, 2015	Upper-Middle
Kyrgyz Republic	31-Aug-91	6.20	December 20, 1998	Lower-Middle
Tajikistan	9-Sep-91	2.09	March 2, 2013	Low
Turkmenistan	27-Oct-91	5.76	Observer (2020)	Upper-Middle
Uzbekistan	1-Sep-91	32.39	Observer (1994)	Lower-Middle

they joined after World War II. As a result, political elites consolidated their power by declaring themselves "nation builders" and "national heroes." .

Figure 4.1 looks at the change in property rights score of Central Asian countries between 1995 and 2020. It seems like Heritage Foundation[47] started to evaluate the region more closely in 2016, where a considerable jump in property rights was observed since such increase was not observed in related issues in these countries in any other sources. Despite the imperfect data, Kazakhstan is protecting property rights better than others in the region. The score of Kazakhstan

[47] Contacted Heritage Foundation seeking an explanation to this jump but have not heard until this day. March 18, 2021.

is more than thrice of Turkmenistan's in the year 2020. The only country in the region with declining property rights in Turkmenistan. The rest of the countries improved their year-to-year record.

According to the description of the last reported scores by the Heritage Foundation[48], only Kazakhstan qualifies to be "moderately free," defined as "Enforcement of property rights is lax and subject to delays. Corruption is possible but rare, and other branches of government may influence the judiciary. Expropriation is unlikely".[49] In 2020 the score of Uzbekistan also increased almost by 10 points from the previous year, bringing it to the same category as the Kyrgyz Republic. Both are under "mostly unfree" with a definition that the court system is Inefficient and subject to delays. Corruption may be present, and other branches of government may influence the judiciary. Expropriation is possible but rare[50]". Tajikistan is almost the same category as the Kyrgyz Republic and Uzbekistan but missed the cut with 0.9 points. However, Tajik nation may qualify to that category in a year or two if it shows incremental improvement. Turkmenistan is the only country with an abysmal property rights score, which shows no improvement but deteriorated more than 10 points in property rights. Heritage Foundation's explanation for this point category which Turkmenistan qualifies for is the following: "Private property is weakly protected. The court system is so inefficient and corrupt that outside settlement and arbitration are the norms. Property rights are difficult to enforce since

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[48] To give an idea of where countries stand in property rights following explanation will be helpful. Any country with a 70 or above property rights score is "mostly free." Scores between 60 -69 are "moderately free." "mostly unfree" is between 50 and 59. Anything below 50 and 40 is "repressed." For more information: https://www.heritage.org/index/property-rights (Accessed on August 5, 2020)

[49] https://www.heritage.org/index/property-rights (accessed on August 2020)

[50] https://www.heritage.org/index/property-rights (accessed on August 2020)

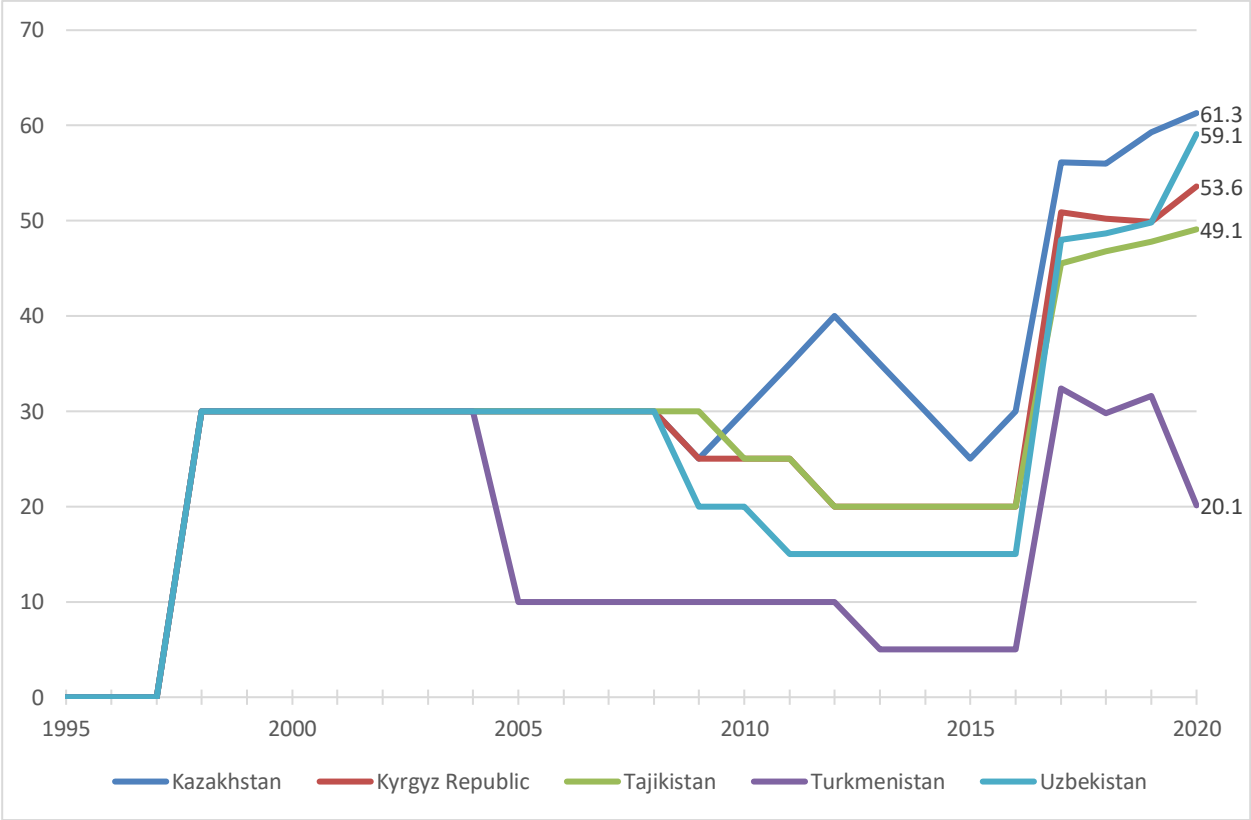

Figure 4.1. Property Rights in Central Asia 1995-2020
Source: Heritage Foundation

judicial corruption is extensive. Expropriation is common". As shown in Figure 4.2, Kazakhstan outperforms neighbors in the region on investor protection, and it is also above the world median. Both the Kyrgyz Republic and Tajikistan protect investors better than the average of the world nations. Unfortunately, Uzbekistan and Turkmenistan scores are missing again, which makes both countries' data scarce. However, it would be unrealistic to expect both to outperform the neighbors or the lower half of the world. If two had higher investor protection, governments would have an incentive to share it with international institutions to attract further investment. Even though property-right scores of the Heritage Foundation may be flawed, it gives an idea

regarding the current standing of countries on this subject. It is difficult to track the transition in years since there is not much variation up until 2017.

The World Bank collects relevant information about how to start a business in each member's economy and time to register or start up a business and assign scores. These scores measure regulations in 190 economies and rank economies in 10 categories. These regulations are enforced upon businesses in various areas, such as initiating a business, registering property, or enforcing a contract. As a result, the Bank publishes an overall ranking of each country based on the ten factors. This information can be used as a proxy instead of the property right scores and analyzed further. However, Turkmenistan is unfortunately not among 190 countries that exacerbate already data scarcity about the country.

According to 2020 the World Bank ranking, Kazakhstan ranked highest (25/190) among Central Asian countries.[51]As shown in Figure 4.3, among ten factors, the best-ranked enforcement of contracts is the highest compared to other nations, ranking 4th, and the worst one is trading across the borders. That seems a prevalent problem in the region where there is still no agreement for the free flow of goods. Moreover, Kazakhstan has also excelled in protecting minority stakeholders. Kazakhstan is the best performer in Central Asia, but it also outperformed the Russian Federation in this evaluation, where it ranked 28th. The World Bank started ranking countries in 2006, and Kazakhstan made it to the list from 86 (out of 155)[52]While Russia ranked 79 and Kyrgyz Republic ranked 84. In fourteen years, Kazakhstan improved its business

[51] Uzbekistan ranked at 69 while the Kyrgyz Republic and Tajikistan are following with 80 and 106, respectively.

[52] https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB06-FullReport.pdf (accessed on August 17, 2020)

environment to the top 25 while neighboring Turkmenistan could not even make it to 190 countries.

Uzbekistan also made the World Bank listing from 138 in 2006, where Sierra Leone, Angola, and Eritrea had a better business environment than Uzbekistan. The ease of starting a business and contract enforcement in Uzbekistan is ranked high according to Figure 4.4. However, it is ranked only 69 out of 190 countries overall. Its ranking is exacerbated by high regulation in construction permits, trading across borders, and resolving insolvency. Once the sovereign resolves those three issues, the ranking of the country will improve drastically. The country achieved a long way from 138 to 69 in fourteen years, and reforms accelerated with the new President since 2016. In the year 2015, the country was ranked at 141[53] and in a year it jumped to 87[54]. Despite these improvements, registering property and paying taxes seems to be a burden to businesses in this economy. Tajikistan also made to the list in 2006 from 130. That was better than Uzbekistan at the time, and it ended up as 106th in 2020.

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[53] https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB15-Full-Report.pdf (accessed on August 17, 2020)

[54] https://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB16-Full-Report.pdf (August 17, 2020)

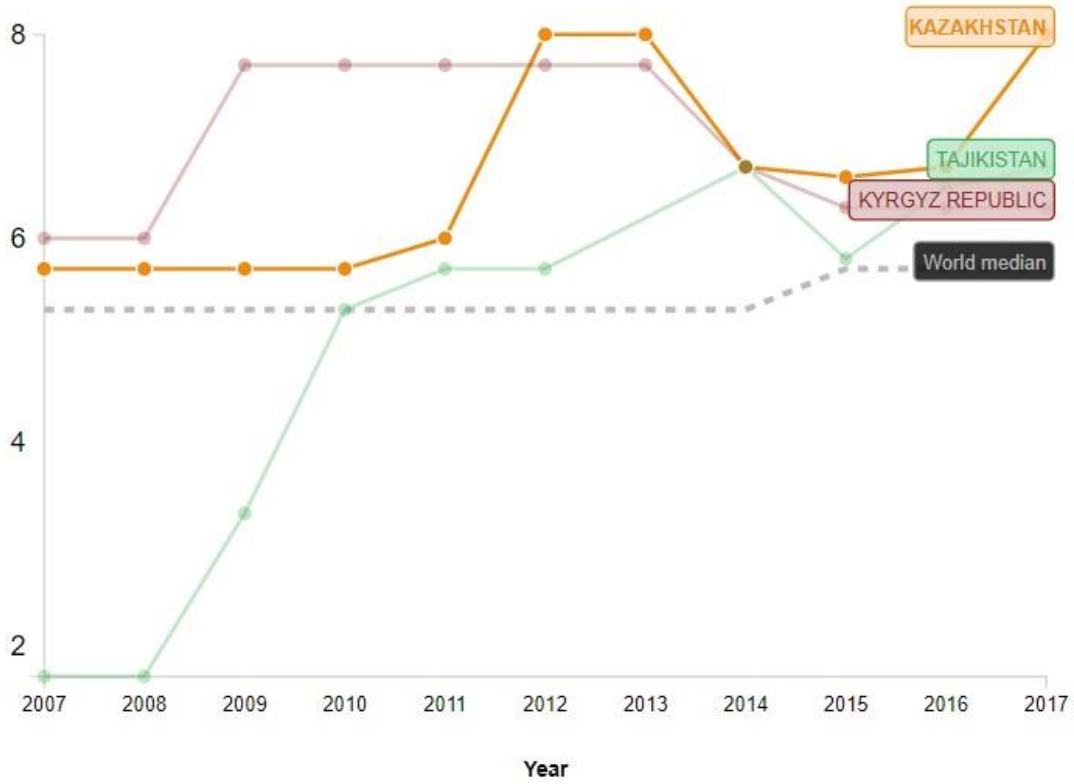

Figure 4.2. Strength of Investor Protection
Source: World Bank

Even though the World Bank doing business data is flawed[55], it still paints a picture of the region's economies. Despite imperfect data, it still shows that Kazakhstan (Figure 4.3) is performing better than its neighbors while Uzbekistan (Figure 4.4) is trailing all in listed nations from the region while Turkmenistan is not even on the list. The World Bank started to evaluate each country in doing business category in 2006, which coincides with the death of the first

[55] https://www.economist.com/finance-and-economics/2020/09/03/the-world-banks-business-rankings-mess (accessed March 19, 2021)

president of Turkmenistan, Saparmurat Niyazov. President Berdimuhammedov was inaugurated in the following year, but that did not change the accessibility of reliable data from the country.

Figure 4.3. Ranking on Doing Business in Kazakhstan (25 out of 190)
Source: World Bank[56]

4.3 Presidents' Policies 1991-2000

In 1979, the Tengiz oil field was discovered in Kazakh Soviet Socialist Republic (KSSR), currently located in western Kazakhstan. The field was believed to have at least 25 billion barrels of oil and 1.3 m^3 of natural gas (Lisovsky et al., 1992). To develop the field, foreign (Western) technology and expertise were needed at that time. Nazarbayev was all-in for the introduction of

[56] https://www.doingbusiness.org/en/data/exploreeconomies/kazakhstan (Accessed August 17, 2020)

Figure 4.4. Ranking on Doing Business in Uzbekistan (69 out 190)
Source: World Bank[57]

market principles in the Soviet Union once Gorbachev's perestroika started.[58]. This action differentiates the future president from other future counterparts of Central Asia. He was involved in the initial agreement with Chevron, which was negotiated late 80's nearing the end of the Soviet Union. Chevron agreed to develop the field with 50% interest, and the field started to be developed in 1990. With the fall of the Union, independent Kazakhstan claimed the field and continued to work with Chevron. A new deal was signed between Chevron and newly independent Kazakhstan in 1992 while the President of Kazakhstan visited the White House to

[57] https://www.doingbusiness.org/en/data/exploreeconomies/uzbekistan (accessed on August 17, 2020)

[58] This may be due to his experience in steel plant while he was young. Later in his book wrote that "the central allocation of capital investment and the distribution of funds," where he meant that infrastructure was poor, workers were overloaded and demoralized with centrally set targets. It seems like he saw the more significant problem of the Soviet Union in the microcosm of a steel plant.

meet the Bush Sr. in DC. Later in 1996, Mobil also negotiated a 25% interest share in the Tengiz oil field for just over a billion US dollars, reducing Kazakh interest to 25%.

Once Kazakhstan became an independent nation, Nazarbayev opened the country to foreign investment, hoping to accelerate the transition to the market economy. In 1992, Chevron committed to investing 20 billion US dollars in the Tengiz oil field and later led to the establishment of TengizChevronoil[59] (TCO) following year. This partnership was not only enormous in the region, but it was the largest in post-Soviet space and happened in the very early days of transition (Yessenova, 2015). This sole agreement diverted the path of Kazakhstan from others since the Kazakh government, aka president Nazarbayev wanted a rapid transition. At the same time, neighboring nations were suspicious of such a fast pace. Even before the fall of the Union, Nazarbayev was for rapid transformation of the economy and had a positive experience with negotiating with a western oil giant Chevron. I argue that this sole experience played a significant role in Nazabayev's economic liberalization approach than neighboring leaders and may have lessened the indoctrinated doubt or animosity against capitalism in him.

Kazakhstan was the last nation to declare its independence from the Union with vast natural resources, including crude oil and natural gas. After independence, the government adopted shock-therapy transition like Russian Federation. Mass privatization started in 1994 with the first voucher auction. Same year Kazakhstan liberalized prices in basic goods such as bread and milk while keeping strategic industries like agriculture and energy untouched. Following

[59] https://www.chevron.com/projects/tengiz-expansion (Accessed on January 5, 2021)

1995, directed credits and foreign trade licenses were eliminated, which means that the state does not pick who receives credit and who can make foreign trade.

Moreover, state orders in agriculture were eliminated where the state could not set annual targets for farmers to produce specific tonnage of wheat or cotton. The surrender of foreign exchange was also abolished in 1995. The following year country agreed to another IMF program (initial was in 1993) and introduced full account convertibility. Moreover, the first sovereign Eurobond was issued. In 1997, the banking sector introduced the first American Depositary Receipt (ADR)[60] which is an alternative way to attract foreign investors into the finance sector.

In 1998 Foreign Investors' Council (FIC) was established by the decree of the President of Kazakhstan Nursultan Nazarbayev. The FIC[61] operated as an advisory board chaired by the President himself to promote investment climate in the country for foreign investors and address the crucial issues to attract business. Other members were high-ranking officials of investors in the country, including Charles Frank, Vice-President of the EBRD. This institution is vital for investors to access the President to resolve issues if/when deemed necessary. The FIC also plays a significant role in policy formations, and the EBRD works through this institution to influence national policies for a successful transition to the market economy. By 1997, most of the EBRD scores of the nation had reached three or above (Table 4.2). Subsidies for food items were eliminated in the sovereign, but this was not the case with neighboring countries in the region.

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[60] The ADR allows US banks to become shareholders in foreign banks. The ADR allows foreign banks to trade their shares without being listed in US stock exchanges.

[61] For more info, visit: https://fic.kz/

Kazakh authorities introduced immediate privatization by liquidating state assets to accumulate funds for the state. However, that attempt has failed due to the lack of institutional infrastructure to implement such policy successfully and sustain transition reforms (Pomfret, 2006). Bankruptcy law has been enacted to liquidate unprofitable enterprises[62] by the Kazakh government in 1997. The outcome of the liquidation was not as expected due to the rent-seeking of authorities (Gürgen et al., 1999) since there was no mature institution to support and enforce contractual and property rights in the early transition. Since the Kazakhstan government implemented shock therapy in the early years, the nation experienced the pain of transition much earlier than other nations in the region. Uzbekistan and Turkmenistan have adopted gradual (it was more of a limited) transition which delayed the suffering of their nations. Kazakhs' pain in the 90s was also exacerbated due to the integrated Soviet system like with member countries. Extracted commodities were processed in other Soviet republics to promote the interdependence of member republics. With the fall of the Union, each country started to seek their interest rather than one another's as mandated in the Union (Kaser, 2003).

In the 90s, Central Asian economies were still interdependent with the Russian economy. However, the disintegration of the Soviet economy still has not been finalized in the region. Therefore, the Russian financial crisis in 1998 was detrimental to the Kazakh economy. Hence, authorities took economic measures to prevent further damage to the national economy. Energy prices plummeted during that period. Temporary trade restrictions were introduced with export

[62] EBRD Transition Report, 1998.

surrender policies. In the meantime, the government was trying to implement transition policies while dealing with the crisis's adverse effects. Several bonds were introduced in 1999, including corporate and municipal ones. National Development Bank[63] was established to promote the non-resource sector of the country, aiming to diversify the economy from resource dependency. Same year KOREM wholesale power trading company was established to achieve energy efficiency. With the turn of millennia, energy prices increased, which brought relief to nations in the region, especially Turkmenistan and Uzbekistan, to keep the status quo intact.

While Kazakhstan was adopting shock therapy and transitioning its economy, the government was also quick in the region to invest in people to educate future bureaucrats to make their transition successful and sustainable. The soviet-educated workforce would not be able to facilitate newly adopted programs of the government since that education's animosity towards anything other than the communist regime. Therefore, Bolashak[64] the program was introduced in 1993 to educate much-needed professionals to support the transition process. The program sends Kazakh students to western colleges with a full scholarship and assures them to return and serve in domestic institutions. The program initially promoted studies in the USA, UK, Germany, and France. By the end of 2004, 780 scholarships were given to students studying in thirteen different countries. Applicants for this scholarship chose a field that was previously designated by the state. Once they receive the scholarship, recipients had to return to the country and serve five years in assigned positions. Initially, students were from the economics and

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[63] https://www.kdb.kz

[64] https://www.bolashak.gov.kz/en/o-stipendii/istoriya-razvitiya.html (accessed on August 20, 2020)

humanities field, but later, innovative industrial development, logistics, management, education and science, marketing, new information technologies, housing, and utility fields were added. In 2005 number of students reached up to 3000 annually to supply the state with qualified cadres[65]. In 1998 new civil service law was introduced to reduce corruption and improve the quality of bureaucrats. This law made the hiring process more competitive and transparent. To support this law, a code of ethics was adopted the following year. However, all other sovereigns in the region have yet to adopt such an encompassing program to educate personnel to support the transition efforts and increase the integrity of the institutions and quality of bureaucrats.

Since the nation's independence, Uzbekistan was ruled by Islam Karimov, the 1st Secretary of the Uzbek Soviet Socialist Republic. As other leaders in the region mentioned earlier, former Communist Party members become founding members of the Democratic Party. Karimov was not an exception and was a founding member of the People's Democratic Party of Uzbekistan. He ruled the country with an iron fist until his death on September 2, 2016. Like his Turkmen counterpart, he adopted limited reforms, which was too slow to implement much-needed reforms in the economic and political sphere (Havrylyshyn et. al., 2016).

After the declaration of independence, limited transition prevented the country from experiencing an immediate deep recession compared to neighboring Kazakhstan. However, due to macroeconomic imbalances, delayed reforms caused significant exchange rate devaluation during 1995 and 2000. Those imbalances were due to public sector deficits which ran as high as 9%. Hence, the government prioritized access to foreign currency which resulted in a boost in

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[65] https://www.bolashak.gov.kz/en/o-stipendii/istoriya-razvitiya.html (Accessed on August 24, 2020)

the market rate of US dollars. Market rate soared to 400% over official rate (EBRD 2003, pg.22). During the emergence of dual-rate, Uzbekistan was working with IMF. That cooperation produced a positive result: market and official exchange rates converged and were very close by the end of 2002. After the 2000s, the government was more disciplined in public spending and decreased the deficit to 3% in 2001 and 0.8% in 2002.

After independence, the policy of import substitution was introduced due to fear of competition from abroad. The government introduced a trade barrier to protect nascent domestic industries in 2002. Therefore, registered company imports were charged with 30% surtax while individuals were requested to pay up to 90% customs fee. These kinds of high fees paved the way for more corruption and illegal imports. Although these rates have been reduced to 20% and 70%, these goods' prices were still steep for people. Moreover, Uzbekistan also banned shuttle traders through administrative means. Only licensed importers could trade with other countries, resulting in increased prices for consumer goods and entrepreneurs without licenses to trade (EBRD, 2003, pg.26). However, illegal cross-border trade with neighboring countries continued despite the clampdown by the government of Uzbekistan.

Between 1998 and 2003 pace of real growth in the economy was below 20%, the lowest among CIS countries. Every other CIS country achieved at least 20% real growth when Kazakhstan was championing 39% (EBRD, 2003, pg.20). Due to delays in reforms country experienced a dual exchange rate as Turkmenistan. Specific measures were taken to ease that rate due to the agreement with the IMF Staff Monitored Program in January 2002. However, the program has expired without realizing the full convertibility of local currency som.

Up until 2020, Turkmenistan was the least transitioned country among members of the EBRD.[66] both economically and politically. Therefore, it has the least competitive market. According to the EBRD reports, the government has less or no incentive to transition to a market economy while heavily relying on export revenues. Turkmenistan experienced economic shock immediately after declaring its independence in 1991. Following years government tried to stabilize the market by introducing local currency to prevent spillover shocks from Russia. As an economy, Turkmenistan did adopt a gradual transition method rather than shock therapy. However, after more than a quarter-century, the country is still in the early stages of transition. In the late 90s and early 2000s, commodity prices increased, resulting in hefty export revenues, which lessened the need for investment from international financial institutions. Namely, the government has no incentive to liberalize the market to attract foreign investment after surviving initial harsh years of independence.

4.4 Presidents' Policies 2001-2020

From the past mistakes, Kazakhstan learned to save the surplus from oil and gas to diversify its economy or use it as a rainy-day fund when needed. Therefore, National Fund, a sovereign wealth fund, was created in 2001 overseen by the National Bank of Kazakhstan

[66] Turkmenistan Country Strategy 2019 – 2024 by the EBRRD (pg 9.)

(central bank), and as of 2018, the fund reached 60 billion USD[67] which makes more than a third of the Kazakh economy. The tax code was simplified the same year, and capital amnesty was announced to bring funds from abroad. In 2002 Kazakhstan further refined the foreign investment law to attract an additional stream of foreign funds.

In 2003, Kazakhstan adopted another program to further diversify the economy from relying on natural resource rents. The following year, the central bank of Kazakhstan started to focus on inflation rather than the exchange rates. To this date, Turkmenistan central bank's sole aim is to keep the exchange rate fixed. Therefore, there is a black-market rate that is five times higher than the actual rate. Uzbekistan's central bank[68] also aimed to keep the national currency stable. However, the Uzbek government abandoned currency control to attract foreign investment on September 5, 2017. Value of the currency immediately devalued by half from 4,210 Uzbek som per US dollar to 8,100.[69] This decision automatically cleared the dual exchange rate in Uzbekistan overnight since everyone had access to foreign currency without any restriction.

In 2005, the Kazakhstan government increased foreign bank ownership to 50% and introduced an institution to supervise conglomerates in the nation's economy. In 2006, the telecom market was liberalized entirely. The EBRD introduced a new program to Kazakh banks with the government of the Netherlands and EU to develop their domestic and international factoring business. However, this integration was costly to the nation, followed by a mortgage

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[67] https://www.swfinstitute.org/profile/598cdaa50124e9fd2d05b556 (accessed on October 23, 2019)

[68] http://www.cbu.uz/en/o-banke/pravovoy-status-i-funktsii/ (accessed on October 24, 2019)

[69] http://www.cbu.uz/en/arkhiv-kursov-valyut/ (accessed on October 24, 2019)

crisis in 2008 because domestic financial institutions were immediately cut off from the wholesale external funding following the crisis. Until then, the Kazakh economy was driven by high commodity prices and easy credit from abroad. As a result of scarce credit, the real estate bubble busted while it was detrimental to the banking and construction sectors. Dropping oil prices further exacerbated the suffering in the nation. Kazakh economy was hit twice with tanking commodity and energy prices. Unlike Kazakhstan, both Turkmen and Uzbek leaders were joyous in avoiding such crisis. Both economies were not affected due to loss of funding from abroad since they were not integrated into international markets. However, it still suffered from a steep decrease in energy prices. Hence, Kazakh leadership understood the need for the further diversification of the economy again. In 2008 Sovereign Wealth Fund Samruk Kazyna[70] was established. According to the website, the joint Stock Company was established to gather state-owned companies under one roof to improve corporate governance, including oil, transport, and logistics, chemical and nuclear, mining, energy, real estate, and mechanical engineering. The sole shareholder of the Fund is the government of Kazakhstan, and it aims further to improve the welfare of Kazakhstan and support the transition to a market economy. As a result of the financial crisis, Samruk and Kazyna merged into one giant company and now controls about 40% percent of the economy.

The Kazakh economy recovered from the 2008 financial crisis with the government's successful policies and the recovery of the commodity. Kazakhstan tapped the National Fund during the crisis that alleviated its negative effect, which was established in 2001 by savings

[70] https://sk.kz

from surplus oil and gas revenues. During the crisis, the EBRD was also seeking to assist the Kazakh authorities with FDI attraction, balancing the role of the state and private markets. Moreover, the EBRD provided small and medium enterprises with access to the financial resources in local currency, which further alleviated the effect of the crisis. Additionally, Kazakhstan eliminated customs with Russia and Belarus with a customs union that became operational in 2010.

Kazakhstan pursues multi-vector foreign policy by balancing its relations with the West, China, and Russian Federation. Kazakhstan was the first country from Central Asia and former Soviet republics that held the chairmanship of OSCE in 2010. According to the EBRD, this prestigious chairmanship is associated with heightened responsibilities and more commitment to democracy, the rule of law, and human rights (EBRD, 2010[71]). This chairmanship translated with more commitment to democratic transition with political parties, elections, media, and local government (EBRD, 2013). While Kazakhstan seeks alliance and cooperation with the West, it is also actively engaged with the former Soviet Union members, especially with Russia. It is active in CIS and is also a founding member of Eurasian Economic Union's[72] single economic space that came into force in 2015. Moreover, Kazakhstan is one of the first members in Shanghai five which later transitioned as Shanghai Cooperation Organization[73] that includes China and Russia, and which was founded in 2001. This is an organization that includes all countries in Central Asia except Turkmenistan. The aim of this organization is intergovernmental

[71] Strategy for Kazakhstan, EBRD, 2010

[72] http://www.eaeunion.org/

[73] http://eng.sectsco.org/

cooperation in trade, politics, economy, transit, etc. The active role of Kazakhstan in regional organizations shows that it is not only engaged with the West and Russia but is also actively seeking cooperation with China. The two countries share more than a thousand miles of the border east of Kazakhstan. That is a huge opportunity for energy-rich Kazakhstan to have access to the energy-scarce Chinese market. Moreover, Kazakhstan is an active member of the Collective Security Treaty Organization (CSTO) and the newly established Asian Infrastructure Investment Bank (AIIB).

The Year 2015 was crucial for Kazakhstan. In that year, Kazakhstan signed the Enhanced Partnership and Cooperation Agreement (EPCA) with the EU, which elevated the relationship with the EU. Also, Kazakhstan became a member of the World Trade Organization (WTO). Moreover, the government has also signed an Enhanced Partnership Framework Agreement with the EBRD, which lifted the partnership to a new level. The country further signed similar agreements with the World Bank, Asian Development Bank, and Islamic Development Bank.

After the September 11, 2001 incident, Central Asia attracted much-needed interest from the international community, especially the US, due to its proximity to Afghanistan. This was a golden opportunity for the region sovereigns to accelerate both political and economic reforms to attract investment. Unfortunately, such a chance was wasted by the Central Asian nations. For instance, in 2003, the EBRD held its annual meeting in Tashkent, the capital city of Uzbekistan, to promote cooperation. However, Uzbekistan failed to seize the opportunity (EBRD, 2003) due to the inaction of the President, which was crucial to the Bank to cooperate further with the country. The Bank expected a commitment for reforms and the end of systematic torture in

prisons by President Karimov. Also, the international community engaged with Uzbekistan to promote reforms in both the political and economic sphere, but it resulted in disappointment.

Furthermore, the use of indiscriminate deadly coercive power on civilians in the Andijon region of Uzbekistan in May of 2005 was rumored to cause the death of 187 up to 1500 (Megoran, 2008). Despite President Karimov's defense of events as legitimate law enforcement operations, Western governments, organizations, and media framed the incidence as a massacre of innocent demonstrators (Megoran, 2008). Uzbek government refused to cooperate with an independent investigation of the event that resulted in a furor of international community. As a result, the international community, including the Bank, reduced their interaction with the Uzbek government to a minimum, increasing the Karimov government's grip on Uzbeks' political and economic lives. Uzbek government responded by refocusing the foreign policy of Uzbekistan by breaking military alliance with the USA, closing internationally funded media and development projects. Hence, the country became closer to China and Russian Federation (Megoran, 2008).

Islam Karimov passed on September 2, 2016, and Mirziyoyev became an interim president. Elections were held on December 4, 2016, where the interim president became an elected one. Office for Democratic Institutions and Human Rights[74] (ODIHR) sent full election observation mission to this election first time in the history of post-Soviet Uzbekistan. ODIHR reported the election lacked a "genuine choice". The final report[75] concluded that the Presidential election "underscored the need for comprehensive reform to address long-standing

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[74] An institution under Organization for Security and Co-operation in Europe (OSCE)

[75] https://www.osce.org/files/f/documents/c/2/306451.pdf (Accessed on September 25,2021)

shortcomings." It recommended policies to bring the polls to international standards. Advised recommendations have been taken seriously by the Central Election Commission of Uzbekistan, and policies were outlined to be implemented in elections to come. However, it is one thing to correct laws to try to appeal to international institutions and another thing to apply them. It needs to be further observed how future elections are conducted in Uzbekistan.

As a result of an executive change, long-delayed reforms started to be realized. In early 2017, the government of Uzbekistan published a development strategy for years until 2021, which included political, administrative, and judicial reforms. The administration became more transparent; the rule of law and judicial independence increased significantly. Uzbek government started to adopt policies to transition an inward-oriented economy toward an export-oriented one by removing barriers and opening up the economy. The fixed exchange rate policy was abandoned and allowed to flow by September of 2017 freely. Even though these are significant progress, further reforms are needed since the country started the progress from a low base. Substantial structural challenges remain to be needed for a sustainable economy. After these progresses, the EBRD began to be actively involved with Uzbekistan by setting up short-term goals and started assisting the country in integrating both regionally and globally and increasing competitiveness by enhancing the role of the private sector in the economy (EBRD, 2017). Uzbekistan improved relations not only with international organizations such as the EBRD but also with its neighbors and other countries. President Mirziyoev's visit to Washington DC on May 16, 2018, is an example that he is trying to raise the profile of his country, which was isolated during his predecessor.

The development strategy called for a reform in the judiciary to increase its authority and ascertain that the courts function independently. Hence, a Supreme Council was founded by a presidential decree in 2017, responsible for selecting, promoting, and disciplining judges by reducing the presidential powers. This council aims to operate independently from the government and strengthen the judiciary. Moreover, the decree guaranteed a secure tenure of judges as recommended by the UN Human Rights Committee. A detention period without seeing a judge was reduced from 72 hours to 48 hours. To give a perspective, Turkmenistan can detain its citizens for up to a month without seeing a judge, which can be extended further if deemed necessary. Reducing the power of the executive and strengthening the judiciary is another positive sign to establish sustainable institutions in the country.

Currently, there are four political parties in Uzbekistan, and all are represented in parliament. Although those parties represent different segments of society, they lack diversity in policy ideas, and all parties support the current government's policies. It seems like those parties have been founded to satisfy international norms rather than policy differences. In the 2016 Presidential election, the remaining three candidates could garner only 11% of the vote while the interim president was elected to office with 88%. However, controversial policy discussions started to happen on state-owned media, which is a massive step for a country with an authoritarian history. This is a good sign in the right direction, but it is too early to reach international norms.

Uzbek experience of more than a quarter-century shows how the President is a gatekeeper to reforms and transition. The initial experience was inward-oriented and resulted in the exodus of citizens searching for jobs in other countries, mainly in neighboring Kazakhstan

and Russia. Mirziyoyev initiated rapid transition and progress. Yet, it is early to celebrate. That is because when presidents get elected, they tend to reform till they consolidate power. Once they achieve that, presidents show their true colors, like in the case of Turkmenistan after 2006.

In a 2004 report, the EBRD notes that after 13 years of independence, the government of Turkmenistan does not realize the "need for reforms, corporization or privatization in critical areas such as energy, cotton.[76] and the financial sector" (EBRD, 2004). Due to Article 1 of the EBRD, the Bank does not invest in the public sector unless countries democratize the country. Therefore, in 2004 the Bank's investment portfolio in the Turkmenistan economy was 80% in the private sector while 20% is in public. Similar language is utilized in the 2014 country report by the EBRD. It reports that changes in legal reform and attracting investment will depend upon the government's willingness to transition to a market economy. Namely, the Turkmen government by 2014 still does not show any desire to reform even though the country is ruled by two presidents. Hence, there is little will to adopt market-oriented reforms even though the Bank is "ready to act as a catalyst and enabler to attract much needed FDI by investing alongside foreign strategic investor" (pg.19, EBRD, 2014).

As observed from the events in Uzbekistan and Turkmenistan, a strong executive without any accountability or constraint is a gatekeeper for any transition and reforms. If the executive considers reforms are not "beneficial" to his country, those reforms are not realized. As a result, "color revolutions" in FSU's become inevitable for citizens. That is a nightmare for "elected" authoritarians in the post-Soviet region, and rulers had to suppress any possible uprising from

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[76] Uzbekistan and Turkmenistan were designated states to produce cotton during the Soviet time. Therefore, it is a crucial commodity in both countries.

citizens at any cost. However, the EBRD support to Kazakhstan should not be translated as the sovereign is becoming more democratic in the region. Kazakhs adopted market-oriented reforms and successfully transitioned better compared to neighbors. The EBRD seems to support the sovereigns despite lagging in adopting and implementing political reforms, aka democratization. However, Turkmenistan and Uzbekistan did not show that much willingness to garner the support of the Bank.

4.5 Presidents' Policies and International Organizations

The EBRD started to evaluate the post-communist economies quantitatively immediately after its inception and continued to do so until 2014. Evaluation is based on the score of 1 and 4+, where 1 indicates that nothing has changed and 4+ means the evaluated category has completed its transition. The following analysis is the interpretation of the last assigned scores by the EBRD in 2014.

According to the World Bank, Uzbekistan is the most populous country in Central Asia, with over 33.5 million in 2019. Therefore, the EBRD had invested the most in Uzbekistan until 2000. Same year investment in Kazakhstan has surpassed Uzbekistan due to macroeconomic reforms and favorable investment conditions in the country due to adopted reforms.

Even though Uzbekistan and Tajikistan had some plans to privatize the public sector, they have not been realized by 2014. According to Table 4.2, small-scale privatization has been completed by all well-performing trio (Kazakhstan, Kyrgyz Republic, and Tajikistan) with tradable ownership rights according to the EBRD scores. Namely, countries that scored 4 are

defined by the Bank as "complete privatization of small companies with tradable ownership rights." In large-scale privatization, the Kyrgyz government gave up at least a quarter of shares, while in Turkmenistan, there was no privatization on large state-owned enterprises at all.[77],[78] Uzbekistan seems to have a program ready for implementation. Again, Turkmenistan lagged in this category compared to its neighbors. It did not privatize shares of small-scale enterprises and did not have any prepared plan for implementation even by 2014[79] according to the EBRD.

Governance and enterprise restructuring are among the least performing categories for Central Asian sovereigns where none has achieved any substantial reform. In the governance category, score 2 indicates that moderately tight credits and subsidies[80] with weak enforcement according to indicators definition by the EBRD as shown in Table 4.2[81]. In all countries, little reform has been introduced and implemented to strengthen competition and corporate governance. Kyrgyz republic gave up all its control on prices and performing as a developed nation where prices fluctuate depending on supply and demand. The Kyrgyz government does not control or dictate prices of essential staples in the market such as bread, milk, meat, etc. Tajikistan also completed price liberalization. Kazakhstan has not fully liberalized prices but is still better compared to neighboring Turkmenistan. In this category, the Uzbek nation has lifted some controls on market prices, but still, "state procurement at non-market prices remains

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[77] Tradable ownership rights: ownership of companies can be exchanged in full or certain shares.

[78] https://www.ebrd.com/transition-indicators-history (accessed August 10, 2020)

[79]The last date, the Bank evaluated the economies in these categories mentioned in Table 2.

[80] During the Soviet Union, state-owned enterprises enjoyed lax credits and subsidies that weakened the company's financial discipline. Therefore, scoring 2 is an improvement but far from perfect (4 or 4+).

[81] For more information: https://www.ebrd.com/transition-indicators-history (accessed on July 27, 2020)

substantial" according to the EBRD methodology. In trade and foreign exchange systems, the Kyrgyz Republic operates as any developed industrial nation. At the same time, Uzbekistan and Turkmenistan have import and export controls and restrictions on access to foreign exchange. Turkmenistan's score shows that the local currency (manat) is in principle fully convertible, but in practice, it is difficult to realize. Hence, there is a dual exchange rate in the country, official, and market. To the present-day, that dual exchange rate persists in the economy.[82] due to a shortage in foreign currency.[83]

All the countries in the region had the least number of reforms in the Competition Policy category. The state regulates the market to ensure no company dominates the market or abuses it. Moreover, the policy assures that an entry into the market is unrestricted. Only two countries (Kazakhstan and the Kyrgyz Republic) introduced such legislation and set up institutions. However, further enforcement is needed to implement those reforms, and institutions should operate according to their establishment purposes. Although Tajikistan took some steps to enhance the competition in the market, Turkmenistan did not take any steps to improve market conditions for new entries or to prevent abuses and domination by certain players. These scores were published in 2014 and may have shown some improvement since then.

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[82] As of August 11, 2020, Turkmenistan has a dual exchange rate: the official rate of one US dollar is 3.5 manats while the market rate is 23 manats. (As of March 18, 2021, it is 30.70 manats per USD)

[83] https://www.ebrd.com/cs/Satellite?c=Content&cid=1395237866249&pagename=EBRD%2FContent%2FContentLayout (accessed on August 11, 2020).

Table 4.2. The EBRD Transition Scores as of 2014
Source: EBRD

Country	**Large-scale Privatization**	**Small-scale Privatization**	**Governance**	**Price Liberalization**	**Trade and Foreign Exchange System**	**Competition Policy**
KAZAKHSTAN	3	4	2	3.67	3.67	2
KYRGYZ REPUBLIC	3.67	4	2	4.33	4.33	2
TAJIKISTAN	2.33	4	2	4	3.7	1.67
TURKMENISTAN	1	2.33	1	3	2.33	1
UZBEKISTAN	2.67	3.33	1.67	2.67	1.67	1.67

As shown in Table 4.2, surprisingly, reforms implemented by the Kyrgyz Republic and Tajikistan have outperformed Kazakhstan. What incentive caused their government to reform their institutions? The answer to that question probably lies with their interaction with the IMF. Since both Kyrgyz Republic and Tajikistan were members of low-income countries, they had access to low-interest funds, as shown in Table 4.3.

Table 4.3. Transaction with the IMF[84]
Source: IMF

	GRA(years); PRGT (years)	GRA Disbursements	PRGT Disbursements	Total Disbursements	Total Repayments	Total Charges/Interest Paid
Kazakhstan	1993 - 1998; N/A	538,300,000	0	538,300,000	538,300,000	92,874,335
Kyrgyz Republic	1993; 1994-2017	43,860,000	403,184,000	447,044,000	327,086,000	21,133,633
Tajikistan	1996-1998; 1998-2012	30,000,000	247,680,000	277,680,000	238,535,000	8,481,273
Turkmenistan	N/A	0	0	0	0	0
Uzbekistan	1995-1996; N/A	165,200,000	0	165,200,000	165,200,000	43,008,747
	Total	**777,360,000**	**650,864,000**	**1,428,224,000**	**1,269,121,000**	**165,497,988**

Table 4.3 shows that Kazakhstan and the Kyrgyz Republic were the ones who accessed funds via the IMF in 1993. Uzbekistan utilized the IMF funds first in 1995, while Tajikistan did the following year. Only Tajikistan and the Kyrgyz Republic withdrew funds from Poverty Reduction and Growth Trust (PGRT) while all other withdrew funds from General Resources Account (GRA). GRA funds have a higher interest rate, while the PGRT rate is much lower compared to GRA. Kazakhstan repaid its debt in 2000, and in total, more than half-billion funds cost little above 17%, including interest and fees. However, Uzbekistan paid off its debt to IMF

[84] Accessed to imf.org on February 28, 2019.

in 2006 and paid more than a quarter back to the Fund in charges and fees. However, the PRGT rate seems like it is well below 2%, and in 2018 the Fund[85] announced that it will be zero for the following two years. The Kyrgyz Republic and Tajikistan utilized low-interest-rate funds from the IMF and are still paying back. According to Table 4.3, Kazakhstan has withdrawn the highest amount among Central Asian countries. In contrast, Turkmenistan did not even borrow a penny, indicating further that Turkmenistan lacked external incentive to introduce necessary reforms to transition its economy.

Table 4.4 shows that Turkmenistan attracted funds from the EBRD second to last while Uzbekistan had the least per capita while Kazakhstan attracted the most funds from the EBRD in the region. Kazakhs attracted funds from the EBRD more (388 Euros) than some of the rest (236 Euros). The Kyrgyz Republic has attracted more than a hundred Euros per capita, while Tajikistan has attracted 65 Euros per capita. The difference may be due to the democratization of the political system in the Kyrgyz Republic, which needs to be further investigated. The EBRD invested the least in Uzbekistan and Turkmenistan. Table 4.4 shows that per capita funding stays minimal once the Bank is not satisfied with the pace of reforms; it ceases to invest in public projects in member countries. However, the Bank continues to fund private enterprises, but those are also minimal compared to private funding in fast-reforming nations. According to the Bank, the transitioned economy should not only have a well-functioning market, but it should also be competitive, well-governed, environmentally friendly, robust, and integrated. To achieve these features, reforms in both economy and governance are crucial. Therefore, Kazakhstan is doing

[85] https://www.imf.org/en/News/Articles/2016/10/06/PR16448-IMF-Executive-Board-Modifies-PRGT-Interest-Rate-Mechanism (accessed on March 26, 2019)

something right compared to its neighbors in Central Asia despite lagging in democratizing their political system in general.

Table 4.4. Total Per Capita Investment by the EBRD (in Euros)
Source: EBRD

KAZAKHSTAN	388
KYRGYZ REPUBLIC	106
TAJIKISTAN	65
TURKMENISTAN	44
UZBEKISTAN	24

There are some regional banks that Central Asian countries are members of, such as the Asian Development Bank (ADB) or the Asian Infrastructure Investment Bank (AIIB). However, those institutions do not require any reform in return like the IMF does. The EBRD does not have any strict conditionality as the IMF but still requires members to democratize their institutions to finance public projects per its Article 1.[86] Therefore, interaction with other institutions would not incentivize member sovereigns to reform their local institutions to secure funding. Hence, it is not included in this work. Moreover, the AIIB was established in 2016 and headquartered in Beijing, while the ABD is headquartered in Manila, Philippines. China has more influence on the former one while Japan has on the latter.

[86] For more information: https://www.ebrd.com/downloads/about/aspects.pdf (accessed on July 27, 2020)

Interaction with regional or international institutions gives an incentive for countries to introduce reforms. However, in these economies, the executives have the most power and decide with whom to interact. Once the executive branch chooses to cooperate with international institutions, those institutions get a chance to influence the policy and reform process in that country. Hence, the interaction of nations with organizations such as the IMF and the EBRD gives incentive to governments to reform their domestic institutions to secure further funds. Since energy scarce Kyrgyz Republic and Tajikistan have cooperated with the IMF and the World Bank, they have transitioned better than the other three, especially relatively two non-reforming energy-rich states: Uzbekistan and Turkmenistan. However, Kazakhstan has championed the region among energy-rich neighbors Uzbekistan and Turkmenistan. As sovereign Kazakhs did not hesitate to cooperate with international institutions in its more than quarter-century history when the executive deemed necessary, it is expected to have a better business environment in the country compared to its neighbors. Kazakhs did not hesitate to transform their economy towards a market-oriented one but did not show the same eagerness toward democratization. Despite the Article 1 of the EBRD, the bank still showered the nation with its support.

4.6 Conclusion

Up until the turn of millennia, Kazakhstan chose to be aggressive in reforming its economy despite the challenges, while Uzbekistan and Turkmenistan were cautious in their transition aspirations. By the end of the 90s, Kazakhstan achieved a better economic environment than Uzbekistan, but the growth of the respective economies was similar, according to a study (Alam

and Banerji 2000). The authors concluded that further research is needed to understand the reason but re-iterated that Kazakhstan's policy performance is superior. These reforms, however, did not result in measurable growth and development immediately but after more than a quarter-century of independence. Moreover, the high performance of the Uzbek economy may be due to higher energy prices in the late 90s which delayed further much-needed reforms in both Uzbekistan and Turkmenistan and never been realized during their first presidents.

As both Kazakhstan and Uzbekistan cooperated with the IMF, Kazakhstan received more than a billion US dollars while Uzbekistan secured 165 million US dollars, as shown in Table 4.3. Kazakhstan was reforming at in much faster pace; hence, it needed more funding to transition its economy. However, Uzbekistan agreed to a much lesser amount (165 million USD) despite the population difference. Uzbekistan delayed necessary reforms to transition its economy. Kazakhstan liberalized its trade and foreign exchange regime by 1996, while Uzbekistan was still planning. The 1998 crisis hit the Kazakh economy hard; therefore, the government introduced some measures to reduce the effect of future crises. Early liberalization in the Kazakh economy enabled the Nazarbayev government to make mistakes and eventually learn from them even though his government could not reap the benefits of reform before the turn of the millennia.

Meanwhile, Uzbek and Turkmen presidents were too hesitant to take such a step and chose to implement reform policies gradually. Delaying economic reforms would cost both Uzbek and Turkmen people dearly with the turn of the century. Citizens of both countries would be doing laborious jobs in relatively developed neighboring nations such as Russia, Kazakhstan, and Turkey.

Moreover, the aforementioned policies and agreements covered Kazakh reforms. The sovereign pursued to transition its economy to market one by cooperating with the international institutions and reaching out to immediate neighbors Russia and China to strengthen their economy and cooperate with them where mutual interests prevail. It is expected from Soviet-trained executives to collaborate with counterparts in Russia and China; however, Nazarbayev did not hesitate to cooperate with Western nations and institutions. His positive experience with the Tengiz oil field provided much necessary confidence to cooperate with international institutions and adopted market-oriented policies in the early years of independence. Even though the nation experienced early shocks of reform like CEE nations, they reaped the benefits later.

In the early years of transition, many scholars rushed to argue what went wrong in the Kazakh experience (Pomfret, 2006; Gürgen et al., 1999; Kaser, 2003; Gleason, 2003). However, once the country is evaluated relative to its neighbors, it is evident that the nation tried to transition its economy and made many mistakes. A Russian proverb says the he who does not risk never drinks champagne. The government took the risk, made mistakes, and learned from them. Eventually transitioned to the market economy much earlier than its neighbors and now drinking the champagne.

The gradual transition brought Uzbekistan and Turkmenistan stable growth in the '90s, but Kazakhstan outperformed both with high energy prices and the right policies implemented by the government. However, there is also an argument that Kazakh elites enriched themselves with shock-therapy style privatization and later protected their spoils by establishing the rule of law

and institutional framework (Irnazarov, 2009). This critique begs the question of why Kazakh elites were satisfied with what they got while neighboring elites wanted to have the whole cake.

During the transition, Kazakhstan has not alienated anyone, received assistance when needed, and integrated its economy into world markets. Furthermore, it has not isolated itself, unlike Uzbekistan and Turkmenistan. Kazakhstan adopted shock-therapy transition and took crucial steps to liberalize its economy immediately after the independence. As a result, the nation suffered without solid institutions to control the transition, and the Russian financial crisis exacerbated it further. Structural changes happened with the advice of international institutions such as the IMF and the World Bank, but the EBRD played the most critical role in policy advising, funding, and attracting much-needed foreign investment. Kazakhstan mastered institution-building skills, especially after the Russian crisis in 1998. The government became more efficient in privatization and utilization of funds even though early efforts failed due to rent-seeking. Establishing a Kazakh national fund to save surplus energy revenues was a calculated move to use it when necessary, and it became handy during financial crises.

As a result of the policy analysis, I conclude that the presidents and their approach to reform played a critical role in the path and the pace of transition**.** There were no strong institutions to constrain, check or balance the executive branch, and presidents were the primary decision-makers in the speed and direction of the post-communist Central Asia transformation. Therefore, presidents of these countries were and still are gatekeepers or roadblocks for any reform to achieve market-oriented economies and pluralistic democracies. If a president decides not to reform and adopt gradual transition, then there is no institutional barrier preventing him from taking such an action or changing his mind to do otherwise. This is also true if the president

wants further to limit the gradual reforms as in Turkmenistan and Uzbekistan. However, if presidents adopt the shock-therapy model, they need international organizations' support to fund their policies. Otherwise, the President only has an incentive to cooperate with international institutions when necessary to keep the status quo in his country.

Cooperation with international organizations would result in better reforms and a better business environment. Once the president decides how to proceed with the transition, the international and regional institutions will have an opportunity to influence the transition process for the better. The member country should cooperate with external institutions to secure and attract funds. This cooperation and conditionality generally assist in adopting more market-oriented policies with relaxing restrictions. As a result of collaboration, the nations will have better property rights compared to non-cooperating neighbors. Namely, Kazakhstan has more protection of the rights relative to Uzbekistan due to more close interaction with the institutions. In case of conditionality, the EBRD also requires inclusive reforms in the political environment. Therefore, any country that interacts with more international or regional institutions should have liberalized economy. In the case of the EBRD, more interaction with the Bank should result in a more pluralistic political environment in a host nation. However, that was not the case with the Kazakh's despite the transformation of their economy. It seems like the EBRD favors market reforms over political ones if it comes to choosing.

CHAPTER 5

CONCLUSION

The fall of the Soviet Union resulted in the demise of the Warsaw Pact. Communist economic doctrine failed and needed to transition and reform the failed economy. Even though there was enormous political change in the late '80s and early '90s, this political and economic change will be initially handled by the very communist educated bureaucrats, technocrats, and politicians. A sudden shift in the political sphere also resulted in an overnight change in political views while nations started to declare their independence either from the Soviet Union or Yugoslavia. Former staunch communists started to promote nationalism as well as transition to a market economy. Therefore, the support of the Western economies and international organizations such as the IMF and the World Bank played a crucial role in such a historic time. However, no one had a concrete idea of what to do, and as a result, the great experiment started to transition these nations' both economy and politics. One thing was common in all nations, new or not, scarcity of capital to reform the economy. Therefore, this dissertation aimed to shed light on how post-communist countries transitioned their economy with much-needed foreign capital.

The EBRD produced positive results, especially in Central and Eastern European nations after its establishment as a regional institution. The IMF standby agreements, EU accession, and public support motivated governments to implement reforms in political and economic spheres. In the early years of transformation, the public suffered but reaped benefits after reforms were implemented, even though it was not immediate.

The EBRD reduced the information asymmetry about new markets to international investors who were eager to expand but hesitant due to unknown and untested lands. The Bank

evaluated each member's economies annually and quantified the progress in six categories. Those transition scores were reliable information about newly emerging markets, and it was also more encompassing than Political Risk Scores. Therefore, its transition indicators were significant in attracting FDI to all post-communist sovereigns. Governments who scored high on privatization of large state-owned enterprises attracted more investment from abroad, making it harder for governments to return to a controlled economy. Without giving up large enterprises, states could not attract investment to sensitive industries such as finance. Therefore, the second paper analyzed the greenfield FDI to the finance industry in post-communist nations to understand.

The EBRD played a significant role in mediating between governments and international investors. Moreover, the Bank also played an active role in developing domestic financial institutions by nurturing them to sustain, support, and satisfy future domestic finance needs. The Bank used different tools available in its shed to introduce foreign capital to the market with being a lender on record and with guaranteed loans. Since the Bank has access to politicians in member nations, it was able to intervene, when necessary, on behalf of investors to resolve issues by alleviating the political risk. Moreover, guarantees by the Bank minimize the chance of loss in new markets. Of course, return is much lesser than direct investing, but so is a risk. Analysis shows that guaranteed loans attract more green investment to the financial sector of member sovereigns and contribute to and sustain domestic economic growth.

Even though all countries were defined as post-communist, each had different forces that played a crucial role in their overall transformation. The public in Eastern and Central European nations was adamant about democratizing their county while accession to the EU

forced governments to adopt the shock-therapy model to transition faster. There are sovereigns such as Ukraine and Russia that were too important to leave alone by the West. Therefore, hegemon power like the US did not mind intervening when necessary to provide funds despite failing to meet international organizations' prior set conditions. Thus, the IMF was unable to enforce those conditions, aka reforms, when necessary. Therefore, the transition in Ukraine and Russia was stalled even though they adopted shock therapy in the early days of transition. Then there are nations without any public pressure, the experience of democracy or proximity to EU, Central Asian countries. The executive played the decisive role in these nations whether there should be any transition and, if so, which reforms should be implemented and at what pace. These nations experienced a transition in a vacuum without any internal or external forces in play.

In Central Asia, international and regional actors effectively advised, guided, and provided funds to such nations when executives deemed necessary. Three energy-rich countries of Central Asia, Kazakhstan, Turkmenistan, and Uzbekistan, adopted different policies despite there was no internal or external pressure to adopt reforms. Kazakhstan is the only one adopted shock-therapy policies to reform its economy. Turkmenistan and Uzbekistan adopted gradual reforms initially, but the transition to the market economy still has not been finalized thirty years after their independence.

There is no domestic institution that oversees the executives branch in Central Asia. Unlike Baltic countries, the public did not have any experience with democracy. Therefore, presidents operate without any public push for any change. The most they can do is vote with their feet and leave the country seeking a better life in another one.

Kazakhstan's path of development was different compared to the two neighbors. After more than a quarter-century, Kazakhstan attracted more investment from abroad, and it seems like investors enjoy better property rights. Even though Uzbekistan is the most populous nation in the region, the EBRD invested more in Kazakhstan. Despite Kazakhstan lagging in the democratization of the political system, economically prospered, the EBRD was there to make sure the nation liberalized its economy.

In conclusion, after more than a quarter-century, each nation's experience differed, and various factors were decisive in determining the transition path. Public involvement is the most significant element that dictates the course and pace of transition. Without such force in play, the executive dominates decision-making and does not produce the best transition as promised. Proximity or accession to the EU is another crucial motivator for both public and government to adopt reforms promptly. International and regional organizations were salient in accelerating reform pace, and the EBRD played the most critical role in providing guidance and expertise, sharing best practices in the region. The most important one was introducing investors to the region through different means. With all its shortcomings as an institution, the EBRD is making the region a better place.

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BIOGRAPHICAL SKETCH

Vepa Rejepov was born in Mary, Turkmenistan under the USSR. He started his schooling in his village school and graduated from Mary Turkmen Turkish High School in 1997. He earned his Bachelor of Arts degree in Economics from Bogazici University, Istanbul, Turkey in 2003. He received his Master of Arts in Political Science from The University of Texas at Dallas in 2014. Early years of his doctoral studies he was part-time in the program since he was professionally working as a Budget Analyst. Later, he dedicated all his time to his studies. Due to his interest, he focused on transitions of the post-communist countries to market economy. He is interested in economic and political transition, foreign direct investment, international and regional institutions, and democratization in post-Soviet sovereigns.

CURRICULUM VITAE

Education

PhD,	University of Texas at Dallas Political Science with IPE concentration	May 2022 (expected)
	Dissertation: "Three essays on transition of post-communist sovereigns "	
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MA,	University of Texas at Dallas Political Science	2014
BA,	Bogazici University (Istanbul, Turkey)	2003

Academic Employment

Graduate Teaching Instructor	University of Texas at Dallas	Fall, 2018
Graduate Teaching Assistant	University of Texas at Dallas	2016 – 2018

Teaching Assistant

PSCI 3325	American Public Policy	University of Texas at Dallas	Fall, 2016
PSCI 4329	Global Politics	University of Texas at Dallas	Fall, 2016
PSCI 4356	Int. Political Economy	University of Texas at Dallas	Spring, 2017
GOVT 2306	State and Local Government	University of Texas at Dallas	Fall, 2017
GOVT 2306	State and Local Government	University of Texas at Dallas	Spring, 2018

Teaching Experience

SOC 3305	Applied Data Science	University of Texas at Dallas	Fall, 2018

Other Experience

USAID Armenia Mission: Integrity Systems/Rule of Law Evidence Review 2019

Research Interests

- International Organizations and sovereigns
- Political risk and FDI International
- International and Regional Development Banks
- Property and Contractual Rights
- Rule of Law
- Transition Economies

Conference Participation

1. "Foreign Investment and development in transition economies." MPSA Annual Conference, April 2018. Chicago, IL.
2. "The role of the EBRD in alleviating the political risk and attracting FDI to financial sector in the post-communist economies." ISA- Midwest, November, 2018. St. Louis, MI.
3. "The role of the EBRD in alleviating the political risk and attracting FDI to financial sector in the post-communist economies." Texas Triangle International Conference, January 2019. Fredericksburg, TX.
4. "Property and contractual rights in Central Asia." MPSA Annual Conference, April 2019. Chicago, IL.
5. " How Kazakhstan transitioned fared better in Central Asia." MPSA Annual Conference, April 2022. Chicago, IL. (upcoming).

Grants

University of Texas at Dallas Departmental Travel Grant — Spring, 2018
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Professional Membership

The American Political Science Association
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Statistical Analysis Software

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English (fluent), Turkmen (native), Turkish (fluent), Russian (advanced)

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