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Master's Degree in International Development Policy

Characteristics of Foreign Direct Investment (FDI) in Central Asia: Comparative case study of Kazakhstan and Uzbekistan

February, 2014

Program in International Development Policy

Graduate School of International Studies

Seoul National University

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Characteristics of Foreign Direct Investment (FDI) in Central Asia: Comparative case study of Kazakhstan and Uzbekistan

A thesis presented

by

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A dissertation submitted in partial fulfillment
of the requirements for the degree of Master
of International Development Policy

Graduate School of International Studies
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February 2014

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THESIS ACCEPTANCE CERTIFICATE

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ABSTRACT

Today, taking into consideration the fact that FDI can push economic development, the role of FDI for economies is growing, and this significance is becoming more and more important. While in early 90s developed countries were dominating over developing countries in terms of attracting FDI, beginning in mid-90s the tendency began to change. Developing countries, with the relatively cheaper labour, are becoming more attractive.

As with other developing and transition economies, Central Asian countries are becoming more attractive for foreign investors. This thesis is devoted to the study of the current trend of FDI in the region and the distribution of FDI among regional economies, particularly, the cases of Kazakhstan and Uzbekistan in using comparative analyses.

Kazakhstan is the largest FDI-receiving country in the region and hosts almost 70% of total FDI into region. Uzbekistan is the second largest receiver, but differences between the two countries are huge.

This research will cover the reasons of the extremely high unequal distribution of FDI in the region and, according to the study, will give relevant recommendations for Uzbekistan for further development of the country economy for attracting larger amounts of FDI.

At the same time, as a government official I will do my best in implementing the knowledge I gain during my education in Seoul National University, and particularly thesis researching, in my future professional career.

Key words: Central Asia, Kazakhstan, Uzbekistan, Foreign direct investment, investment environment, development

Student Number: 2012-24126

ABBREVIATIONS

CIS: Commonwealth of independent countries;

CA: Central Asia

CPI: International's Corruption Perception Index

CU: Custom union

FDI: Foreign direct investment;

FTA: Free trade agreement;

GATT: General Agreement on tariffs and trade;

Kaz: Kazakhstan;

KOTRA: Korea Trade-Investment Promotion Agency;

MFN: Most favourite nation;

MVESIT: Ministry for foreign economic relations investment and trade;

OECD: Organisation for Economic Co-operation and Development;

SEZ: Specialized economic zone;

SIEZ: Specialized industrial economic zone;

TNC: Transnational corporations;

Uzb: Uzbekistan;

WB: World Bank;

WTO: World Trade Organization.

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CHAPTER ONE

1.1. Introduction

Foreign investment is essential for a country's economic growth and prosperity. Foreign direct investments (FDI) used to be regarded as one of the factors that can push forward economic growth (Wang, 2009). Most of developed and developing countries believe that FDI helps them get through stagnation and even circumvent the poverty trap (Brooks, 2010).

But in the real life are the FDIs always beneficial? Or can they always lead to economic growth? Policy makers and academic scholars have different ideas about the correlation between FDI and economic development. Some of them argue that FDI has no relation to economic growth, while others have proven a significant positive relationship. A third group of policy makers and scholars believe that FDI can push forward economic growth only in certain conditions.

Chakraborty and Basu (2002), through the cointegration and error-correction model, have examined the link between FDI and economic growth in India. They concluded that GDP growth in India is not caused by FDI, and the causality runs more clearly from GDP to FDI.

Ericsson and Irandoust (2001) have examined the causal relationship between the FDI growth and output growth for four OECD countries: Denmark, Finland, Norway and

Sweden. Based on the results, they concluded that FDI into the economies of these countries have no causal relationship with output growth in Denmark and Finland.

Liu (2002) examined the possibility of a long-run relationship among economic growth, foreign direct investment and trade in China. In the research, he used a co-integration framework with quarterly data for exports, imports, FDI and the growth of China during the period from 1981 to 1997. From his findings, he concluded that a causal relationship among FDI, economic growth and exports does exist.

Wang (2002) stated, "FDI inflow most likely contributed significantly to economic growth". The author used data from 12 Asian economies for the period of 1987-1997, and concluded, "Only FDI in the manufacturing sector has a significant and positive impact on economic growth and attributes this positive contribution to FDIs' spillover effects".

Laura Alfaro (2003) stated that FDI inflows into the primary sector tend to have a negative effect on growth, whereas FDI inflows in the manufacturing sector tend to have a positive one. According to her, "FDI agriculture and mining have little spillover potential for the host economy; FDI in the service sector has an ambiguous effect". The author concluded, "Not all forms of foreign investment seem to be beneficial to host economies". She also points out that the economic nature of the host country is also an important determinant.

Carkovich and Levine (2005), using the databases of the World Bank dataset and International Monetary Fund for the period 1960-1995 and analysing with Generalized

Method of Moment (GMM), found that "FDI inflow does not exert independent influence on economic growth, while sound economic policies may spur both growth and FDI".

FDI enhances the foreign technology absorptive capacity, innovation, technology transfers and management skills; it promotes international trade integration and strengthens the competitive environment in a host country (Khoich, Madiyarova, 2011).

Foreign direct investment has grown at a phenomenal rate since the early 1980s, especially for developing countries. Taking into consideration that in most cases FDI has a positive correlation with economic growth, today competition among developed and developing countries for attracting FDI is growing.

Investment into the export industry primarily benefits the economic productivity of developing countries. Much of contemporary thought about capitalism in developing countries is proven erroneous by Louis Wells. Author in publication, "Third World Multinationals" (1975), stated that "The Rise of Foreign Investment from Developing Countries. Oftentimes, society believes that export products produced in developing nations cause a "race to the bottom," where factories keep wages low and working conditions poor and, thus, perpetuate the cycle of poverty".

On the contrary, Wells found that the investment to the export industry in many developing countries has lead to development of high-wages and high-tech industries. In agreement with Wells, Ernest Zedillo stated:

> what is now clear from the historical evidence of the last century, is that every case where a poor nation has significantly overcome its poverty, this has been achieved while engaging in production for export markets, and opening itself to the influx of foreign goods, investment and technology, that is, by participating in globalization. (1994)

The development path of Hong Kong, Singapore, Malaysia and Taiwan, all Newly Industrialized Economies, can be evidence for the positive role of FDI for development. At present:

> There is hardly any country around the globe, big or small, financial base or newly emerging, which is not in the race of capturing foreign investment. Developing countries are becoming increasingly attractive investment destinations, in part because they can offer investors a range of 'created' assets. (Mallampally and Sauvant, 1999)

But as Blomstrom and Kokko (2003) noted, today even countries with a small economy can compete for FDI in the world market. Globalization and regionalization is increasing market integration and reduces the importance of market size as a determinant of investment location, which is very important for developing countries.

Figure 1 shows the tendency of the world FDI growth and its distribution between developed and developing countries. As shown in the figure, beginning from 1997, the world FDI has been increasing dynamically, but the main location of FDI is still developed economies, especially the USA and some EU countries.

Figure 1. **World FDI, 1995-2011 (in billions of USD)**

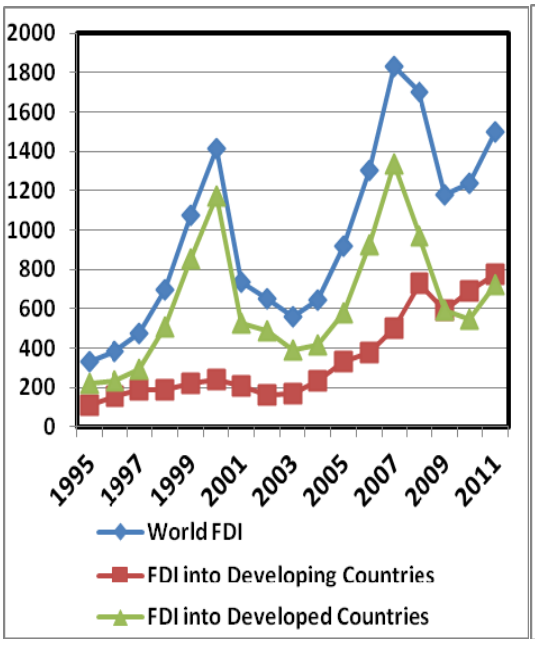
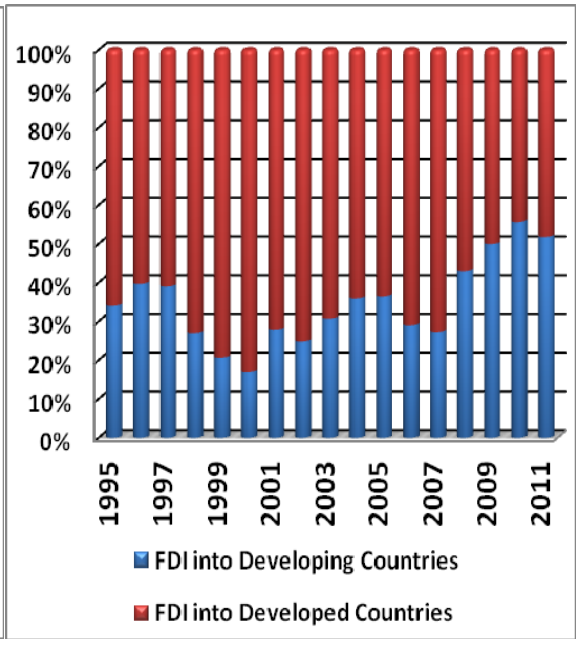


Figure 2. **Distribution of FDI among developed and developing countries, %**



Source: World investment reports, 2000 – 2012.

In 2000, the FDI reached the highest point and increased to $1,411 billion. Also that year was the largest discrepancy between the FDI inflows into the developed countries and into the developing countries.

Due to slow economic growth in developed countries, the world FDI dramatically decreased in 2001 and continued to decrease the following two years (2002-2004). Beginning from 2004, the flow of FDI into economies of developing counties dramatically increased.

For the first time, developing countries hosted an equal amount of FDI with the developed countries in 2009. In the following two years, the share of developing countries became bigger than developed countries, partly supporting the theory that

developing countries can be attractive for FDI. FDI into developing countries increased more 6.8 times, from $113 million in 1995 to $777 billion in 2011, or from 30% to more than 50% (Figure 2).

According to the UN "World Investment Report" (2012):

> Developing and transition economies will continue to keep up with the pace of growth in global FDI in the medium term. Transnational corporations (TNCs) executives responding to this year's ranked six developing economies among their top 10 prospective destinations for the period ending in 2014.

In case of the FDIs in Central Asia, it should be noted first of all that, as other developing countries of the world, Central Asian countries are emphasizing a policy priority for attracting FDI into their economies and actually becoming more attractive for FDI.

In 1991, the amount of attracted FDI into region was $118 million; in 2000, the region attracted $1.7 billion; and in 2011, FDI into region reached $20.5 billion. The most successful year in terms of attracting FDI was in 2009 when the region received $24.3 billion FDI (Figure 4a, b).

Overall, during the last two decades the region attracted $143.1 billion foreign investment. Researching researching deeper into the numbers, distribution of FDI among countries in the region was very uneven (Figure 5b).

For example, Kazakhstan is the most successful case in terms of attracting FDI. During the period of 1991 – 2011, Kazakhstan attracted 66% of total FDI into region, or $94.2 billion; Uzbekistan received 19%, or $27.8 billion; Turkmenistan, 12%, or $16.7 billion; Kyrgyzstan received only 2%, or $2.8 billion; and Tajikistan, 1%, which is only $1.7 billion.

Figure 3. **FDI into Central Asia, 1992 – 2011**

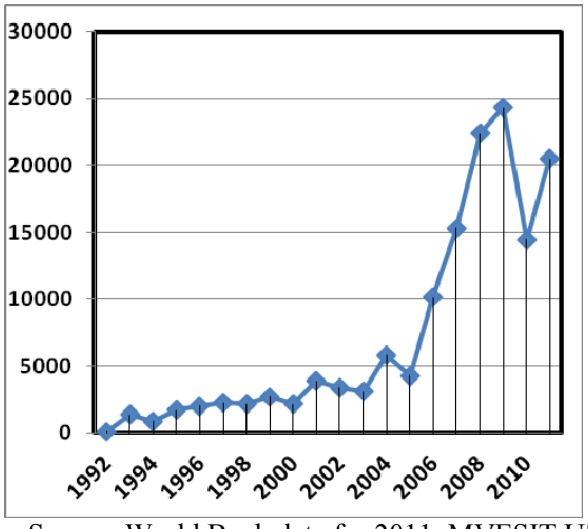
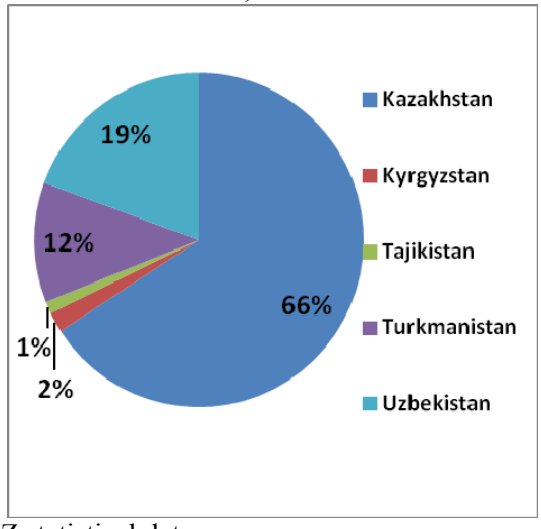


Figure 4. **Distribution of FDI in Central Asia, 1992 – 2011**



Source: World Bank data for 2011, MVESIT UZ statistical data

Why is the FDI distribution uneven in the region and what are the main factors of that? Later, this thesis analyses the case studies of Kazakhstan and Uzbekistan to find out determinants and factors of these countries' FDI attraction.

1.2. Economic theory, "Eclectic Model"

There is a large range of theories that are used to explain the business world, but this research for analyzing the characteristics of FDI in Central Asia will follow Dunning's

"Eclectic Theory," which provides a flexible and popular framework for understanding the determinants of FDI.

The eclectic paradigm is a theory in economics that is also known as the OLI-Model, or OLI-Framework. In his theory Dunning argued that there are three main determinants of foreign direct investment (FDI) that can attract foreign investors into a market, such as ownership advantage, location advantage and internalization advantage.

Ownership advantage (OA) deals with competitive advantages of enterprises seeking to engage in foreign direct investment (trademark, technology, entrepreneurial skills, and returns to scale). The greater the competitive advantage of investment firms, the more foreign investors become interested in investing into the economy.

Location advantage determines the advantage for MNCs to invest over alternative countries or regions in order to have ownership advantage. The factor of location advantage can be determined by labour cost, existence of raw materials, available special taxes policies or tariffs, trade barriers and the possibility of political risks.

For example, there is high possibility that MNCs do not invest in politically unstable countries, as they cannot measure the exact possible return or gain. Also the countries with high trade barriers, such as a high tax level, are not considered to be very attractive for foreign investors.

Internalization advantages are concerned with MNCs' prefererence for internalizing the market in such way that they achieve a reduction of production cost. In other words, MNCs prefer directly organizing the production system within the border of a country

rather than producing goods in other countries and trading across borders. In this way, they avoid additional costs, such as transportation costs or tariffs, which have high value for MNCs.

Additionally, MNCs have other motives to invest in a country. We can classify these motives into four different groups: resource seeking, market seeking, efficiency seeking and strategy asset seeking.

Resource seeking FDI concerns MNCs that are interested in investing into foreign countries because of their available resources. These resources can be natural resources. These raw materials might not be produced in home markets or might be available for higher price and labour resources.

Market seeking FDI is concerned with the size of host countries market, which has the most important value for MNCs and is the primary motive for attracting FDI for host countries with large GDPs (Dunning, 1998). These motives deal with the size of the market and the demand (consumption) in a hosting county. These factors are very important motives for FDI and have an indirect relation to GDP per capita and the economic growth of the hosting country.

Efficiency seeking FDI occurs "when investors take advantage of differences in the availability and costs of traditional factor endowments in different countries or take advantage of the economies of scale and scope and of differences in consumer tastes and supply capabilities" (Dunning, 1993). In other words this is advantage that an investor can get from investing the market.

Strategy seeking "FDI aims at acquiring a new technological base, rather than exploiting an existing asset" (Dunning). This is the last category pointed out by Dunning. In this case, you cannot see the same advantages of gains as the investing motives. Today, all these above-mentioned factors and motives for FDI are very important for investors in the process of decision-making.

According to previous research, there are also other variables of inflow of FDI into developing countries. In reality, these variables are not less important. According to Walsh and Yu (2010), there are several variables for inflow of FDIs into developing countries. These variables include market size and growth potential, openness of economy, exchange rate valuation, clustering effects, political stability, and available institutions.

According to them, larger host countries' markets might be associated with higher foreign direct investment due to larger potential demand and lower costs based on scale economies. He also mentioned that FDI could increase as a result of the openness and weaker real exchange rates of host developing countries.

The authors emphasized, "political and macroeconomic stability is one of the key concerns of the potential foreign investor in making decision in investing for foreign economies" (p 43). According to them, "Institutional quality is a likely determinant of FDI, particularly, for less-developed countries, for a variety of reasons" (p 49).

Besides this, several researchers, such as Nunnenkamp (2002), Kahai (2004), Azemar and Delios (2007) Buthe and Milner (2008), Kinda and others, emphasized the

importance of economic and political stability, economic freedom, and corruption. Azemar and Delios (2008), using the data on Japanese companies in developing countries, analyzed the efficiency of tax systems of these countries.

In his research, Sekkat (2007) considered the openness of an economy, available infrastructure and political situation of developing countries. According to the author, these variables are very important in composing an attractive business environment for these countries.

Burne and Milner studied the role of GATT/WTO, FTAs and preferential trade agreements. They emphasized that membership in these kinds of agreements can increase the attractiveness of these economies.

In sum there are several factors, motives and variables for measuring the attractiveness of economies of developing countries for foreign investors, and all of them play a valuable role in the decision-making of investors (table N1). Combinations of them can guarantee the attractiveness of a country.

Table 1. Characteristics of FDI in developing countries

Characteristics of FDI in developing countries			
Policy framework Rules regarding entry and operations of TNCs Bi-and multinational agreements on FDI Tax and regulation GATT/WTO and Preferential trade agreements		**Business facilitation** Administrative procedures Availability of infrastructure FDI promotion FDI incentives	
Political condition indicator Political stability Corruption		**Macro-economic indicators** Openness and economic condition GDP, economic growth and per capita income Inflation rate and balance of payments deficit	
Economic determinants			
Recourse seeking FDI	Market seeking	Efficiency seeking	Strategic asset seeking
- Raw materials - Complimentary factors of production - Physical infrastructure	- Market size - Market growth - Regional integration	- Productivity - adjusted labour cost - Business related service - Sufficiently skilled labour - Trade policy	- Knowledge based assets - Technological and innovative capacity - Different culture, institutions and system

Source: UNCTAD (1998) and Dunning (2001)

CHAPTER TWO

Background: Main FDI indicators of Kazakhstan and Uzbekistan

Kazakhstan and Uzbekistan are the largest two economies of Central Asia. Both countries are landlocked and have small domestic markets. The population of Kazakhstan is 16.3 million, and the population of Uzbekistan, 29.6 million.

Kazakhstan and Uzbekistan are very rich in natural resources. Kazakhstan has the sixth largest reserve of natural resources in the world, with the ninth largest proven oil reserves (table 2). There have been 99 elements discovered, 70 elements explored, 60 and recovered and used in Kazakhstan's soil out of the 110 elements of D. I. Mendeleyev's periodic table. Mineral and resource bases in the Republic of Kazakhstan consist of 5,004 fields, of which the estimated value is around USD 46 trillion.

Table 2. Kazakhstan's ranking in the world for the size of natural resource reserves and production

N	Resource	Ranking in production	Ranking of reserves	Resource	Ranking in production	Ranking of reserves
1	Oil	19	9	Chrome	3	1
2	Coal	10	8	Zinc	9	3
3	Iron ore	13	5	Gold	21	10
4	Uranium	3	2	Silver	10	5
5	Bauxite	10	10	Lead	11	4
6	Molybdenum	12	8	Copper	10	11

Source: www.invest.gov.kz

So far only 160 oil and gas deposits have been explored in Kazakhstan, and recoverable reserves are 2.7 billion tons. Kazakhstan's oil field under the Caspian Sea is estimated to represent the largest discovery worldwide in the past 30 years. Kazakhstan is also a source of gold, copper, cobalt, chromium, nickel and uranium, as well as iron and coal.

Uzbekistan is among the leaders in the provision of stocks of silver, tungsten, phosphate, potassium salt, rare earth metals and other valuable minerals. The country is ranked 4th in term of reserves of gold, 7th in uranium, 8th in molybdenum, 8th in copper stocks, 14th in natural gas, 3rd in extraction of cadmium, 6th in uranium, 8th in gold and natural gas, and in the top 15 in extraction of molybdenum, feldspar, and a number of other industrial raw materials. It is also 2nd in the production of doodle, 5th in cotton, and 6th in raw silk. Additionally, Uzbekistan is in top 20 in the world among producers of sulfuric acid, nitrogen fertilizers, mineral lubricating oils and paraffin wax, cotton yarn and fabrics, tomato paste, dried fruits, melons and grapes gathering, shearing wool, and rail freight.

1.1. Main economic indicators

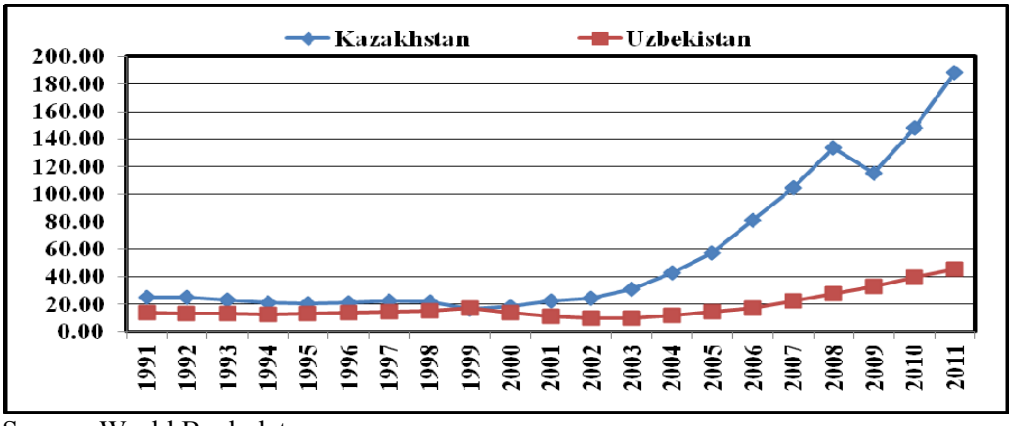
Kazakhstan and Uzbekistan today are politically stable countries. This quality is one of the favourable characteristics for FDI, since it can provide a long period of stability and prosperity.

After the demise of the former USSR, Kazakhstan and Uzbekistan, like many other Central Asian countries, faced a number of difficulties during the transition period. The economy of Kazakhstan shrank roughly 50% between 1991 and 1995, with six years of negative growth in the 1990s. Only in 1996 did Kazakhstan achievea positive growth of GDP. Beginning from 2000, however, the economy fully recovered and achieved sustainable economic growth, averaging over 10% between 2000 and 2007.

One of the main reasons for this rapid and sustainable economic growth was the change in the world price for oil. The more than doubling of oil prices in 1999-2000 and the subsequent steady rise in oil prices from 2002 to 2008 also helped the country sustain high levels of economic growth.

The extensive reforms following independence finally paid off and the country was able to profit from the sharp rise in oil prices beginning in 1999. Kazakhstan's GDP increased from $24.9 billion in 1991 to $188.1 billion in 2011.

Figure 5. **GDP of Kazakhstan and Uzbekistan, 1991-2011**



Source: World Bank data

Uzbekistan was relatively stable and has maintained steady economic growth until 2000, when the economy showed a negative growth. During the following three years, the GDP of the country decreased from $17.1 billion in 1999 to $9.7 billion in 2002.

In case of Uzbekistan, we can see that during this period GDP of the country increased from $13.9 billion in 1991 to $46.0 billion in 2011. In 1999, the GDP of Uzbekistan was even larger than GDP of Kazakhstan for that year. However in 2000, Uzbekistan showed negative growth while Kazakhstan achieved positive growth.

After 2000, we can see that countries maintained stable growth of their economies, particularly Kazakhstan achieved a very dynamic growth of the economy while Uzbekistan showed a relatively slow growth. Much research has stated that such a dynamic growth of Kazakhstan can be explained with the rapid growth of the prices for oil in the world.

As a result of the oil price increase, the income of the population in these countries has been increased, but in different ways for the two countries (Figure 6). In 1991, the GDP per capita of Kazakhstan was $1,512 compared to $659 in Uzbekistan; today, the GDP per capita of Kazakhstan increased 7.5 times and now is $11,356.6 compared to $1,546 in Uzbekistan.

At the same time PPP per capita has increased in Kazakhstan from $4,530 in 1991 to $13,099 in 2011. In the case of Uzbekistan during the same period, PPP per capita in Uzbekistan increased from $1,457 to $3,788 (Figure 7).

According to the Kazakhstan government, inflation rate in country was only 6% in 2012; meanwhile, Uzbekistan was also maintaining an inflation rate around 7 to 8% during recent years.

Figure 6. **GDP in Kazakhstan and Uzbekistan, 1991-2011**

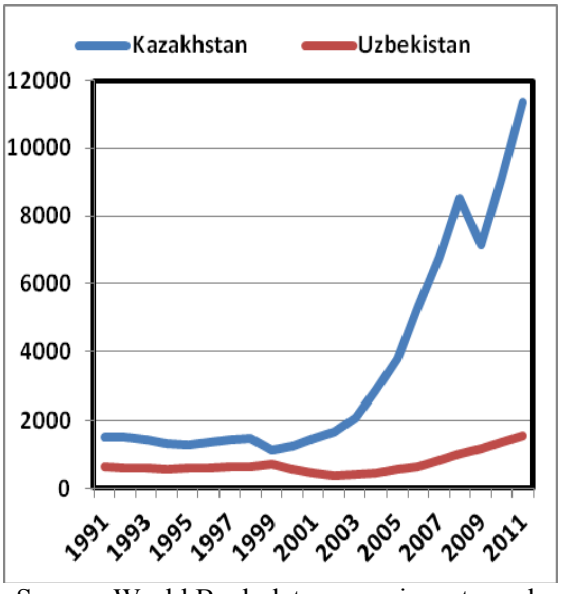
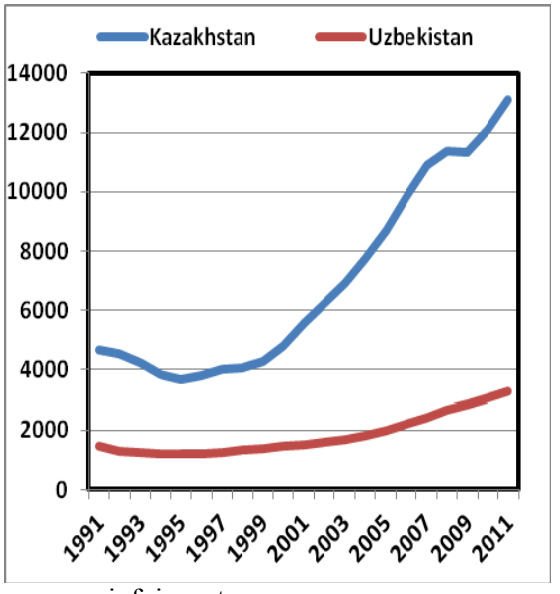


Figure 7. **PPP per capita in Kazakhstan and Uzbekistan, 1991-2011, $**



Source: World Bank data, www.invest.gov.kz, www.uzinfoinvest.uz

Inflation rate in Kazakhstan, according to the Kazakhstan government, was only 6% in 2012, while in Uzbekistan during the last decade, it has been maintained around 7-8% annually.

Figures 8 and 9 show the GDP compositions of Kazakhstan and Uzbekistan between 1992 and 2010. First of all, if we look at the GDP composition of two countries, it must be noticed that today the service sector has the largest share in GDP of both countries. In the case of Kazakhstan, this was 43% in 2010; in Uzbekistan, it was a bit higher at

48%. In both countries, the share of agriculture is decreasing. In Kazakhstan from 1992 to 2010, the share of agriculture in GDP decreased from 28% to 6%; in Uzbekistan, from 30% to 11%.

Figure 8. **GDP composition of Kazakhstan, 1992-2010 (%)**

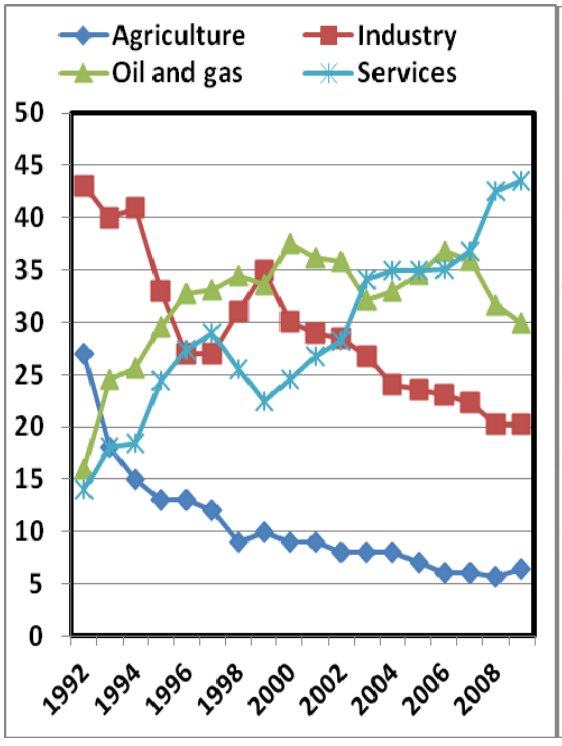
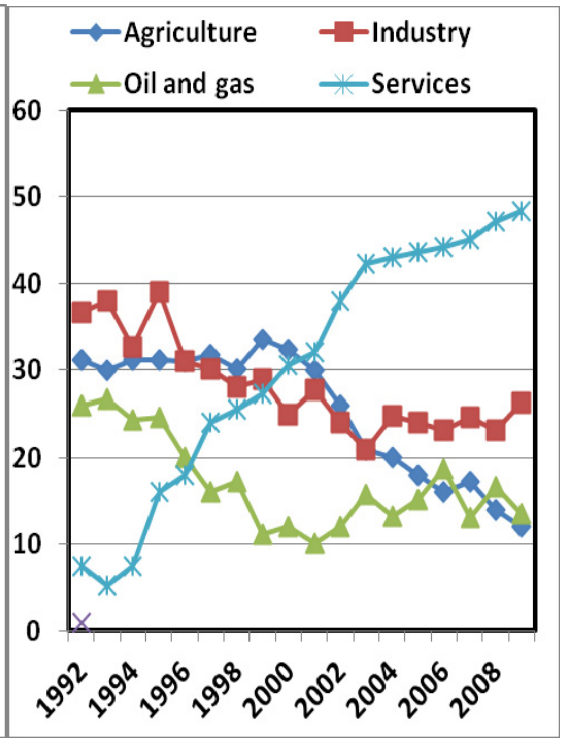


Figure 9. **GDP composition of Uzbekistan, 1992-2010 (%)**



Source: www.invest.gov.kz, www.mfa.kz, www.mfer.uz, www.uzinfoinvest.uz

In the early 90s, manufacturing had the largest share in GDP of both countries, but today this trend has reversed. The manufacturing share, in the case of Kazakhstan, decreased from 43% to 19%, while in Uzbekistan, that number decreased from 37% to 26%. At the same time we should mention that, in terms of actual value, these numbers increased several times.

One different trend between that countries' GDP composition was that in Kazakhstan, the share of oil and gas in industry increased from 14% in 1992 to 28% in 2010, while the share decreased from 30% to 12% in 1992-2010 for Uzbekistan.

1.2. Political condition indicator

Political factors of these two countries are relatively similar to each other. Firstly, both countries are politically stable, which can have positive push for attracting more FDI. The countries announced independence in 1991 after the collapse of USSR, and today Kazakhstan and Uzbekistan are ruled by their same governments that were elected in 1991.

In terms of corruption, according to the OECD report, both countries show high corruption levels among government officials. If we look the facts given by the OECD, today Uzbekistan has higher corruption levels among government and corruption in the country was stated as a pervasive. At the same time, Kazakhstan is progressing in terms of decreasing the corruption. For the past few years, corruption in Kazakhstan has decreased (OECD, Corruption Perception Index report, 2012).

1.3. Corruption levels in Uzbekistan and Kazakhstan

One of the other biggest factors affecting the attractiveness of the countries is the level of existing corruption inside the country. In its report about corruption in two countries, the OECD came to different conclusions about their current statuses.

According to the OECD Istanbul Anti-Corruption Action Plan report, in recent years Kazakhstan has taken certain steps to address recommendations it was provided in the area of criminalization of corruption. Since the first round of monitoring in 2005, Kazakhstan adopted two important laws that introduced comprehensive changes in the provisions on liability for corruption offences (Law of 21 July 2007 N308-III and Law of 7 December 2009 No. 222-IV), and both of them aimed to implement the Istanbul Anti-corruption Plan Report recommendations. These changes criminalized bribe taking by an official for a third person's benefit and removed some inconsistencies between provisions of the Criminal Code and the Code of Administrative Offences.

Although some progress has been achieved in decreasing the corruption in the country, corruption level is still quite high. According to the OECD Istanbul Anti-Corruption Action Plan report in 2012, Kazakhstan ranked 105th out of 178 countries with a score of 2.6 in the 2010 Transparency International Corruption Perception Index.

While Kazakhstan's score in 2005 was 2.6 (107th out of 158 countries), it then fell to 2.1 in 2007 (150th out of 179 countries) and rose significantly in 2009 to 2.7 (120th out 180 countries). Surveys have shown that corruption is widely seen as a serious problem in Kazakhstan, mainly in the area of public spending.

According to the OECD Istanbul Anti-Corruption Action Plan, while the OECD noted the achievement of Kazakhstan's decrease in the corruption within the country, about Uzbekistan it was stated that corruption was perceived as pervasive. In 2011

Uzbekistan ranked 177th among 182 countries in Transparency International's Corruption Perception Index (CPI), and its rating has decreased over the past few years.

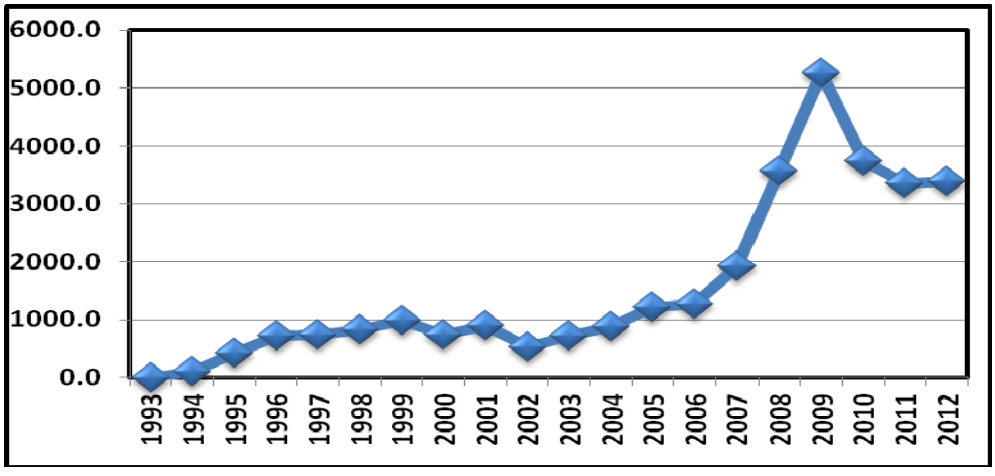
Chapter Three

Analyses of current FDI trend in Uzbekistan

1.1. Current FDI trends in Uzbekistan

The role of FDI in the economic development of Uzbekistan is very important, and government is trying hard to attract larger FDI. Uzbekistan is a country with the rich natural resources, particularly gas. However, Uzbekistan is not as rich as Kazakhstan in natural resources, especially with oil, leading to less investment when compared to such a country.

Figure 10. **Total amount of attracted FDI into the economy of Uzbekistan, 1993-2012 (in billions of USD)**



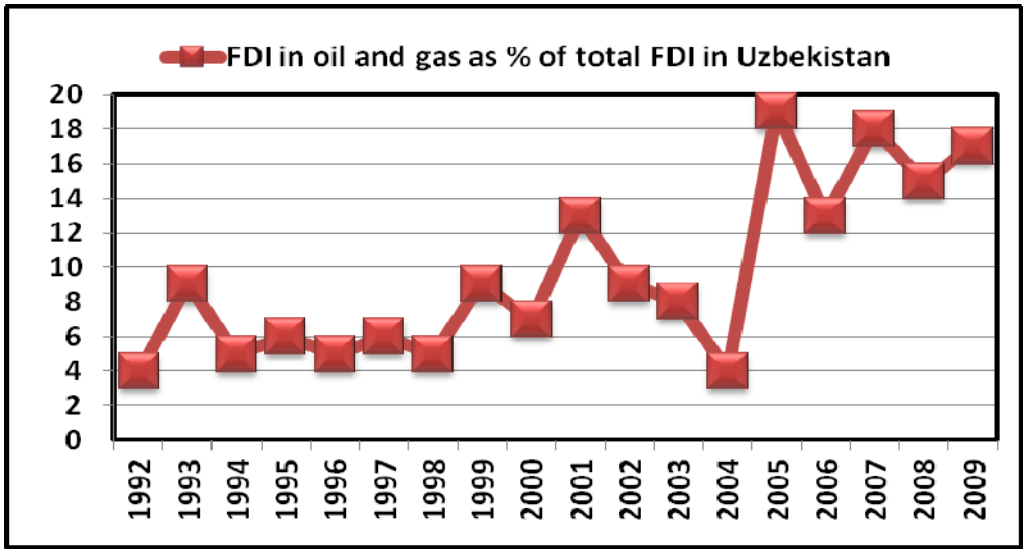
Source: uzinfoinvest.uz; mfer.uz

During the last 20 years, Uzbekistan received $31.2 billion from foreign direct investment (Figure 10). The FDI trend for Uzbekistan shows that Uzbekistan is

becoming more attractive for foreign investment, and the role of FDI in the GDP of the country is increasing.

During the period from 1994 to 2011, the country received $91.4 million in FDI. With the country hosting $5.3 billion in FDI, 2009 was the most successful year in this time period. During the following three years after 2009, FDI has decreased, and in 2012 the amount of FDI attracted to the country totaled $3.4 billion.

Figure 11; **FDI into oil and gas sector as a % of total FDI in Uzbekistan, 1992-2009**



Source: www.uzinfoinvest.uz; www.mfer.uz.

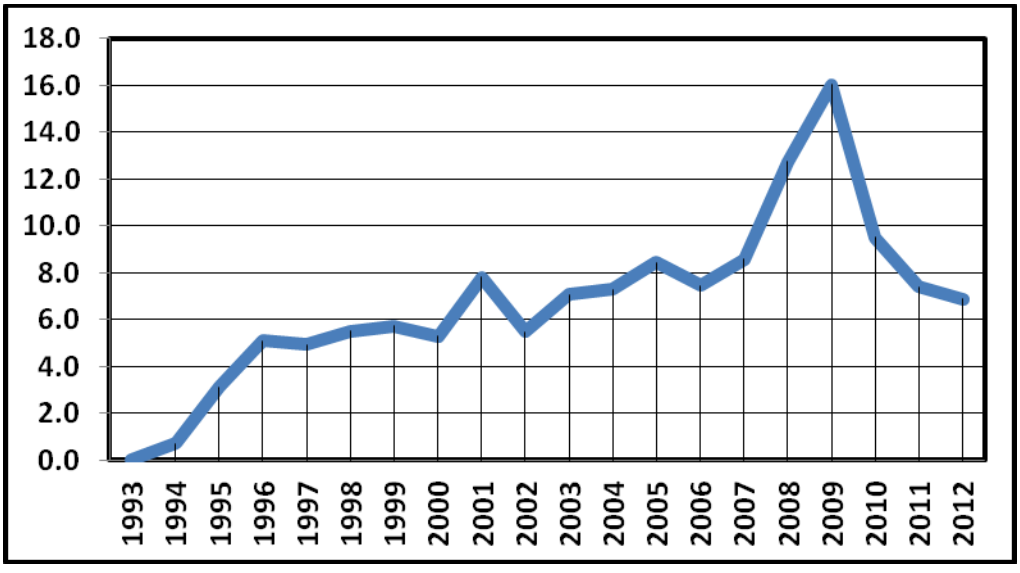
Figure 11 shows that the share of the investment into oil and gas sector in total FDI in Uzbekistan.

First, it should be noted that the cases of Kazakhstan and Uzbekistan are quite different. In Kazakhstan this numbers are very high, and in some years they were around 80%.

The figure shows that FDI into Uzbekistan is less concentrated in this area. This number in Uzbekistan is not high, but it has been steadily growing. In 1992, that was around 4%, while today it has moved to around 16%.

Now let's see the clear picture about the percentage of the FDI of total GDP of Uzbekistan (Figure 12). In case of Kazakhstan, we could see that this numbers are highly fluctuating.

Figure 12. **Share of the FDI in total GDP of Uzbekistan, 1992-2009**.



Source: uzinfoinvest.uz; mfer.uz

In 1994, Uzbekistan's share of FDI in total GDP was only 1%. That share would increase until 2001, when it reached 8%. After dropping to 6% in 2002, it moved back to from 8 % in 2004. After that it increased steadily and, in 2009, achieved the highest level, reaching slightly higher than 16%.

Mostly this was the result of the significant increase in FDI in transportation systems for Uzbekistan in 2009. The FDI for the sector has slightly decreased each year since 2009, and it was 8% in 2012.

In Kazakhstan, FDI is very concentrated in natural resources, with almost 70% of total FDI being destined to the oil sector. In Uzbekistan as shown in Figure 13, FDI into the industry and the transport and communication sectors took the largest share in total FDI.

Figure 13 **FDI into sectors in Uzbekistan in 1993-2012, $mln**

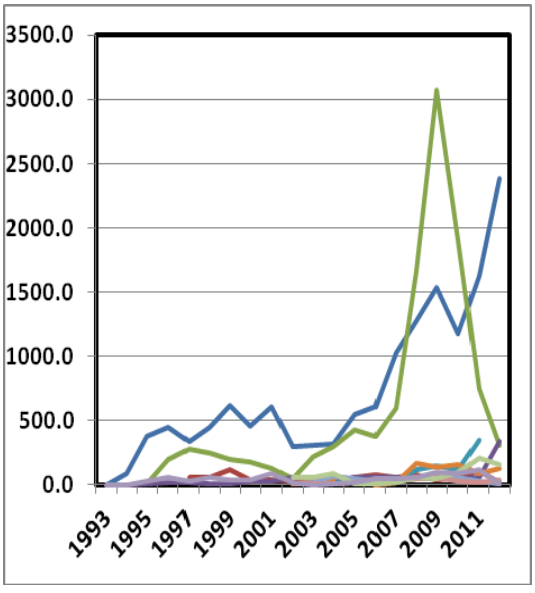
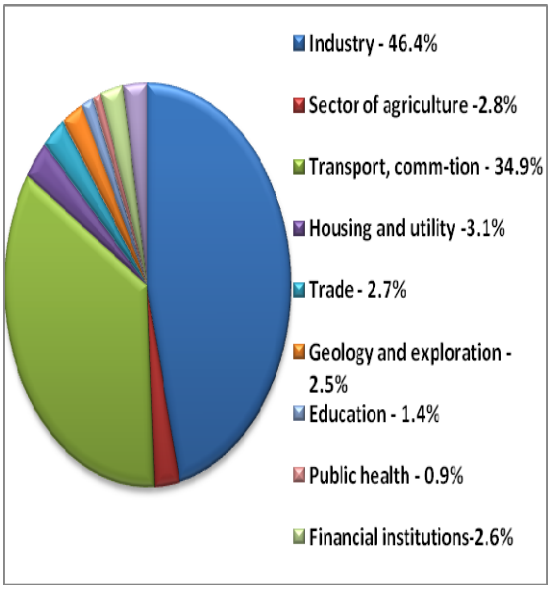


Figure 14. **Distribution of FDI into sectors in Uzbekistan in 1993-2012, $mln**



Source: uzinfoinvest.uz; mfer.uz

FDI into industry sector has been steadily increasing. Although the largest share in the industry are the energy (oil, gas, coal and electro energy) and mining sectors, the automobile, chemical, light industry, construction productions, consumer productions and pharmaceutical sectors are attracting large amount of FDIs.

Only the textile sector during the independence period received more than $1.9 billion, and the pharmaceutical sector attracted more than $200 million foreign investment. The second largest FDI (34.9%) went into transport and communication sector, which reached its highest level in 2009. That year, $3.1 billion FDI was attracted into this sector; however, today it is showing a negative trend.

There is positive dynamic growth in FDI into the housing and utility service sector. In 1993, the sector received $0.6 million in FDI; in 2011, $59.0 million; and in 2012, $333.1 million. In total, this sector received $971.2 million in FDI over the last 20 years.

Table 3. The largest investor countries into Uzbekistan, 1993-2012

N	Investor countries	FDI, $mln	Share	Investor countries	FDI, $mln	Share
1	Russia	6,964.3	22.3%	Turkey	1,015.6	3.3%
2	China	5,468.0	17.5%	France	585.8	1.9%
3	Switzerland	1,675.5	5.4%	Israel	213.2	0.7%
4	Great Britain	1,657.0	5.3%	Azerbaijan	205.2	0.7%
5	S. Korea	1,510.9	4.8%	Malaysia	175.8	0.6%
6	USA	1,365.7	4.4%	Gibraltar	143.9	0.5%
7	Germany	1,300.8	4.2%	Virgin Irelands	136.7	0.4%
8	Japan	1,204.2	3.9%	International institutes	2,922.4	9.4%
9	Netherlands	1,125.6	3.6%	Other countries	3,516.8	11.3%
Amount of total FDI - $ 31 187.4 million						

Source: uzinfoinvest.uz; mfer.uz

With regards to investors, more than 50 countries invested in Uzbekistan. The largest investor for FDI in Uzbekistan during the 1993 – 2011 period was the Russian Federation (table 3). Russia has invested about $7.9 billion, which is more than 22.3% of total FDI into the country. China is the second largest investor in the country, investing more than 17.5% of total FDI into the country. We should state one more fact, which is FDI into Uzbekistan does not strongly depend on the investment of one or other country. That makes the economy less dependent from particular country.

Although the amount of FDI into Uzbekistan is relatively smaller than the FDI into Kazakhstan, it needs to be noted that area of the investment is less concentrated in resources and more evenly distributed among sectors in Uzbekistan.

Uzbekistan also has many points to be improved. Table 4 shows a clear picture that FDI in Uzbekistan is strongly concentrated in few locations. More than 60% of total FDI is concentrated in the capital city Tashkent. FDI in the Tashkent region and the city of Tashkent together account for more than 66% of total FDI.

The high geographical concentration may reflect about uneven regional development. Some regions such as Sirdarya, Khorezm, Surkhandarya and Djizak received less than 1.0 % of total FDI.

Table 4. **Distribution of FDI among regions of Uzbekistan, 1993-2012**

Regions	FDI, $mln	%	Regions	FDI, $mln	%
Karakalpakstan	1135.9	3.6	Samarkand	772.1	2.5
Andidjan	1016.4	3.3	Surkhandarya	327.2	1.0
Bukhara	1446.8	4.6	Sirdarya	263.5	0.8
Djizak	177.1	0.6	Tashkent	1752.1	5.6
Kashkadarya	2817.7	9.0	Fergana	1128.3	3.6
Navai	819.5	2.6	Khorezm	310.9	1.0
Namangan	373.7	1.2	Tashkent city	18846.2	60.4

Source: uzinfoinvest.uz; mfer.uz

The fact that Tashkent is hosting more FDIs than other regions is very natural as Tashkent is a very developed city with very developed infrastructure and a high standard of living. Most of the high skilled-labour of the country is living in this city. But this can be an important cause of the other regions being less developed and less attractive for FDI. If Uzbekistan wants to achieve sustainable development, foreign investment should also be attracted to regions other than Tashkent.

It is difficult to achieve this goal without providing good infrastructure and conditions for FDI in other regions. So Uzbekistan should first develop the infrastructure in other regions. All the regions should be connected to each others with good roads, provided with electricity and given other social infrastructure.Foreign investors should be provided with special incentives by the government to invest in the other regions of the

country. As Samuel and Festus (2011) noted, FDI in a host country mostly depends on incentives given by host country.

According to Blomstrom and Kokko (2003), globalization and regionalization of the international economy have changed the factors leading to FDI, such as a reduction of the importance of market size as a determinant of investment location. Hence, a sufficient incentive package can be enough for attracting investment in all regions.

1.2. Regulation and investment incentives in Uzbekistan

The government of Uzbekistan provides a whole portfolio of incentives for the foreign investors. The government is promoting consistent policy on reduction of tax burdens for legal entities. In particular, between 1992 and 2012, the income tax rate imposed on legal entities was reduced from 45% to 9%. Foreign investors are provided with the full portfolio of advantages and preferences on taxation and loans.

According to statistics for 1996-2010, tax rates for textile companies were reduced from 38% to 7%. In compliance with the Tax Code of the Republic of Uzbekistan, a special unified tax system was introduced instead of generally established taxes and other mandatory charges for small and medium textile companies. In regards to the reduction of the tax burden and financial for support of textile companies, the rate of unified tax was reduced by 6 % from 13% in 2005 to 7% in 2011.

Also, the Uzbekistan government is providing number of incentives for all foreign investors, particularly for the ones investing in special economic and industrial zones.

Foreign investors granted the following exemptions: payment of tax on profit imposed on legal entities; property tax; tax imposed on improvement and development of social infrastructure; unified tax payment imposed on micro companies and small enterprises; mandatory deductions to the Republic Road Fund. The aforesaid tax privileges are granted on conditions. If the volume of FDI is from $300 thousand to $3 million, it is granted for 3 years; if between $3 million and $10 million, for 5 years; and if over $10 million, for 7 years.

There are also incentives for foreign investors in the Free Industrial Economic Zone in Navoi. They are exempted from land tax, property tax, profit tax of legal entities, social infrastructure development tax, unified tax payment for micro firms and small enterprises, compulsory contributions to the Republican Road Fund and the off-budget Republican School Fund. The privileges available depend on the volume of FDI and the criteria for the exemption are as follows: if from 3 to 10 million Euros, exemption for 7 years; if from 10 to 30 million Euros, exemption for 10 years, as well as rates of profit tax and unified tax payment fixed at the level of 50% of current rates for the following five years; in case more than 30 million Euros, exemption for 15 years, and for the following 10 years rates of profit tax and unified tax payment are fixed at the level of 50% of current rates.

If there is an increase by a Navoi FIEZ resident in the volume of FDI to a level that receives more privileges, the privileges are applied from the month when the

application of the privileges on the volume of investments appears. They are valid during the remaining period till the end of the term of thevalidity of the privileges.

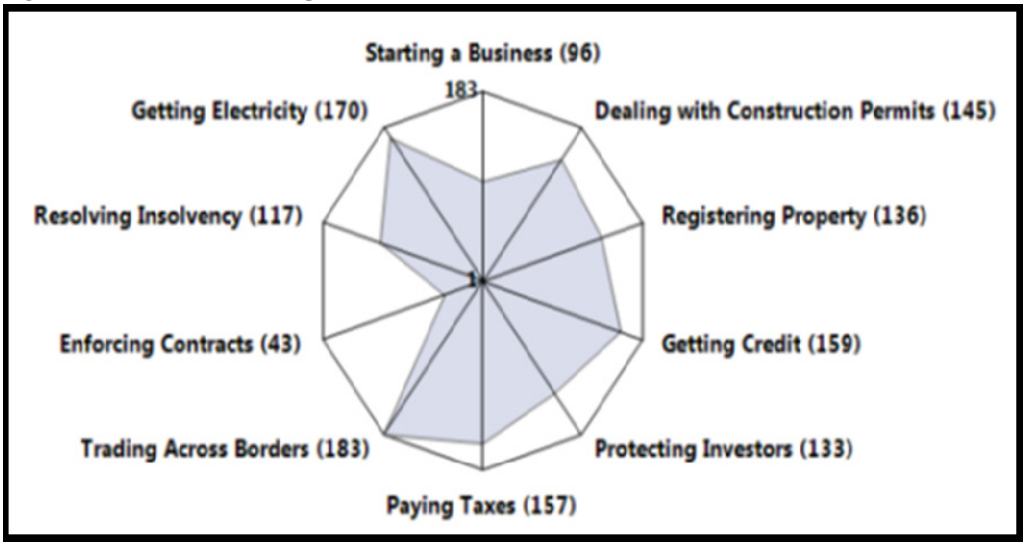
Concerning incentives in the Special Industrial Zone in Angren, the resident textile companies in Angren are exempted from the payment of: income tax; property tax for legal entities; tax on improvement and development of social infrastructure; the single tax for small businesses; mandatory contributions to the Republican Road Fund; and customs duties on the equipment, components and materials not produced in the country that were imported into the territory of SIZ "Angren" for the implementation of projects. Such exemptions are granted for a period of 3 to 7 years, depending on the amount of investments. Investments of $300 thousand to $3 million are exempt for a period of 3 years; investments from $3 million to $10 million are exempt for a period of 5 years; and finally, FDI investments worth more than $10 million are exempt for 7 years.

Along with the above mentioned indicators, there are many other factors determining the attractiveness of the country for FDI. These include available infrastructure, business dealing conditions, government support and facilitation for FDI and protection of foreign investment, and membership of the country in different international agreement or organizations (WTO, FTA),

1.3. World Bank, Business dealings in Uzbekistan

According to the World Bank report on easy doing business (Figure 15), Uzbekistan ranked only 166th among 185 countries, which does not paint a good picture.

Figure 15. **Doing business for Uzbekistan, 2012**



Source: World Bank, Doing Business database.

This figure shows that Uzbekistan should have improvement in all aspects of this report, especially in the provision of electricity, the provision of credits, the tax system, and cross border trade. If the last factor, trade across the border, is mostly the result of geographical location of the country, other factors must be improved by the government of the country.

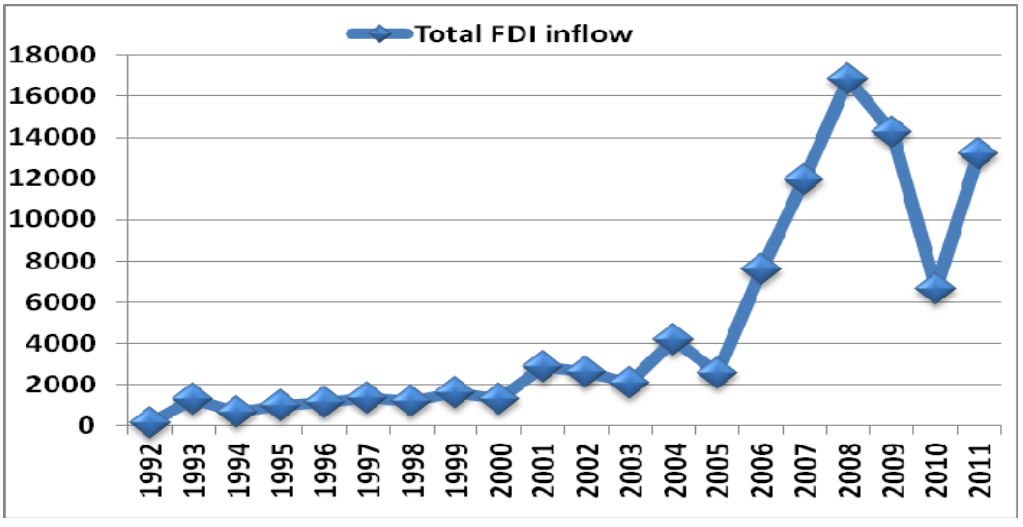
Chapter Four

Analyses of current FDI trends in Kazakhstan

4.1. Current FDI trends

Like other developing economies, Kazakhstan is focusing on attraction of FDI into country, and the role of FDI is growing annually. From 1991 to 2011, Kazakhstan attracted more than $94 billion. FDI inflows picked up after 2000 and from 2001 to 2005 were twice those of the preceding five years. But the real take-off in FDI inflows occurred after 2005, with inflows in 2008 reaching $16.8 billion, or several times as high as three years earlier (figure 16).

Figure 16. **Total FDI inflow into Kazakhstan, 1992-2011 (in billions of dollars)**

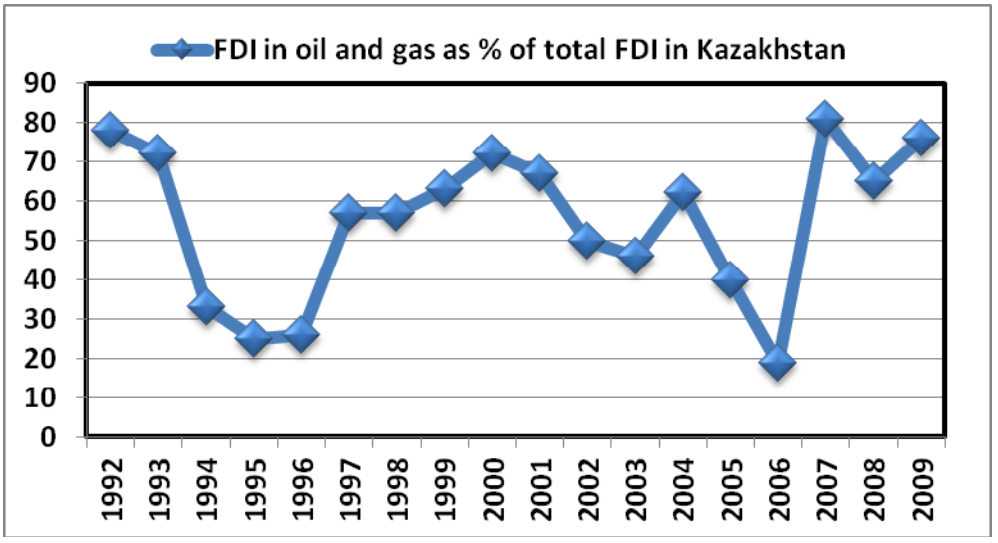


Source: www.invest.gov.kz, www.mfa.kz

Although Kazakhstan has been performing quite well when compared to other nations, in receiving foreign investment annually over passed period, foreign direct investment

into the economy and exports from Kazakhstan are still highly concentrated (more than 70%) in natural resources (figure 17).

Figure 17 **FDI into oil and gas sector as a % of total FDI in Kazakhstan, 1992-2009**

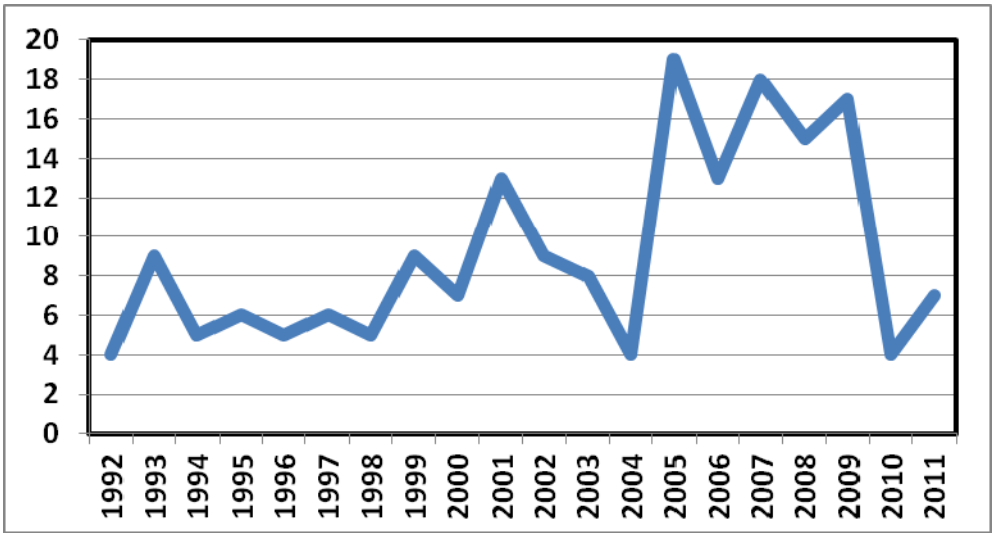


Source: www.invest.gov.kz, www.mfa.kz

From the figure, we can see how high the share of investment into oil and gas in total FDI has been. In 1992, that number was 80%. In 1996, that dropped to 25%. But in 2009, we can see this share was higher even than in 1992.

Also, figure 12 gives us a clear picture about the percentages of the FDI in total GDP of the country. In case of Kazakhstan we can see that this percentage is highly fluctuating. In 1992, that number was only 4%, but it increased until 2001 when it reached 12%. After 2001, that number fluctuated greatly according to the price of the oil in the world market. In 2004, this dropped down to 4% from 12% in 2001, and in 2005 increased dramatically to almost 20%, which is the highest result up to today.

Figure 18. Share of the FDI in total GDP of Kazakhstan, 1992-2009.



Source: www.invest.gov.kz, www.mfa.kz

If we take the average share of FDI in Kazakhstan from 1991 to 2011 as a percentage of the total amount of GDP of countries in the same period, we can see that it is 8.1%.

According to the National Bank of Kazakhstan the largest investor country into economy during during the 1991-2010 time fram was the Netherlands, whose investment accounted for almost 40% of the total inward stock.

Also, US firms were the some of the largest investors, followed by those in France, Japan, China and the United Kingdom. The US oil company Chevron, for example, played a prominent and significant role in the Tengiz oil field.

Table 5. **List of the biggest investor countries in Kazakhstan, 1991 - 2010**

N	Country	FDI, $mln	FDI, %	Country	FDI, $mln	FDI, %
1	Netherlands	33397	38	Switzerland	1881	2
2	US	14828	17	Russia	1337	2
3	France	6975	8	Korea	1031	1
4	Japan	3111	3	UAE	978	1
5	China	2927	3	Germany	936	1
6	UK	2633	3	Turkey	504	1
7	Canada	2209	2	Romania	449	1
8	Austria	1979	2	Others	13825	16

Source: www.invest.gov.kz, www.mfa.kz

The lion's share of FDI is coming into the mining and real estate sector, which includes geological surveys and prospecting. Attracting foreign investors into priority sectors is one of the key platforms for achieving economic diversification, yet the evidence from the inward investment in non-extractive sectors suggests that much of the work of diversification still remains to be done. FDI inflows and exports from Kazakhstan are still highly concentrated (more than 70%) in natural resources, and the bulk of the GDP is mostly based on the oil and gas industry.

The table 6, we can see the real distribution of the FDI in the different sectors of economy in Kazakhstan, which can prove the fact that natural resources are the most attractive field for FDI.

Table 6. **Distribution of FDI into sectors in Kazakhstan in period 1992-2011**

Sector	FDI, $mln	%	Sector	FDI, $mln	%
Agriculture	75	0.1	Distribution	3293	3.7
Extractive industry	64348	72.3	Hotel and restaurant	165	0.2
Manufacturing	8592	9.7	Transport, pipes	234	0.3
Electricity	519	0.6	Telecommunication	792	0.9
Construction	1486	1.7	Finance	5266	5.9
Other	4180	4.7			

Source: www.invest.gov.kz, www.mfa.kz

In order to support broad-based economic development and mitigate some of the macroeconomic volatility associated with fluctuations in global commodity prices, the government of Kazakhstan has elaborated long-term plans of diversifying its economy away from natural resources. Attracting foreign direct investment into priority sectors of the economy is one of the key platforms for diversifying the economy away from natural resources. Of course, the government and its regime and way of implementation of these goals will determine the success of this issue.

In recognition of reforms – include demonopolization, debt restructuring, custom and tax reform, establishing security and exchange commission, liberalizing trade and reforming the banking sector – Kazakhstan was granted market economy status in 2002 by the United States. The OECD Investment Guide to Kazakhstan produced in 1998 noted that "Kazakhstan has introduced a convertible currency, has completed a large

part of its privatization program and is undertaking radical reform of pensions, financial services, competition legislation and public sector institutions".

In order to diversify the field of investment, the government of the country has made considerable efforts to remove bureaucratic obstacles, as measured in the World Bank's Doing Business rankings. However, attracting FDI in non-extractive sectors requires more things to be done. At the same time, one of the most important things to achieve the targets is establishing the strong regulation system which can provide free activity of FDI in the country.

4.2. Regulation system and investment incentives in Kazakhstan

If we look at the current situation, today Kazakhstan still has no general screening mechanism for foreign investment and few sectoral restrictions (OECD report on Kazakhstan, 2012). The constitution of Kazakhstan provides the same rights and obligations to foreign entities and individuals as to Kazakhstani citizens, unless specified elsewhere in legislation. In terms of the typical statutory restrictions on FDI found in other emerging economies, Kazakhstan is relatively open to foreign investment. Foreigners may invest in any sector, with equity limits in only a handful of sectors. But at the same time, a number of measures introduced in the past decade to diversify the economy and create greater local value added from foreign investments (particularly in the subsoil sector) have increased operational restrictions on foreign investment and added greater uncertainty for investors.

Although Kazakhstan has an investment law from 2003 governing both foreign and domestic investment, many other pieces of legislation concern foreign investors. For example, in the oil and gas sector, the biggest sector of the economy, main laws and regulations governing the sector are the Subsoil Law and the Tax Code. Other prominent legislation includes the National Security Law, Laws on Arbitration, the Law on Special Economic Zones and rules on hiring foreign personnel.

The Law from 2003 offers guarantees of legislative stability, but these guarantees do not cover the following:

- changes in the legislation of Kazakhstan or legislation coming into force, or alterations in international treaties signed by Kazakhstan that change the procedures for the import, production and sale of excisable goods; and
- changes and amendments made to legal acts of Kazakhstan to ensure national security and environmental safety, health or public morality. Excisable goods such as oil are not guaranteed stability, law promises guarantee only for stability for contracts.

Tax Code (2001) has faced changes several times and with each change became more restrictive for the extractive sector. Finally the new tax code was adopted on January 1, 2009. The overall aim of the new tax code was to shift some of the tax burden away from small and medium-sized enterprises and the non-extractive sector. At the same time, it aimed to make the extractive industries more restrictive.

Beginning from January 2011, the rate of corporate income tax was reduced from 30% to 20%. At the same time, a number of tax concessions were eliminated, including a

corporate income tax exemption for up to ten years and property and land tax exemptions for up to five years.

In accordance with the law of the Republic of Kazakhstan, January 8, 2003 act "On Investments" stated that by entering into a contract with the Investment Committee of the Ministry of Industry and Trade of the Republic of Kazakhstan, investors may be given the following investment privileges:

- Exemption from customs duties of imported equipment, its components, raw materials and spare parts required to implement investment project;
- State natural grants: plots of land, buildings, structures, machinery and equipment, computers, measuring and control instruments and devices, vehicles, except for cars, industrial and household equipment;
- Tax benefits for the period up to 7 years for investment strategic projects (land tax - 0%, property tax - 0%);
- Industrial taxes for investment strategic projects in the regions with low level of socio-economic development (reimbursement or payment of the part of expenses connected with gas, electric energy, purchase of land plot, purchase or construction of buildings, structures);
- Tax allowances: value of preference entities and (or) the subsequent costs for upgrading reconstruction can be related to deductions over a period up to three years. Term for tax loss carry forward is 10 years.

Also, there are nine special economic zones in Kazakhstan. Investors are additionally exempted from paying corporate income tax (CIT), with an application of a zero factor to the corresponding rates; assessing land tax, with an application at a rate of 0% to the mid-year value of taxable items when assessing property tax; VAT exemption for sale within a SEZ; and zero taxes on land rent for up to 5 years.

Also, the investment projects located in the "PIT" special economic zone are exempted from the social tax, if tax laws are being kept. According to the principle of extraterritoriality, legal entities registered outside of "PIT" SEZ are considered as SEZ participants if the law "On Special Economic Zones" and tax laws are observed as required. Software depreciation rate also increased to 40 per cent (15% in general regime).

In "Astana-new city," special economic zone investors are exempted from VAT rates on goods that are used up in construction and put into operations infrastructure, hospitals, clinics, schools, kindergartens, museums, theatres, educational institutions, libraries, sport centres, administrative and resident buildings in compliance with design specifications, according to the list of goods determined by the government of Kazakhstan

The list of priority activities approved by the government of the Republic of Kazakhstan, which includes agriculture, manufacturing (food processing, textile industry, wood processing, fabricated metal products, machinery and equipment, electrical equipment), transport, tourism, and rental housing.

4.3. World Bank, Business dealings in Kazakhstan

The regulation and taxation system in Kazakhstan concerning the oil and gas sector is relatively non-stable, which leaves investors in the sub-soil sector open to various changes in tax legislation, including those concerning royalties and production sharing, environmental fees or other regulatory levies, and special fees by regional or local authorities (Mack, 2006). According to the OECD report "FDI Regulatory Restrictiveness Index", Kazakhstan ranks 12th out of the 51 countries included in terms of regulatory restrictions on FDI, with a total score of 0.137. The score is 1.7 times the OECD average; it shows more statutory restrictions on FDI than Ukraine, but relatively fewer than in the Russian Federation.

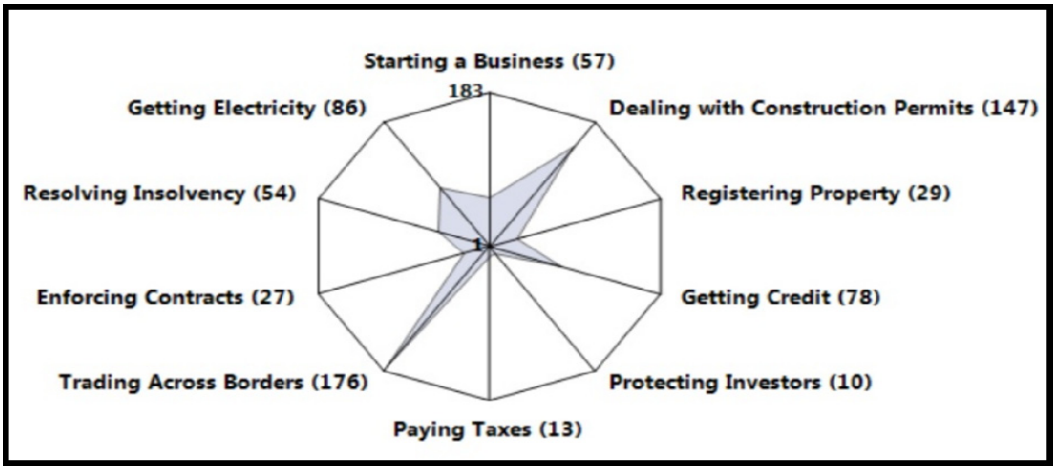
Sectoral restrictions mostly involve limits on foreign equity ownership in air transport, media, telecommunications and certain financial activities. Certain sectors also face operational restrictions in areas such as branching. By sector, Kazakhstan is more restrictive than the average for OECD countries in most of the principal sectors with a few exceptions (figure 8). Kazakhstan is also more restrictive than both the Russian Federation and Ukraine in a number of sectors, notably media and telecommunications and agriculture and forestry.

The government has made administrative simplification, international competitiveness improvement, and in its Doing Business rankings a high political priority. The 2007 Licensing Law reduced the number of licensed activities.

State registration was streamlined in 2012 to facilitate the establishment and operations of small and medium-sized enterprises through the following measures: a) simplified registration for small enterprises and for legal entities carrying out their activities on the basis of the model charter; b) minimum capital requirement for limited liability companies was reduced to roughly USD 1000 and for small enterprises set at only KZT 100; c) obligation for small businesses to submit notarized constituent documents was abolished.

According to the World Bank Report in 2012 on Doing Business, Kazakhstan's performance was quite high. At the time, Kazakhstan ranked 47th in terms of the overall ease of doing business among 183 world countries, and highest in Central Asian economies (figure 19).

Figure 19. **Kazakhstan's business doing ranking, 2012**



Source: World Bank, Doing Business 2012.

From the figure we can see that Kazakhstan had different rankings in different sectors. For example, in protecting investors, paying taxes, signing enforced contracts and registering the property, the country is ranked quite high. However, there is still a need for improvement in a number of sectors, such as provision of electricity and construction permits given.

In terms of trading across the border, Kazakhstan is ranked especially low. Among 183 countries, Kazakhstan's ranking was only 176th. One reason for this is that the country is geographically land locked. Another reason is that the country has not solved the issues related with the joining the WTO.

Chapter Five

Conclusions and implications

5.1. Conclusions

The political situations of these two countries are relatively similar to each other. First, both countries are politically stable, which can be a positive asset for attracting more FDI. Both countries announced independence in 1991 after the collapse of the USSR, and today Kazakhstan and Uzbekistan are ruled by their first governments, which were elected in 1991.

In terms of corruption, according to the OECD report both countries have shown high corruption levels among government officials. According to the OECD, today Uzbekistan has higher corruption levels among government officials, and corruption in the country was stated as a pervasive. At the same time, Kazakhstan pushed through a number of positive changes to reduce the corruption. In recent years, corruption in Kazakhstan has significantly decreased (OECD, 2012).

Based on the analysis on the conditions of the two countries as noted above, Kazakhstan has the largest economy in Central Asia, with the almost 70% of total GDP of the region. Kazakhstan's GDP in 2011 was $188.1 billion, which is four times larger than the economy of Uzbekistan for that period. It is essential, that Kazakhstan with the largest economic size, attracts more FDI than Uzbekistan. Also Kazakhstan has a larger GDP per capita relative to Uzbekistan, so Kazakhstan has a bigger capacity for demand,

even if the demand market in Uzbekistan (30 million) is almost twice the size as Kazakhstan's demand market (16.3 million).

In regards to the inflation rates in Kazakhstan, it was 6% in 2012. Uzbekistan has also maintained the stable inflation rate of around 7-8% during recent years.

Kazakhstan and Uzbekistan are still not member countries of the WTO. Even though Kazakhstan started negotiations on joining the WTO a long time ago, the process is not successfully finished. Kazakhstan has still strong restrictions in many fields, which are not acceptable under the accession criteria.

Kazakhstan participates in a customs union with Russia and Belarus. Uzbekistan is not in membership in FTA agreements. At the same time, both countries have signed a number of MFN agreements with other countries. According to the World Bank Business Doing report, Kazakhstan has better conditions for doing business (47th) when compared with Uzbekistan (166th). Particularly, it has more attractive conditions in terms of investor protection, the tax payment system, registering property and starting a business.

FDI is very important for both of the countries, and they are focusing on attracting FDI and improving the environment inside the country. In terms of infrastructure availability, Kazakhstan, with its larger economy, can provide more progressive infrastructure for investors. At the same time, we should notice that the sector of transportation and communication in Uzbekistan is the second largest sector in attracting FDI. This sector has attracted almost 35% of total FDI into country. This

means Uzbekistan is improving the roads and communication system, which is a very important part of infrastructure.

Both countries have very similar conditions and attitudes in terms of business facilitation and support. They are providing whole portfolios of incentives for foreign investors, including tax holidays, exemptions from custom duties in import of products for project implementation, and other economic incentives. These are very important for countries that want to remain attractive destinations for FDI.

The higher corruption and low ranking of Uzbekistan by the World Bank in investment protection are large barriers for investment facilitation. Kazakhstan today, in order to maximize the effect of the investment into oil sector, has been trying to avoid the strong concentration FDI inflow into the field. It has been working to diversify the investment fields in the country by putting more restrictions on the oil sector and giving more relieves and incentives for investors who invest into other sectors.

In the case of Uzbekistan, the government is providing additional portfolios of FDI incentives and privileges for investment outside of Tashkent, as FDI is strongly concentrated in this region. Also the two countries organized SEZ and SEIZ, in which investors are provided with the large amount of incentives.

Both countries are resource abundant countries. Kazakhstan is the 6th largest country in terms of resource reserves, with very large oil reserves. This is the most attractive recourse for investors. Uzbekistan is also rich in natural resources and raw materials, such a gas, uranium and other metals; however, it is still not as rich as Kazakhstan,

particularly since there are no very big oil reserves in the country. According to these conditions, Kazakhstan has a larger natural potential for attracting more FDI.

In terms of market size, it was noted that Uzbekistan has almost twice the population of Kazakhstan, and this should mean a larger demand and market. However, Kazakhstan has a demand four times larger at $11356.6 (PPP $13099), while Uzbekistan GDP per capita is $1546.0 (PPP $3288). This shows that Kazakhstan's GDP per capita is 7 times larger than in Uzbekistan, which means a larger purchasing capability. In recent years, both countries have experience very stabilized economic growth. They are maintaining their annual GDP growth rates at around 7-8%.

The level of regional integration in two countries is also very similar to each other. They are both not members of the WTO or other FTA agreements. They are both in a regional SCO agreement. But at the same time, Kazakhstan has a customs union with Russia and Belarus.

The labour cost in Uzbekistan is relatively cheaper than in Kazakhstan, which can be another favourable determinant for FDI. According to the World Bank, both countries have very high literacy rates in their population, which is above 99%.

The culture differences are quite large between the two countries, as there are a lot of nations and ethnic groups with different culture and religions living within the countries. In Uzbekistan, for example, there are more than 130 nations and ethnic groups.

If we take the amounts of FDI attracted into Kazakhstan and Uzbekistan, we can see a big difference in distribution. Kazakhstan has been much more successful in this area.

As seen above from 1992 to 2000, FDI in Kazakhstan was relatively smaller than now. In 2001, FDI increased from $1,283 million to $2,835 million. Also after 2005, FDI increased by more than a factor of three, from $2,550 million to $7,610 million in 2006. According to relevant research, this has been mostly caused by the rapid growth of the price of oil. As a country with large oil reserves and large amounts of oil exports, FDI into Kazakhstan has increased dramatically.

It is expected that Kazakhstan, with its larger economy, can attract larger FDI. Still, if we look the share of FDI in the GDP, we can see that in from 1992 to 2000, the share of FDI in total GDP of Kazakhstan moved from 4% to 7%. In 2001 increased from 7% to 13% as a result of price increases. Then in 2004, this share decreased to 4%, which is very small when compared to the level in 2000. The rapid price increase for oil in 2005 increased the share of FDI in the total GDP from 4% in 2004 to 19% in 2005. In 2011, it was back down to 7%.

In case of Uzbekistan, the share of FDI in total GDP from 1994 to 2007 steadily increased from 0.7% to 8.6%, and in 2008 increased rapidly to 12.7% and then to 16% in 2009. Mostly, FDI in 2008-2009 increased as a result of rapid growth of the amount of FDI in the transportation and communication sector. FDI into this sector was $597 million in 2007 and $1.67 billion in 2008. It increased to $3.078 billion in 2009. In 2012, the share of the FDI in total GDP of Uzbekistan was 7%.

When looking at the average share of FDI in total amount of GDP from 1991 to 2011, we can see that in the case of Kazakhstan, it was 8.1%, and in the case of Uzbekistan this number was 7.2%. In this regard, it is possible to state that FDI in Kazakhstan holds a larger share in total FDI of the country and has been more successful in attracting FDI.

Kazakhstan has larger economy and is attracting more FDI than Uzbekistan, and this is the main factor of such a big difference - having such unequal amounts of FDI between these two countries is due to the size of the economy. But at the same time, both countries can be more successful in attracting FDI. It is very important to improve their regulation system of FDI, support, incentives and privileges for investors.

5.2. Implications

In order to improve the investment environment in Uzbekistan, the most important goals are to enlarge the amount of FDI, achieve sustainable development of the economy and diversify the location of FDI.

Uzbekistan has a relatively weak reputation, which makes the country less attractive for investors. In order to improve the environment for FDI, the country should progress in many sectors. However, the most important issue is to change the system of regulation of FDI.

Today the problem of Uzbekistan is not, which is very typical for many developing and less developed countries. These countries do not have one only entity that can represent

the interests of the country and the interests of investors on every level. Usually for developing countries, it is very typical that the decision-making process is dependent on the decision of not one government office, but a number of entities that can have different ideas about investment. As a result this can turn the decision-making process into the main impediment for investment activity, making the reputation of the country less attractive.

For foreign investors to be more comfortable and attractive, Uzbekistan must organize a one-window system – in other words, to authorize one only organization to deal with the problems completely. This practice is not new in the world. Many developed countries have built this kind of organization attractive for FDI and efficient for decision-making related to the activities of foreign investors in the country.

For example, Korea has one of the most successful cases in history for economic progress. Korea used to have very similar problems with FDI attraction before establishing the Korea Trade-Investment Promotion Agency (KOTRA). Originally this agency was established in 1962 for trade facilitation purposes, but in August of 1995, cross-border investment promotion and support for technological and industrial cooperation projects were added to KOTRA's mandate.

KOTORA currently operates Invest KOREA, the national investment promotion agency. Originally initiated as the Korea Investment Service Center (KISC) in 1998, the agency was re-launched as Invest KOREA in November of 2003 to support foreign investors by offering more powerful incentives and an expanded range of services.

Today KOTRA has its 120 branches (Korea Business Centres) operating in over 82 countries.

Similarly with the Korea's KOTRA, Uzbekistan has the "Uzinfoinvest Agency," which was founded under the Uzbekistan Ministry for Foreign Economic Relations, Investment and Trade. Today its main activity and goal is to promote FDI into Uzbekistan. Even though the agency provides information and services to foreign investors, and it cannot represent the interests of investors on every level. One of the ways to solve this issue is to increase and strengthen the activities of this agency, giving it more authority and support and trying to open branches of the agency abroad. Organization of one agency that can deal with the all issues related to FDI in the country can increase the amount of FDI and make the country and its investment environment more attractive for foreign investors.

The second goal is related with the current trend of the location of the FDI in the country. FDI in Uzbekistan is heavily concentrated in certain areas. For instance, the Tashkent region has attracted 70% of the total FDI into the country. This can have some negative side effects, such an uneven regional development and unequal improvement of the standard of living for people in the country. Therefore one of the main goals of the government should be to attract FDI into other regions, as well. However, there are a number of challenges for Uzbekistan.

In order to achieve those goals, Uzbekistan's government organized a SEZ in the Navoi and Angren regions where investors can enjoy additional incentives. This plan can be considered successful since it has actually led to development in those regions

Uzbekistan is the 6th largest producer of raw cotton in the world and all regions of the country produce raw cotton, which is a very important foundation for developing the textile industry in the regions. In this regard, government is emphasizing in development of infrastructure in the regions to promote FDI for those areas.

Also there is possibility to develop the food production industry in all regions of the country, as every region has high potential in agriculture and cattle breeding. Also in the neighbourhoods located near big rivers and lakes, the fishing industry can be promoted.

Tashkent is the most developed region in the country, and it is also its capital city. Furthermore, it is the city where the most educated population is concentrated. In this regard, Tashkent has a comparative advantage for being financial centre. High skilled and educated labour abundant industries, as well as the other industries, can be developed in the region.

The regions of Karakalpakstan, Navoi, Bukhara, Kashkadarya, Surkhandarya and Tashkent (not the city) are very rich in natural resources, such as oil, gas, gold, uranium, iron, aluminium, and copper, silver and different construction materials. This fact shows that these regions have high potential for developing the natural resource processing industries.

The Khorezm, Bukhara, Kashkadarya, Samarkand and Tashkent regions have a very rich history, and the tourism industry has been developing dynamically. Specifically, the Tashkent and Surkhandarya regions and Fergana Valley have high potential for sport tourism and summer tourism. Nevertheless, it seems that Uzbekistan is fully utilizing its resources and opportunities for attracting more FDI for the tourism sector.

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ACKNOWLEDGEMENTS

First of all, I want to thank everyone who participated in the organization of such a wonderful course over the past 14 months. Being a part of this program, I highly appreciate the opportunity given to me and have enjoyed the company and friendship of every person I was able to meet during that period.

In this regard, first of all I would like to express my gratitude to all the professors,as well as all lecturers for the very useful experience and the knowledge that they have shared with us during this time.

My special gratitude goes to my adviser, Professor Ahn DukGeun for his guidance and good counsel throughout the writing of this thesis and the program manager, Professor Eun Ki-Soo. I also thank all the other staff members of MIDP for their kind assistance and friendship during the whole program.

Also, I want to say only the best words about my group mates for their great attitude and friendship. I wish to stay in touch with all of them, with no exception.

Last but not least, I wish to thank my family in Uzbekistan and also my office for all their love, support and encouragement throughout my studies.

Today the only thing I regret is that this wonderful time is coming to the end and has passed so fast. I will miss all of these wonderful experiences in the future.