Macroeconomic Grounds for Countries' Participation in Integration Projects

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Today's global economy is characterized by a rapidly forming of new institutional structure, infrastructure and competitive environments, a significant element of which is the growing importance of emerging economies and their increasing influence on the dynamics of global economic processes.

Of course, such processes require significant domestic and external investments, as well as strengthening of integration relationships and opportunities. Of great importance are the large emerging countries that are on the way to becoming new global leaders and whose success may contribute to the development of a wide range of relatively small countries (for the latter, entering the highly competitive markets of developed countries on their own is not easy).

It should be noted that the global economy requires permanent strengthening of international economic ties in general and investment relations in particular. It is well known that the emerging countries which managed to maintain their investment attractiveness and to avoid an investment collapse during the global crisis have achieved much better results in the post-crisis recovery (as compared to other countries): higher economic growth, stronger competitive positions, and broader integration options. Moreover, the leading emerging countries were able to strengthen their economies by merging their national investment flows with the global ones, and by taking full advantage of the value added by the business environments of their partner countries (mostly emerging ones) for their own networks.

Despite certain protectionist moods that have re-emerged in the crisis and post-crisis periods, we have gained a deeper understanding of the need for expansion of transnational production and infrastructure projects for further development, which also means a new level of modern integration processes.

The initiative of creation and implementation a transcontinental project – the New Silk Road – is justly regarded as one of the global integration models with the highest future potential. Indeed, this project may be able to update the system of international trade, investment flows, competitive environments, integration networks, etc.

This publication is dedicated to analytical research of the macroeconomic condition and development of post-soviet countries that can take an active part in implementing the mentioned initiative. However, the analytical report presented here should be considered only as the first stage in systematic research of the economic and institutional effects, benefits and risks for the countries.

1. Emerging the "New Normal" of Transcontinental Integration

The global economy is overcoming the consequences of the global crisis of 2008-2009. Although the average annual economic growth rates in the post-crisis period are lower than in the decade before the crisis (3.5% vs 4.2%), we can say with confidence that the risks of new global recession indicators are decreasing from year to year[1]. At the same time, however, the changed economic environment poses new challenges that, if underestimated, may lead to new crisis losses. However, timely and accurate assessment and limitation of these challenges will enable the involvement of appropriate sources of growth and development.

Structural Renovation of the Global Economy. The global economic environment creates additional **requirements for the constituent elements of economic recovery and long-term growth.** This concerns, first of all, countries taking the appropriate positions in so-called *Global Value Chains*, where the production, technological and marketing processes flow with involvement of an ever-growing number of companies and countries (with transnational corporations playing a dominant role). Hence, the place in such chains is a determinant feature of both the competitive and integration capabilities of individual countries and their economic unions or associations[2].

It is thought that a country's weight in the global economy can be assessed through the so-called *Participation Index in Global Value Chains*[3], which can at the same time serve as a certain criterion for the country's economic competitiveness. For example, the highest indices among developed countries are those of South Korea, Finland, Switzerland and Germany, and among the emerging countries those of Malaysia and Thailand, whose competitive positions are rather strong.

It should be mentioned that while the last decades of the past century were mostly characterized by a concentration of production facilities allowing for extensive use of the absolute and relative advantages of individual countries (access to primary resources, cheap labour force), the **characteristic features of today's economic integration processes** include:

- **Expansion and extension of value chains** involving companies and countries not only on a regional but also on a transcontinental level;
- Periodic **displacement of links in such chains** with regard to the development level of individual member countries. Thus, while initially a substantial part of production processes was concentrated in Japan, after which the "Asian tigers" and China took the lead, today more and more other countries in Southeast Asia are coming into play;

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[1] For the most part we adhere to this point of view, though there is an opposing one that the global economy is under pressure from new risks and will be exposed to more waves of crisis in the nearest future.

[2] In this regard, the following factors should be mentioned. The "traditional" competition of goods, services, and other products is more and more often said to be devalued. It has been replaced with competition between management models and systems both in the corporate sector and on the government level. See, in particular: P. Kalyta. Ukraine and the Fourth Industrial Revolution: Threats and Opportunities. – *http://www.ukrrudprom.com/digest/*. However, this is probably in line with the expansion and growing significance of inter-country integration processes, and in fact requires new management levels.

[3] It is measured as a percentage of foreign intermediate goods plus domestic intermediate goods used in third country exports relative to the country's total exports. For more information, see: Prospects for Ukraine's Entry into Emerging Markets (ukr.). / *Scien. edit. V. Yurchyshyn*. – Kyiv: Razumkov Centre, 2015, 124 p.

- **Strengthening of the investment component** in creating value chains. To reach a proper level of competitiveness it is becoming more important not only to transfer goods, raw materials, semi-finished products and other components of production processes, but to provide investment support for such processes. For this reason, **mutual penetration of investments,** as well as business mergers and takeovers in partner countries will continue and will further expand;
- **Institutional support** for productive and effective joint efforts by partner countries, and encouraging further involvement of human and financial capital to improve business performance, primarily in terms of avoiding double taxation, ensuring mutual protection of investments, security of direct foreign investments, proper employment of labour force, etc.

However, it should be noted that the globalisation processes in the post-crisis period are more often subject to revision. The crisis of 2008-2009 entailed a large-scale revaluation of the goals, incentives, and components of economic integration in both developed and emerging countries. This is largely due to the fact that the international focus and transparency of the economy make it (the economy) more dependent on the external environment as well thus increasing the risk of importing external adversities. However, despite the challenges, **economic integration remains the key element of the growth and development strategy**.

Speaking about the latest challenges, it should be mentioned that during the crisis period elements of protectionism were often used as one of the "renovated" areas of economic policy (to protect the domestic markets and industries). At the same time, it is the **inclusion** of production facilities and countries **in the global chains that to a large extent limits the scope of protectionist measures**, as "protection" against imports may undermine export opportunities (resulting from a rise in the cost of production components).

However, a relatively insignificant recovery of the global trade that was an engine for global economic growth in the pre-crisis period raises certain concerns among international experts. In recent years real trade growth indicators have demonstrated almost the same growth rates as the global GDP (see the chart "*Global GDP and trade growth*"[4]). Meanwhile, if the nominal global GDP (at current exchange rates) grows from (US Dollars) $65.5 tr. in 2011 to the expected $77.8 tr. in 2017, the estimated global volumes of exported goods and services will even slightly decrease, from $22.2 tr. to $21.7 tr. respectively.

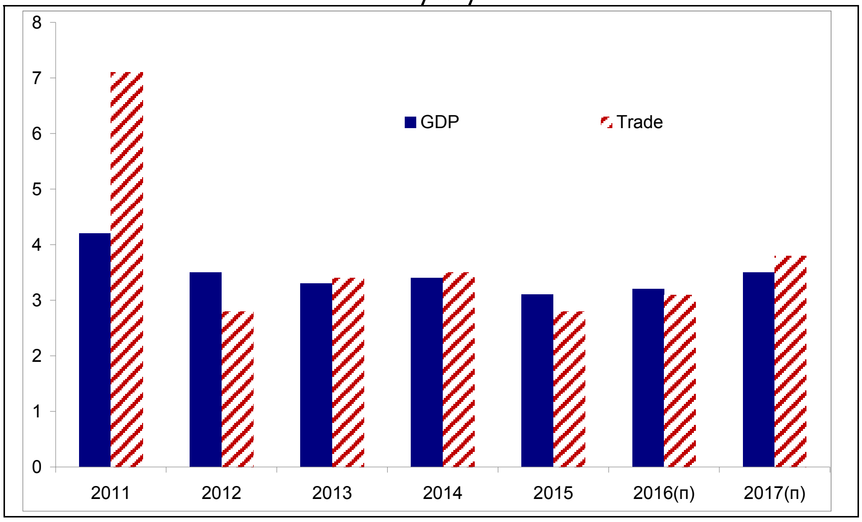
This contradiction is related to **a sharp decrease in the value of primary resources** (first of all, oil) on the global markets in 2014-2016. Of course, such price fluctuations may be the basis for a rapid increase in the value indicators of international trade in a medium-terms due to growing volume of the energy resources (though most estimates show that the increase in the price of exchange commodities will be insignificant). However, in the near future international trade will most likely not be a global accelerator, which may also slow the dynamics of the world economy and reduce the effectiveness of labour distribution.

In the post-crisis period, another feature of modern global business ties became clearly apparent as a "compensation" for the slowing dynamics of international trade. The trade volumes between emerging countries (in the so-called South-South links) are consistently growing, and emerging countries have considerably higher export and import rates than developed countries (see the table "*Trade growth in developed and emerging countries*"[5]). Of course, the key driving force behind this outstripping is that the economic growth in large

[4] World Economic Outlook (issues from various years). – *https://www.imf.org/external/ns/cs.aspx?id=29*. [WEO]
[5] [WEO].

successful emerging countries (first of all, China and India) significantly exceeds the growth in the largest developed countries that determine the global demand and supply.

Global GDP and trade growth,
% y-o-y



Trade growth in developed and emerging countries,
% y-o-y

	2009	2010	2011	2012	2013	2014	2015
Exports,							
Developed countries	-11.8	12.3	6.3	2.0	3.1	3.3	3.2
emerging countries	-7.7	13.6	7.4	4.4	4.6	3.4	5.3
Imports,							
developed countries	-12.2	11.7	5.5	0.9	2.1	3.3	3.3
emerging countries	-7.9	14.1	9.8	6.0	5.5	3.7	3.5

By increasing the volumes of mutual trade and investments, the emerging countries not only support their competitiveness and increase current income, **but also diversify their** export products and markets, which is an **additional global stabilisation factor**. Addressing the tasks of diversification is part of institutional support for mutual trade and investments, in particular, in terms of[6]:

- **finding partners** both for domestic manufacturers and foreign investors, and for foreign economic agents domestically;
- **information and legal support**, and providing full and transparent information as to the specifics of individual markets and countries;
- **reducing** the causes and elements **of price discrimination** with respect to both the exporters and the importers of goods, services and investments;
- supporting the projects for **the improvement of telecommunications, transport, customs and port services, logistics hubs,** etc.

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[6] For details, see: O Kanuto. Global Challenges of Integration (rus.). – *http://www.vsemirnyjbank.org/ru/news/speech/2013/01/16/*.
Prospects for Ukraine's Entry into Emerging Markets (ukr.). / *Scien. edit. V.Yurchyshyn.* – Kyiv: Razumkov Centre, 2015, 124 p.

China's Growing Expansion and Benefits for Emerging Countries. Needless to say, China is and will remain an indisputable leader in expanding global trade by continuing **its trade and investment expansion** despite the continuing crisis processes in many countries. And EU countries are one of the most attractive areas for such expansion. By extending trade relations with European countries China expects to gain substantial future benefits, as the EU is one of its largest trade partners. For example, in 2013 exports to the EU exceeded $370 bn. as part of China's total global exports of $2.21 tr. And China's total imports amounted to $1.95 tr., while imports from the EU reached almost $200 bn. The proportions will most likely remain the same over the next decade.

At the same time, the **countries of Central and Eastern Europe (CEE)** have demonstrated much better economic dynamics in recent years as compared to the "old" EU countries and are becoming increasingly important for China's economic expansion. For example, in 2015 the trade volumes between China and the 16 CEE countries[7] amounted to $56.2 bn. (growth by over 25% as compared to 2010). China's investments in these countries exceeded $5 bn., and investments from CEE in China amounted to $1.2 bn.[8]

That is why enhancing the deliveries of goods from China to the EU and from China to CEE in particular is attracting significant attention[9]. At the same time, today's global challenges call for alternative delivery processes and for the involvement of new countries in cross-border trade, including with regard to new geopolitical and geo-strategic changes.

Thus, the escalating competition requires prompt transportation of large volumes of raw materials and products. And **the increasing political and military tension**, as well as the high risks of escalation and expansion of hostilities to new countries and regions make it necessary to **search for new transcontinental projects** to maintain the economic ties between partner countries even in adverse geopolitical and international economic environment.

China is looking for new optimal ways of making deliveries to Europe and is making investments into the infrastructure of the countries that have significant development potential or that can be used for transit[10]. China is already implementing large-scale infrastructure projects in CEE[11] that will allow it to ensure stability in shipments.

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[7] CEE-16 includes: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia, Slovenia.

[8] '16+1' mechanism opens up new chapter of China-CEE cooperation. – *http://www.china-ceec.org/eng/zdogjhz_1/t1413792.htm.* See also: A. Goncharuk, S. Koshovyi. The Silk Road: From a Concept to Practical Steps (Interaction Format (16+1). – *http://www.tianxia.link/uk/article/*.

[9] Until recently, a vast majority of Chinese export products to the EU's markets were transported by sea. The goods produced in the western regions of China were first transported to the east coast by rail, and only then by sea to countries around the world, including Europe. Sea transportation is relatively inexpensive and does not require any customs procedures on the borders of transit countries. For the EU member countries sea deliveries require customs control only in the EU country that has seaport access.

Since the majority of goods transported between China and Europe do not have a short shelf life (equipment, electronics, clothes and other end-use goods), their owners are generally satisfied with sea transportation, as land transportation is much more expensive, and the customs and border procedures make the overland route less attractive. However, the geographic and time requirements will naturally become more rigid.

[10] China's New Grand Strategy for Europe. – *http://www.tnc-online.net/pic/20150207120233561.pdf.*

[11] Export strengths and competitiveness of China and CESEE in the EU-15 Market. – *https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1559.pdf.*

In this context, after several years of discussion, China's initiative for creating the **Silk Road Economic Belt**, with the **New Silk Road (NSR)**[12] as its constituent element, has finally reached the stage of practical implementation. The international organisation **TRACECA**, which consists of 13 member countries, including Ukraine, plays an important role in **transporting *cargo* on the China-EU route** [13]. There are several transportation corridors that have been tested within the scope of *TRACECA* and in the context of **the NSR** with regard to the geographic features of the member countries and the political and economic capabilities for strengthening integration.

The first of these, already in partial operation and for now the most cost-effective, is through Kazakhstan, Russia, and Belarus. ***The second*** goes through the countries of Central Asia (including Kazakhstan), Transcaucasia, Central and Eastern Europe (including Ukraine). Though this option is currently expensive, the route goes through dynamically emerging post-soviet countries whose involvement will provide substantially more benefits for all member countries in a long-term perspective. *The third route* is through the geographically and politically problematic territories of Afghanistan, Iran and Turkey, and is doubtful for fast implementation.

TRACECA's strategy focuses on creating a stable infrastructure transportation chain with its subsequent integration into the system of trans-European transport networks. Obviously, the *TRACECA* project is closely related to the Chinese NSR initiative. China has already established the Silk Road Fund within the scope of the NSR, in the amount of $40 bn.[14] and also the Asian Infrastructure Investment Bank (AIIB) with a capital of $100 bn.[15] And the countries of Central Asia and Transcaucasia are now increasingly involved in China's investment projects, and in the NSR in particular.

A number of post-soviet countries interested in the NSR (including Azerbaijan, Georgia and Kazakhstan) were among the founders of the AIIB[16]. The bank's shareholding countries (the share in the bank's total capital is determined based on the member countries' GDP) will be able to influence the development of economic and investment policy (in Transcaucasia and Central Asia, including the NSR project).

Generally, despite the high risks, China's current expansion opens up broad opportunities for emerging countries to be involved in transcontinental integration projects, including the NSR. Moreover, **the benefits for individual participants may lead to a synergistic effect** of multiplied prosperity and enhanced development prospects.

This, of course, requires determining absolute and relative production, trade, investment, communication and logistics advantages that can be used as the basis for clear **common opportunities and benefits**. Let us recall that during the integration of CEE countries for

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[12] Great prospects and practical actions for joint creation of the Silk Road Economic Belt and the 21st-century Maritime Silk Road. – Website of the Ministry of Foreign Affairs of China. – *http://www.fmprc.gov.cn/rus/zxxx/t1254925.shtml*.

[13] TRACECA has official status as an inter-state commission. See: TRACECA: **Tra**nsport **C**orridor **E**urope-**C**entral **A**sia. – *http://www.traceca-org.org*.

[14] Silk Road Fund. – *http://www.silkroadfund.com.cn/enweb/23773/index.html*.

[15] The Asian Infrastructure Investment Bank. – *http://euweb.aiib.org/html/aboutus/introduction/aiib/?show=0.*

[16] Currently, the bank's shareholders include 57 countries, the largest of which are China, India, Russia, Germany, and other European countries. The AIIB's statutory capital is 100 billion US dollars. China holds the largest portfolio, giving it veto power over the institution's decisions. International experts expect the AIIB to become a competitor of the IMF, World Bank, and EBRD. For details, see the article by S. Koshovyi "New Geo-economic Configuration of Eurasia: One Belt, One Road". – Prospects for Ukraine's Entry into Emerging Markets (ukr.). / *Scien. edit. V. Yurchyshyn.* – Kyiv: Razumkov Centre, 2015, 124 p.

joining the EU, much analytical research was dedicated to various issues of macroeconomic stabilisation, convergence of institutions, formation of joint visions and mechanisms of conflict resolution. Unfortunately, there is only a small portion of researches on the integration processes in the context of the Silk Road Initiative in the post-soviet space.

This is why we believe that comparative analysis **of macroeconomic development, the investment environment and institutional capacity** for supporting integration expansion of the countries that will take an active part in the NSR project, first of all the countries of the transcontinental infrastructure project with the highest potential – Kazakhstan, Transcaucasian countries (Azerbaijan and Georgia), and Ukraine (AGCU)[17] – is essential and expedient and will provide deeper insight into the transformations required with regard to the implementation of the transcontinental NSR project.

Let us also recall that the GUAM integration association (Georgia, Ukraine, Azerbaijan and Moldova)[18] had a "close geography", but played more a political role rather than functioning as a reliable tool for economic growth, largely due to the lack of realistic systematic consolidating ideas.

Strategic Intentions for Countries of Transcaucasia, Central Asia and Ukraine. After the collapse of the USSR (with its unitary centralised governance system both on the political and economic level), the new countries (former republics):
- experienced a deep **crisis shock** that lasted practically into the late 1990s;
- had no proper institutions or practices of market economy or any reliable financial resources;
- largely remained **under the influence of Russia**, which also had significant economic problems of its own (for example, the disastrous crisis of 1998);
- were only marginally involved in the activities of international financial institutions, trade and economic unions, etc.

Under such conditions the political elites of the new post-soviet countries tried to **find new strategic benchmarks** to renew economic growth and to facilitate development.

Among the **most successful countries** (that emerged out of the former USSR, except the Baltic countries), **Kazakhstan** is worthy of note. Although the country kept its orientation towards Russia (including membership in the EAEC, the Customs Union, etc.), the economic significance of the latter gradually decreased. For instance, in 1992 Russia's share in Kazakhstan's foreign trade was about 80%, but by 2008 this had dropped to 30% (of the total value)[19].

At the same time, Kazakhstan has enhanced its efforts for **new integration processes**. For example, the country has:
- increased its economic focus on the EU, its largest foreign trade partner at present, accounting for over 40% of its total foreign trade volumes;
- intensified its economic cooperation with China (which is currently in third place in Kazakhstan's foreign trade), while China views Kazakhstan as the most significant economic and security partner in Central Asia;

[17] Other post-soviet countries of Central Asia are also willing to take part in the NSR project. For example, Kyrgyzstan, Tajikistan and Uzbekistan are also among the founders of the AIIB and are increasingly involved in the implementation of the Initiative. However, the AGCU countries play the key role for the second corridor, which can be implemented with the involvement of Ukraine.
[18] GUAM Organisation for Democracy and Economic Development was established as an international organisation– *http://mfa.gov.ua/ua/about-ukraine/*.
[19] Kazakhstan's Strategic Significance. – *http://www.eurodialogue.eu/.*

- provided extensive opportunities for foreign investors, first of all the USA (whose direct investments exceeded $15 bn., accounting for one-third of the total inflows).

Moreover, the current efforts of the Kazakh government are generally aimed at creating a modern developed economy in the country by 2050[20], and in particular are pursuing an ambitious goal of forming one of the region's most powerful logistics centres between East and West[21], which would become a central link in the New Silk Road project.

Azerbaijan is also emerging three strategic areas – the EU, the Eurasian Economic Union (headed by Russia) and the New Silk Road, at the same time emphasising its "equidistance" from each of them and expecting to benefit from its neutrality[22].

For now, **Azerbaijan** has very limited economic ties with the EU countries **and** has export revenues only from its oil supplies. The country also is very careful with Russian orientation, first of all because of Russia's position (military support for Armenia) in the so called Nagorno-Karabakh conflict. Azerbaijan's economic contacts with China have also been rather limited, which is why it has broadly supported the Silk Road Initiative with the intention of promoting the country's efforts to join major integration projects.

Of course, Azerbaijan's current strategic development areas are *first and foremost* concerned with substantial expansion and improvement of not only economic, but also political relations with China and the EU[23], and *second*, with increasing the country's participation in NSR projects, which will become one of the important factors in its overall development.

Georgia is one of the countries whose experience of reform should be taken as a model. The country's targeted efforts, first of all, in emerging its business environment (including with regard to the experience of successful post-socialist EEC countries[24]) and joining the EU[25] are generally recognised today (in particular, due to its consistent adherence to the adopted plans for institutional changes[26]).

Though in recent years Georgia has been experiencing certain political conflicts (including as a result of increased Russian pressure), it regularly fulfills **its obligations under the EU-Georgia Association Agreement**[27]. In this context, the country's transit capabilities and the level of investments and Black Sea port development will allow the country to occupy a substantial niche in the NSR project.

For **Ukraine, the importance of the NSR** as a facilitator of integration is beyond any doubt. Moreover, **the EU-Ukraine Association** is an important factor and a stimulus in expanding and strengthening its integration processes[28].

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[20] Kazakhstan 2050. – *https://strategy2050.kz/*.

[21] Between East and West: Kazakhstan's development along China's new Silk Road. – *http://www.osce-academy.net/upload/file/Between_East_and_West.pdf*.

[22] Valiev A. Azerbaijan: Perspectives on Eurasian integration. – *http://www.ecfr.eu/article/.*

[23] Azerbaijan: Country Partnership Strategy (2014-2018). – *https://www.adb.org/documents/.*
"Azerbaijan 2020: look into the future" concept of development. –
http://www.president.az/files/future_en.pdf.

[24] Lessons learned for Georgia: The experience of Visegrad Countries in economic approximation with the EU. – *http://www.ceid.hu/wp-content/uploads/2014/.*

[25] EU-Georgia Association Agreement. – Official Journal of the European Union,
http://www.3dcftas.eu/system/tdf/EU-Georgia%20AA_2.pdf?file=1&type=node&id=137&force=.

[26] Council of Europe Action Plan for Georgia 2016-2019. – *https://rm.coe.int/.*

[27] Emerson M. An Introduction to the Association Agreements between the EU and Georgia, Moldova and Ukraine. – *http://www.3dcftas.eu/system/tdf/Introduction.*

[28] *EU*-Ukraine Association Agreement. – Official Journal of the European Union, *http://www.3dcftas.eu/system/tdf/EU-Ukraine%20AA_1.pdf?file=1&type=node&id=139&force=.*

Unfortunately, for now Ukraine's position in the NSR project is largely at the level of declarations. Ukraine has not demonstrated any interest or ability in sharing in AIIB capital, which may soon restrict the country's investment options. A number of limiting factors prevent **the country from accelerating development of the appropriate infrastructure** that would cover the Ukrainian ports on the Black Sea coast and would be successfully included in the system of sea ways to its northern and western borders.

The importance of these tasks for Ukraine is growing in light of the substantial accumulated disproportions that are slowing economic recovery and forcing the country out of modern global processes. First of all, changes are needed with regard to **the creation of the institutional basis for a competitive economy, strengthening of business and investment potential**, and overall business development, small and medium businesses in particular.

It must be acknowledged that, in the context of the transcontinental NSR project, Ukraine has to promptly eliminate the current shortcomings to increase its economic potential, to facilitate its entry into the global integration environment, and **to strengthen its positions in emerging markets,** including in:

- using Ukraine's transportation potential and emerging it to the level of CEE's transportation capabilities[29];
- joining the **structural, production and service networks** of other countries playing an important role in the NSR, primarily Kazakhstan and Transcaucasia;
- bringing Ukraine directly closer to the Chinese economy by **expanding trade and mutual investments**, first of all with regard to the prospects of the free trade zone between Ukraine and the EU, and Ukraine and Canada.

In the following sections, the author analyses the macroeconomic environment and identifies the areas in which each country has absolute and relative advantages, including institutional support. The findings **can be used to determine the actions** required to improve both the business and the investment environments, as well as the management system on the private and public levels in individual countries, and to provide options for mutual facilitation. And, naturally, **in certain ways we focus more on Ukraine**.

We must acknowledge up front that, even after complex transformations, post-soviet economies cannot yet be regarded as absolutely strong and stable. For example, the AGCU countries, except Kazakhstan, have practically not changed their ratings in one of the most well-known indices, the UN **Human Development Index** (HDI) (see the chart "*GDP per capita and HDI* "[30]). For more than 15 years, the countries have retained their "traditional" ratings within a rather narrow range of 75-85. Only Kazakhstan has somehow managed to improve its indices, though considering its high income from exports of raw materials, the indices might have been even higher.

Here we can clearly see **Ukraine's** losses: with relatively **favourable starting conditions** for development, the country not only failed to facilitate its economic development[31], but incurred major losses in terms of quality of life, which in fact placed the country in the lower half in the HDI rating.

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[29] See, in particular: A. Hamed Ukraine Transport Strategy Alignment within the context of EU Integration. – *http://www.slideshare.net/cityprojectdevelopment/.*
Support to the transport strategy of Ukraine until 2020. – *http://www.transport-ukraine.eu/sites/default/files/images/.*

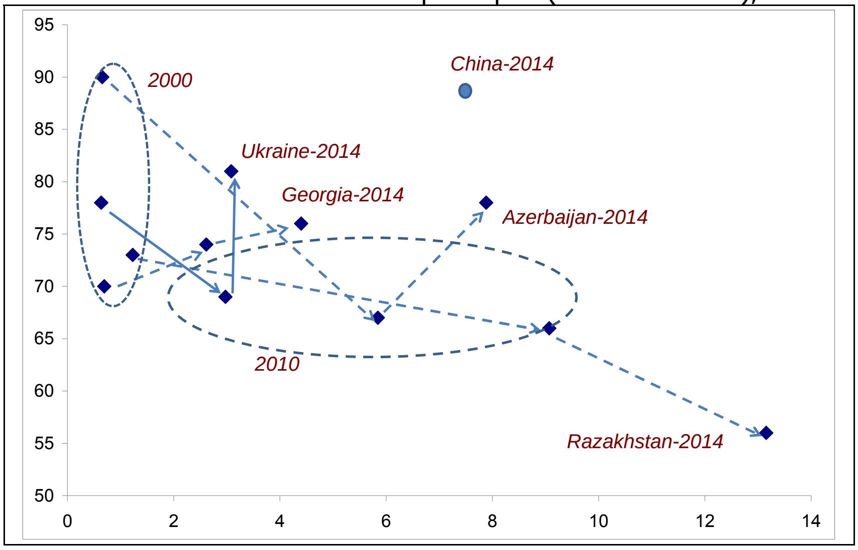
[30] UNDP Human Development Reports (issues from various years). – *http://hdr.undp.org/en/reports.*

[31] In 1990 Ukraine's HDI and GDP per capita were comparable to the European post-socialist countries, and among the former USSR republics Ukraine's potential for successful market transformations was the highest according to international assessments.

GDP per capita and HDI,

Vertical axis: country's rating in HDI (lower places = higher indices),

horizontal axis: GDP per capita (1000 US dollars),



In conclusion, we would like to make another general **comment**. In the era of globalisation, **economic integration**, which is reflected in the acceleration and expansion of trade flows, capital flows, and migration processes, contributes to a rapid **increase in living standards**, reduction of poverty, and improvement of education and healthcare[32]. However, the social and economic achievements may be followed by worsening political confrontations and attempts to solve internal problems by provoking international conflicts and military aggression.

At the same time, global practice shows that **the wider and stronger a country's economic integration relations are, the safer the country feels**. Meanwhile, a country that has not defined its international and integration priorities risks being the victim of political or even military aggression of unscrupulous neighbours.

Ukraine has experienced all the consequences of the aggressive policy pursued by the country that was expected to be the guarantor of peace and sanctity of borders in post-war Europe. Unfortunately, the scenarios of such an aggressive policy are not improbable with respect to other countries of the former USSR. Sadly, the question of **whether strong integration ties can prevent catastrophic scenarios** remains open.

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[32] Wong R. Is the age of Milton Friedman's dream of global integration and free markets coming to an end? – *http://www.scmp.com/business/global-economy/article/2029004/*.

2. The main growth characteristics of post-soviet countries participated in Silk Road Initiative

As it was mentioned, among the countries that declared the interest and involvement in Silk Road Initiative and creation of infrastructural corridor from China to Central and Eastern Europe, the group of 4 countries can be singled out – Azerbaijan, Georgia, Kazakhstan and Ukraine (AGKU). Exactly these countries may play the leading role in development of one of the most promising Road "branch" in the long-term.

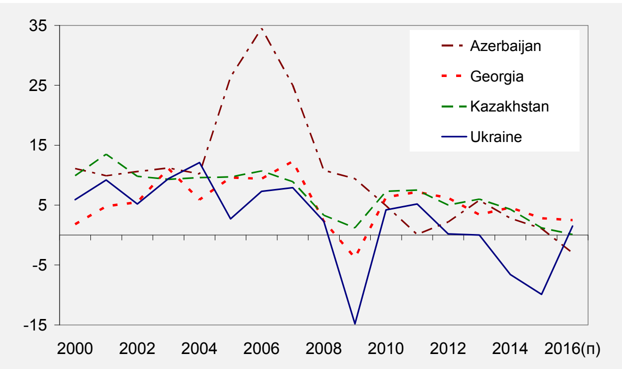
The listed countries have continued (with various successes) post-soviet transformational processes. But it is clear that for them in order to really become a valuable part of transcontinental project **the necessary condition is to form socio-economic environment, characteristic feature of which is the high level of macroeconomic stability, as well as the level of integration and investment activity**. That is why attention in this chapter is paid exactly to determination of certain macroeconomic and institutional features of these four countries.

Economic growth. As for the development of AGKU countries, two "systematic" periods can be singled out. *The first one* – post-Soviet, from the beginning to the end of 1990-s. This period is characterized by tough transformation processes and the formation of modern economic and institutional basis of economic market principles. During this period all the countries suffered significant social and economic losses because of unpreparedness and delaying of transformation processes (transformation from the so-called socialist economic system to formation of market basis). And only on the brake of centuries, the countries managed to reach a positive development dynamics.

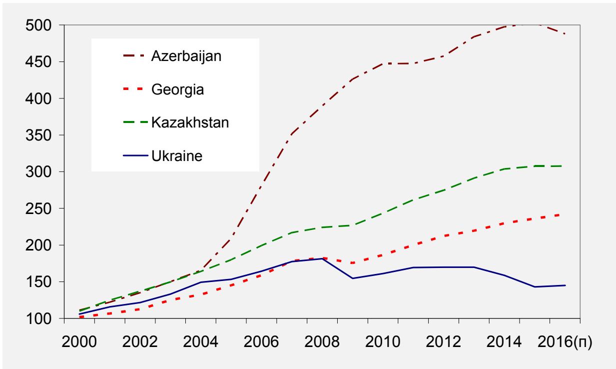
During *the second period* – from the beginning of this century till the present time, the countries with various successes created up-to-date socio-economic institutes, which would provide opportunities to implement policy of sustainable long-term growth and development, consistent increase of welfare. Especially important is the post-crisis part of the second period (since 2010), when *on the one hand* in each county the basis of modern economic activity already had been formed, and *on the other* – each of them had to find its own specific instruments of stabilization policy.

During the pre-crisis period of 2000-2008 AGKU countries had a close economic dynamics with average annual growth at about 7% (diagram "*Real GDP growth*") [33]. Only Azerbaijan owing to favorable oil price dynamics during 2005-2007 rapidly boosted country's income (average annual growth – over 30%).

Real GDP growth,
% to previous year



Real GDP index,
(1999 = 100)



[33] [WEO].

AGKU countries, except Ukraine, with relatively minor losses overcame the peak of global crisis in 2009. But the post-crisis period (after 2010) is characterized by unstable economic dynamics, which is caused by various factors and components. However, as in 2009, **Ukraine suffered the biggest losses** – in 2014-2015 the decline reached 17%. The decline was much **caused by Russian aggression and the necessity to overcome the economic ruination** of the previous years.

But it was not only Ukraine who suffered significant losses. A noticeable deterioration of economic dynamics of Azerbaijan[34] and Kazakhstan during 2015-2016 was to a large extend caused by the collapse of world oil and other raw products prices. The crisis processes in Russia (including the collapse of Russian Ruble) also quite significantly impacted the number of countries, which are still oriented to it (first of all, Kazakhstan which is a member of the Customs Union). Forced weakening of national currencies in the oil exporting countries (which was generally observed in many of these countries) intensified inflationary trends, and thus limited the variety of monetary tools, which were used by developed and successful European emerging countries[35].

As a result, the aggregate growth of countries over 2000-2016 significantly differed: if during that period the real GDP of Ukraine grew only by 45%, in Kazakhstan and Azerbaijan it increased almost 3 and 5 times, although it slowed down over the last years (Diagram "*Real GDP index*" [36]).

At the same time, because of the **high dependence of AGKU countries on the global economy** as well as because of the ambiguous exchange rates dynamics of national currencies in the post-crisis period the GDP level of countries in US dollar equivalent got controversial assessments (Diagram "*Nominal GDP in US dollars*" [37]). Although in national accounts a minimal real growth was fixed. Thus, as a result of slowing down of global economic dynamics, deterioration of economic indicators of the observed countries along with the noticeable depreciation of national currencies, the US dollar equivalents of GDP in 2015 rapidly decreased compared to 2012-2013 in all AGKU countries (and the preliminary estimations show the continuation of decrease in 2016).

Nominal GDP in US dollars,

$ bln.

	2012	2013	2014	2015
Azerbaijan	68,7	73,5	75,2	53,0
Georgia	15,8	16,1	16,5	14,0
Kazakstan	215,9	243,8	227,4	184,4
Ukraine	175,8	181,3	131,8	90,6

It should be noted that AGKU countries much differ from each other by population as well as by territory. All countries greatly inferior to China - the main country of Silk Road (Box "*Selected main characteristics of AGKU countries*") that effects comparative indicators

[34] Bearing in mind that Azerbaijan depends a lot on export of oil and natural gas (their value exceeds 90% of total export of the country), continued low prices of oil in the world markets can make a critical negative impact on Azerbaijan economy including further weakening of the national currency (also in view of limited access of the country to international capital markets). That's why the nearest prospects of the country should be based on its ability to develop along new priorities (not connected with mineral resources export).

[35] Middle East and Central Asia. IMF Rregional Economic Outlook, October 2015. – *https://www.imf.org/external/pubs/ft/reo/2015/mcd/eng/mreo1015.htm.*

[36] WEO. Estimation: author.

[37] WEO.

(Diagram "*GDP per capita*"[38]) and the potential influence of China's economy on AGKU countries[39].

SELECTED CHARACTERISTICS OF AGKU COUNTRIES

The population of Azerbaijan is around 9.5 ml. people (or 0,7% of population of China), Georgia – 4.5 ml. (0,3%), Kazakhstan – 17.3 ml. (1,3%), Ukraine – 43.0 ml. (3,1%).

Comparative nominal GDP level (in current US$) approximately corresponds to the population of the four countries compared to China's indicators (Table "*Selected main characteristics of AGKU countries*"). The exception is Ukraine, whose welfare indicators due to the crisis shock in 2014-2015 declined almost twice compared to the period of 2012-2013.

Selected main characteristics of AGKU countries

% of China's corresponding indicator

	Population	Area	GDP 2014	GDP2015
Azerbaijan	0,7	0,9	0,73	0,49
Georgia	0,3	0,7	0,16	0,13
Kazakhstan	1,3	28,3	2,10	1,70
Ukraine	3,1	6,3	1,27	0,83

The attention should be paid to decline of GDP indicators of 2015 compared to indicators of 2014, which is the reflection of continuing growth of China and strengthening of Yuan combined with deterioration of economic dynamics of AGKU countries and depreciation of their national currencies.

Nominal **GDP per capita in 2014:** in Azerbaijan – 103.9%, Georgia – 48.4%, Kazakhstan – 166.0%, Ukraine – 40,6% from nominal GDP per capita in China.

According to IMF experts, **participation in successful implementation of Silk Road Initiative** may cause already in 2017-2018 both in oil exporting countries (including Azerbaijan and Kazakhstan) and oil importing countries (including Georgia and Ukraine) the growth of *real GDP* by 0,4 percentage points (p.p.), of *real import* – in exporting countries approximately by 3p.p., in importing countries by 2p.p., of *real export* – in exporting countries by 0,3 p.p., in importing countries by 1.2 p.p., of *real investment* in exporting countries by 1 p.p., in importing countries by 1,5 p.p. During the following years the improvement may become more significant.

It is important to underline that oil countries (Azerbaijan and Kazakhstan) due to income from export of raw products managed to considerably increase average indicators of income per capita, and today such incomes in these countries are even exceeding the corresponding figures of China. Meanwhile, the transition countries, who's export model couldn't function properly (in Georgia because of the lack of wide opportunities of raw resources and semi-raw resources export, in Ukraine because of the concentration of export incomes only in particular monopolistic formations and saving a substantial part of revenue in foreign accounts) failed to provide the acceleration of income growth of vast majority of its citizens.

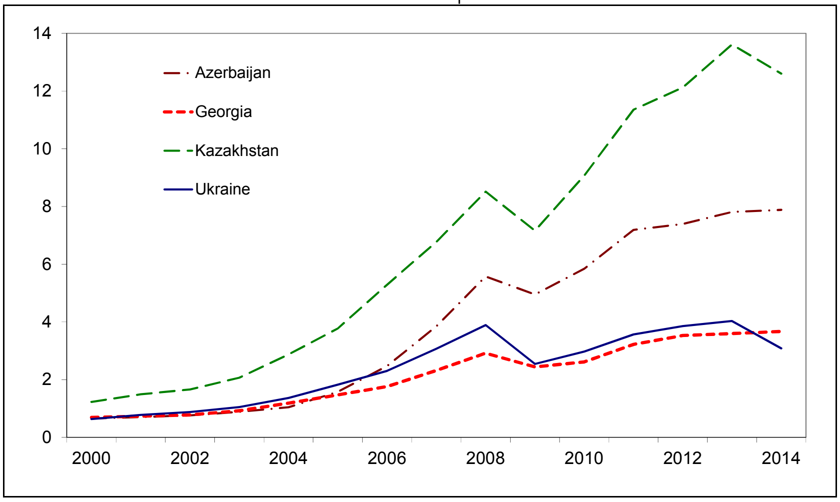
It totally reflects and corresponds to Gross National Income per Capita by purchasing power parity (PPP). Thus, related dollar indicators in 2014 were: in Azerbaijan – 16.4 thnd., Kazakhstan – 20.9 thnd., Georgia – 7.2 thnd., Ukraine – 8.2 thnd (China – 12,5 thnd).

[38] WBI

[39] Regional Economic Outlook, October 2016. – *https://www.imf.org/external/pubs/ft/reo/2016/mcd/mreo1016.htm.*

So, the average GDP per capita in Georgia and Ukraine is more than twice lower compared to corresponding Kazakhstan's indicator.

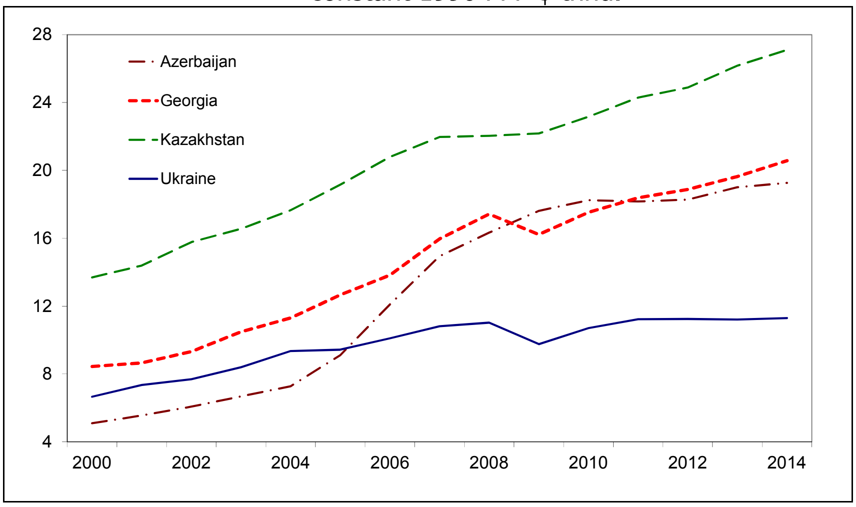
GDP per capita,
2011 PPP $ thousand



Approximately the same ratio is observed in labor expenses. The average monthly salary (in current US$) in 2010 in Kazakhstan was near $530, in Ukraine - $280, in 2013 - $720 and $365, accordingly.

In view of the demographic complications in particular countries (especially Ukraine) GDP per person employed probably will tend to grow minimally next years (diagram "*GDP per person employed*") and so income per capita will be mostly inertial and current revenue gaps will still exist.

GDP per person employed,
constant 1990 PPP $ thnd.

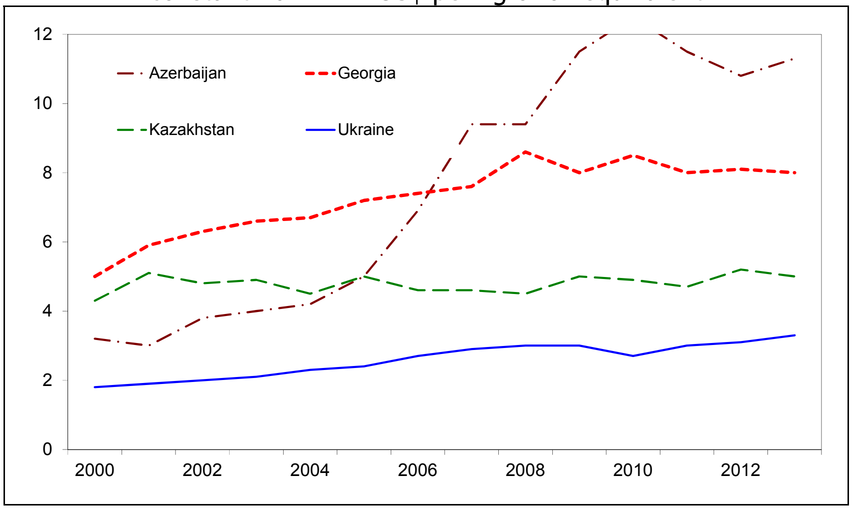


However, we should admit that average income indicators do not adequately reflect real income distribution in countries – **the income distribution** among different groups of population **remains highly unequal** and so social and economic progress in many sectors is not clearly noticeable.

Competitiveness. Successes of Azerbaijan and Kazakhstan are visible (although significantly connected with effective use of favorable conditions) but low efficiency of transition processes in Ukraine is rather surprising. Among the important factors of lack of competitiveness, and therefore the failure of the economy of Ukraine is **excessive energy**

inefficiency of the economy that additionally **erodes productive and investment capital**. Thus, the industrial potential decreases and requires more resources for its reproduction and ultimately enhances unattractiveness for potential investors. Although the Ukrainian economy initiated measures to improve energy efficiency, the lag even from the rest of AGKU countries remains high (Diagram "*GDP per unit of energy use*").

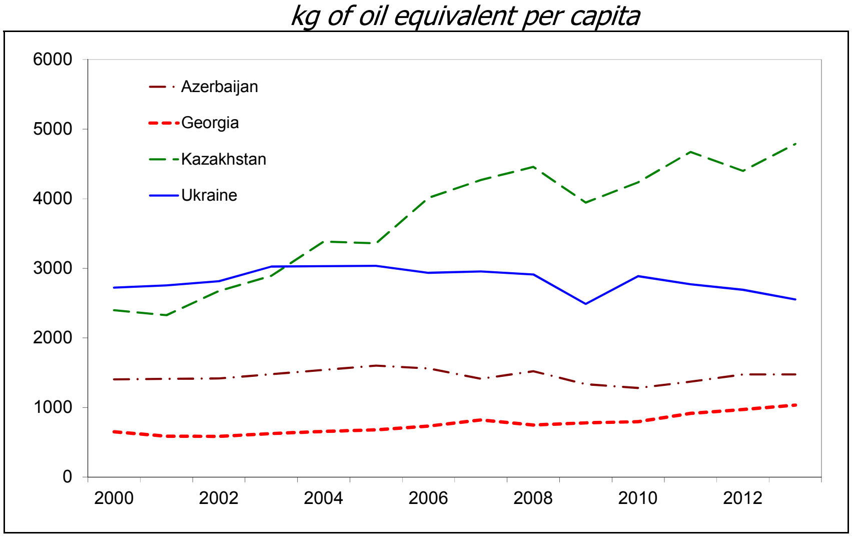
GDP per unit of energy use,
constant 2011 PPP US$ per kg of oil equivalent



To be fair we will make two remarks. (1). As it was already mentioned, the shadow sector of Ukraine (economic activity which is not captured by statistics) is approximately the same size as the official sector. In this case the real GDP nearly twice exceeds the official level, so the energy efficiency of Ukrainian economy is probably indeed at the same level as Kazakhstan's one. (2). High figures of Azerbaijan (GDP per unit of energy use) are achieved by significant increase of exports (of energy resources) the total volume of which in recent years greatly exceeds domestic use, which also brings significant uncertainty in the measurement of energy efficiency of the country.

The other characteristic of energy efficiency of the economy is **energy use per capita** (Diagram "*Energy use per capita*"). Here quite clearly appear different directions of energy use. If Azerbaijan while increasing oil production and export managed to retain almost the same level of energy use per capita, Kazakhstan, in turn, constantly increased the domestic consumption and it had a notable positive influence on domestic investments and welfare.

Energy use
kg of oil equivalent per capita



As it was mentioned, Ukraine in a post-crisis period managed to establish measures of energy efficiency. Nevertheless, the crisis shock and rapid depreciation of national currency in 2014-2015 significantly cut the dollar equivalent of GDP (with a slight reduction in energy consumption). So there is reason to assert that GDP per unit of energy costs will decrease notably in 2015-2016.

International ranking evidences. Difficulties for a country development can be clear up through international indices. Particular, business environments mainly have been improved in recent years (Diagram "*Positions of countries in Ease of doing business rank*"). At the same time it is necessary to emphasize the high level of business improving in Georgia[40] that makes the country to be attractive for further development and integration.

Positions of countries in Ease of doing business rank

	2010	2015	Change (difference in rank positions)
Azerbaijan	38	61	-23
Georgia	11	24	-13
Kazakhstan	63	41	+22
Ukraine	142	83	+59

- (minus) means decrease in a rating

Thus, as for changes in recent years, it is important to mention the following:

- Azerbaijan has substantially increased its GDP and GDP per capita, but the evaluation of the business-environment became notably worse which testifies to the urgent need in structural changes if the country is going to benefit not only from the oil export;
- The Ukraine's positions in ratings changed the most, but the country is still among the last in the list of 100 economies in terms of ease of business evaluation (if reforms are consistent one may expect further improvements in rating position in the nearest future).

Positive changes are observed with regards competitiveness. Difference in **Competitiveness Index** scores (not in rating positions) in the course of 5 post-crisis years in most cases is positive, which is good for demonstration of changes in socio-economic and competition environment of a country (Diagram "*Competitiveness Index Components*").

The biggest positive shifts for all countries concern improving **macroeconomic environment, infrastructure, technological readiness etc.** But the results of 2016-2017 can reveal losses in macroeconomic environments of Azerbaijan and Kazakhstan, in view of loss of export capabilities as a result of shock reduction of oil prices and depreciation of national currencies (which concerns all AGKU economies). Meanwhile, countries which continue consistent upgrading of their macroeconomic and institutional environment will have quite optimistic medium-term expectations (first of all Kazakhstan).

Ukraine's position towards labor markets and technological readiness looks somehow contradictory. Note that labor markets in Ukraine have been liberalized long ago and neither Government, nor Trade Unions have any substantial influence there. Low level of technological readiness of the country also looks strange in the light of positive assessment of higher education and level of education of population (see also hereinafter). Probably the

[40] …permanently belongs to the first 30 economies with favorable business environment. Similar positions the countries take in the Index **of Economic Freedom**. According to 2016 research, Georgia takes the high, 23-d position (72.6 points out of 100), Kazakhstan – 68 (63.6 points), Azerbaijan – 91 (60.2 points), and Ukraine – 162 (46.8 points) – see: 2016 Index of Economic Freedom. –*http://www.heritage.org/index/ranking.*

reason is that current technical and technological basis is lagging behind the levels of education and knowledge in the country.

Components of Ease of doing business Index,
Difference in rank positions in 2010 and 2015

	Azerbaijan	Georgia	Kazakhstan	Ukraine
Starting a business	-63	-1	61	104
Dealing with construction permits	144	-4	51	41
Employing workers	5	-53	-33	-54
Registering property	-80	-1	12	80
Getting credit	-152	23	-27	11
Protecting investors	-102	21	32	21
Paying taxes	87	24	34	74
Trading across borders	176	-48	60	30
Enforcing contracts	9	28	25	-55
Closing a business	4	-6	7	4

- (minus) means decrease in a rating

Competitiveness Index components,
Difference in scores of 2009-2010 and 2014-2015

	Azerbaijan	Georgia	Kazakhstan	Ukraine
Institutions	-0,19	0,39	0,38	-0,12
Infrastructure	0,09	0,71	0,76	0,77
Macroeconomic environment	1,11	1,41	1,03	0,18
Health and primary education	0,20	0,58	0,15	0,73
Higher education and training	0,02	0,19	0,38	0,55
Goods market efficiency	0,15	0,31	0,46	0,25
Labor market efficiency	-0,48	-0,45	-0,03	-0,45
Financial market development	-0,46	0,06	0,22	-0,02
Technological readiness	0,85	0,93	0,63	0,13
Market size	0,27	0,09	0,09	-0,09
Business sophistication	-0,04	0,16	0,07	0,03
Innovation	-0,20	0,15	-0,01	-0,05

- (minus) means decrease in a rating

A need in serious structural changes for the benefit of budsinesses is also demonstrated by the Scores of Logistics performance index (Diagram "*Scores of Logistics Performance Index*"[41]). Only Ukraine has various scores which approach '3' (with the highest store equal '5'). Other countries have notably worse figures, which means relatively low infrastructure readiness of a country, and accordingly, low integration benefits, which in turn requires serious expenditures to improve logistic infrastructure in each of the partner-countries.

[41] Logistics Performance Index. – *http://lpi.worldbank.org/.*

Scores of Logistics Performance Index components

	Azerbaijan	Georgia	Kazakhstan	Ukraine
Overall LPI score	**2,45**	**2,51**	**2,70**	**2,98**
Customs	2,57	2,21	2,33	2,69
Infrastructure	2,71	2,42	2,38	2,65
International shipments	2,57	2,32	2,68	2,95
Logistics quality and competence	2,14	2,44	2,72	2,84
Tracking and tracing	2,14	2,59	2,83	3,20
Timeliness	2,57	3,09	3,24	3,51

Demographic components of growth and development. It is universally accepted that **demographic structure of population** (with regards age, gender, education, qualification features) directly impacts labor productivity, consumption level and structure, savings and investment etc. That is why a demographic analysis is important in the context of development and capability of economy with regards **'consumers'-'employees'** dilemma solution of which may lead to contradictory results. Increase of population means increase of consumers (and therefore increases aggregate demand). Labor increase means increase of the number of employees (which can lead to increase of a total supply), and only later – to consumption and savings. Both components influence the GDP structure (both in terms of incomes and end consumption) and its (GDP) distribution.

Economic problems usually reveal themselves also in demographic situation. Low level of population growth is usually **accompanied by low level of labor force growth** (Table "*Population growth and social and demographic indicators*"[42]). Ukraine has **one of the worst situations with population (and labor force) development in Europe** – recent years decrease has reached 0.6% annually, first of all as a result of low birth rate, high mortality rate (hence – low life expectancy level) and significant outflow of labor force (the most productive ages) cased by unsatisfactory social and economic situation[43]. The similar situation among AGKU economies is also observed in Georgia.

Population growth and socio-demographic indicators

2010-2015

	Population growth rate, % per annum (2010-2015)	Total fertility rate (births per woman)	Life expectancy at birth	Expected years of schooling (mean years of schooling)	Old age dependency ratio (ratio of population aged 65+ and a number of population aged 15-64), %
Azerbaijan	1,1	1,9	70,8	11,9 (11,2)	7,8
Georgia	-0,4	1,8	74,9	13,8 (12,1)	22,0
Kazakhstan	1,0	2,4	69,4	15,0 (11,4)	10,1
Ukraine	-0,6	1,5	71,0	15,1 (11,3)	21,2

[42] Source: Credit Suisse 2013, WBI.

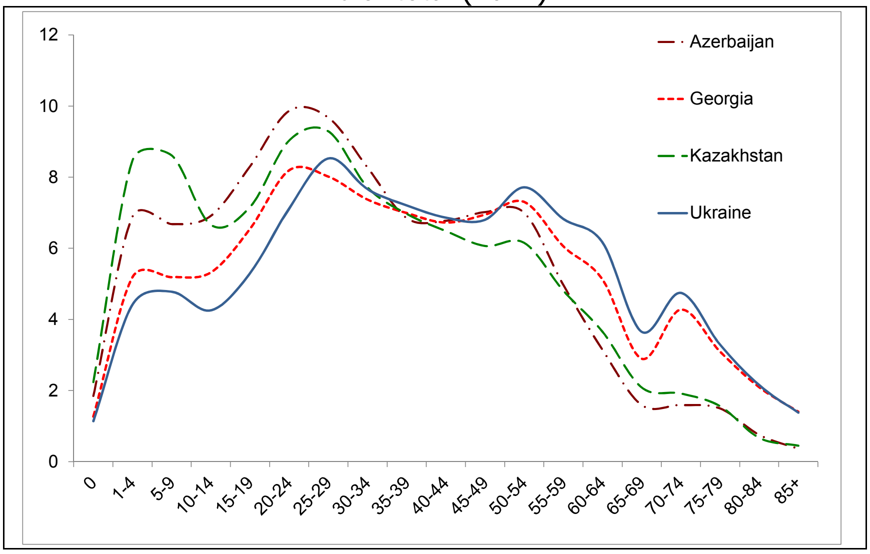
[43] In this context a Swedish phenomenon is of interest. If in 1990s the birth rate in the country was low and labor force increase was even negative (around -0.7% per year in 1990-1995), currently the country is among the leaders in Europe in terms of birth rate, life expectancy and labor force growth.

Demographic situations in Azerbaijan and Kazakhstan are better, though these countries have somehow lower figures of life expectancy which goes in line with health care system problems experienced by them (see Diagram above "*Competitiveness Index Components*").

Demographic age structure of population is an important factor (Diagram "*Age Structure of population*"). The structures of Georgia and Azerbaijan populations are typically similar, which is not a surprise if we remember geographic conditions and historical situation in Caucasus.

In Ukraine a small share of children and youth combined with a big share of people of pre-retirement and retirement age with quite low life expectancy points out at high probability of reduction of population and further deterioration of its (population) demographic structure, which in turn aggravates risks for further effective economic development.

Age structure of the population
% of total (2014)



Note the following:

- In Azerbaijan and Kazakhstan there is quite a big share of children and teenagers among the population. In Ukraine this share is extremely small – all children under the age of 14 make up only 15% of the total number of population,
- in Ukraine, the share of population above 50 years old is notably bigger than the relevant population in other countries which indicates a high possibility of acute problems of "ageing" and deepening pension contradictions already within the next decade or two,
- a share of the most productive population (30-55 years old) in all countries (except for Kazakhstan) is roughly similar (7-8% of total number for every age group), which is a sign of highly negative socio-economic developments in a long-term.

Note, that life expectancy increase alongside with declining birth rate (which is evident in practically all countries) has a sort of "negative" demographic structural feature – **increase of the number of elderly people,** most of whom leave the labour force (i.e. increase of the dependency ratio). In the developed European economies almost a third of population already consists of old age persons and in the near future this process will accelerate. In Ukraine this figure is already quite high and the situation will aggravate because of low life expectancy.

Along with this, one can identify **components of the change of number of population** – **natural increase** of population (birth minus mortality) and **"net" migration** (immigration minus emigration, per 1 000 people). Over the last two decades, in most developed European countries negative population growth has been dominating. Similar trends are developing in AGKU countries – Azerbaijan i Kazakhstan have zero growth, Georgia and Ukraine deepen their negative trends.

A positive feature of Ukraine is high expected level of education, which may promote higher intellectual and cultural level of population and accordingly their preparedness to innovations and better competitiveness. Ukraine already has quite many young people with tertiary education (shares of tertiary school-age population): Azerbaijan has 20%, Georgia – 33%, Kazakhstan – 45%, Ukraine – 79%.

Let's make two remarks. *The first* – though over the last two decades inclusion of women into economic activities has improved, gender inequality is still observed in terms of active involvement into economic activities. It is generally believed that **broader involvement of women** into economic processes helps **positive economic developments** though **international practice does not provide a definite proof** to this point of view.

The second – because of the abovementioned change of employment structure, for the sake of long-term economic growth and development even the current policy has to orientate toward, *first*, creation of jobs where **female labor could be used more extensively** (including in view of higher level of life expectancy among women compared to men), *second*, create conditions (including by means of well-balanced system of retraining) under which **old age people would be able to apply their experience and their skills more actively** to new production processes not limiting employment opportunities of young people[44].

Alongside with the employment structure a decisive role in long-term economic growth and development belongs to **productivity and qualification of labor force**, and effective utilization of labor. In its turn, **economic activity**[45] is often connected with the population structure, first of all with a share of working age population, how quickly youth engages into economic activities, etc.

It is indicated that the components of economic growth are: working age population growth, labor productivity growth[46], labor utilization growth[47] (analysis of those factors goes beyond the topic of this research). **Demographic factors and elements exercise their influence on economic growth** through these components.

The following **mutual impacts** are typical for most countries[48]:

- GDP per capita correlates positively with changes in working age population growth and level of savings, and the current account of the balance of payment improves with bigger share of working age population;

[44] At the same time, over the last two decades the so-called **"crowding-out effect" cased by income** has been observed more often: with growing income of a person or a household the so-called "alternative cost of recreation" growth, that is, **motivation of participation in economic processes weakens** and as a result a certain group of population is crowded-out of employed or even labor force.

[45] Economic activity is defined as a share of working age population actively engaged into formation of value added.

[46] Defined as a GDP created per worked time.

[47] Defined as amount of working time per one working person. Note, that increase of the work utilization level (same as other dynamics indicators) can have negative value as a result of reduction of worked time or growth of working age population.

[48] See: A comparative demographic analysis of EU28. – Credit Suisse Global Demographics and Pensions Research. Why has recent macro-policy not been that effective? A demographic view. – Credit Suisse Economic Pensions Research. – *http://www.credit-suisse.com/researchandanalytics*.

- Developing economies have a **significant potential capability of growth based on better utilization of labor**, in particular, through reduction of unemployment, raising productivity, migration of some residents of rural areas towards industrial production and services;
- Structural changes of households (number of families, gender changes, education, migration, etc.) directly impact the consumption and savings structure. **With reduction of the number of employees investment demand will also reduce**, which will lead to worsening of foreign trade balance and consequently to current account deterioration;
- Because demographic structure impacts savings, investment, foreign trade balance, it also impacts capital flows and **exchange rate changes** (as a reflection of foreign currency demand and supply depending on level population welfare and labor productivity). In their turn, exchange rate fluctuations directly impact relative prices, wages, welfare, production, etc.

Having transferred these interconnections to the AGKU countries one can see that long-term economic development of Kazakhstan looks more attractive and prospective than of Georgia or Ukraine. At the same time, bearing in mind geographic location, Kazakhstan will have to solve much more difficult tasks of remote territories integration compared to the Caucasus countries.

Location of Ukraine on the strategic cross-roads of North-South (Baltics and Scandinavia – Mediterranean countries) and East-West (Asian and European territories) provides the country with **exclusive opportunities and prospects for development** and substantial improvement of welfare of population, which in its turn will become an additional factor of strengthening **integration processes and growth**.

3. GDP structure and its impact for external expansion

Transformation processes impacted the structure of the economy in different ways. Many post-socialist countries managed to preserve and increase the production which was based on investment and technologies in the major national industries. But such changes were not always of a systemic structural nature in emerging countries. The efforts rather were focused on getting quick benefits from favorable external conditions and international prices. That is why economic dynamics, efficiency and effectiveness of the AGKU countries over the last decade are quite controversial.

Changes in the structure of production. AGKU countries have had different structures of production. In early 2000s Azerbaijan, Kazakhstan and Ukraine were regarded as mainly industrialized countries (volumes of industrial output were substantially higher than in the agricultural sector), while in Georgia agricultural sector was practically equal to industrial one (see Diagram *"Share of Agricultural Sector and Industrial Production…"*).

Further on, the pre-crisis period was characterised by growing role of industry in the structure of AGKU economies (with the exception of Ukraine). Azerbaijan and Kazakhstan got good results on that way because they had managed to attract investment in extractive industries and to strengthen their competitiveness based on favourable conditions for oils and gas trading. That gave more weight to the industry in the structure of added value formation and, accordingly, to the GDP of these countries. But the preference was given to those branches and spheres which guaranteed fat profits, and for that reason structural changes were not of a systemic strengthening nature.

Share of Agricultural Sector and Industrial Production in Value Added Formation, % GDP

	Agriculture	Industrial Production
2000		
Azerbaijan	17,1	45,3
Georgia	21,9	22,4
Kazakhstan	8,7	40,5
Ukraine	17,1	36,3
2010		
Azerbaijan	5,9	64,1
Georgia	8,4	22,2
Kazakhstan	4,8	42,9
Ukraine	8,3	31,3
2014/2015		
Azerbaijan	5,7	58,3/37,0
Georgia	9,2	24,4/25,5
Kazakhstan	4,7	36,0/33,2
Ukraine	11,8	25,4/25,9

Generally speaking, though comprehensive economies do not require big volumes of industrial production, countries, with some minor exceptions (where absolute and relative benefits of services development clearly dominate – like financial services and tourism), try to increase their production capacity, first of all the industrial one. Industrial capacity of the AGKU countries had clear, historically developed, structure and depended a lot on geography and natural conditions. Thus, Azerbaijan and Kazakhstan were mainly oriented towards extractive industries, and Ukraine was oriented towards metallurgy, machine-building, etc.

Notably, as a consequence of crises (sharp fall of the world oil and other mineral resources prices as well as substantial reduction of economic development in Russia) in 2015 production output of industries (first of all the extractive ones) in Azerbaijan and Kazakhstan fell down (similar trends were observed also in 2016, but to lesser extend). This only emphasizes earlier mentioned **timeliness of speedy structural changes** in value added creation.

Consumption and savings. The share of consumer expenditures in the GDP structure can also serve as an indicator of economic strength and real well-being. It is recognized that reduction of household consumer expenditure as a GDP share takes place in case of economic development of a country and growing well-being of population. In case of deteriorating economic situation or crisis developments household final consumption expenditure grows. In Ukraine, in view of generally low household incomes population spends more than 70% on final consumer goods and services (table *"Final Consumption Expenditures of Households"*[49]).

It is not only general expenditure which characterizes the households' structure. It is important to evaluate expenditures on various goods and services. There is a general pattern – higher income of countries and households means growing expenditures on long-term goods and services; in poorer countries the share of food products[50] and short-term consumer goods grows.

[49] [WBI].
[50] In the expenditure structure of a Ukrainian household a food products share is more than 50%.

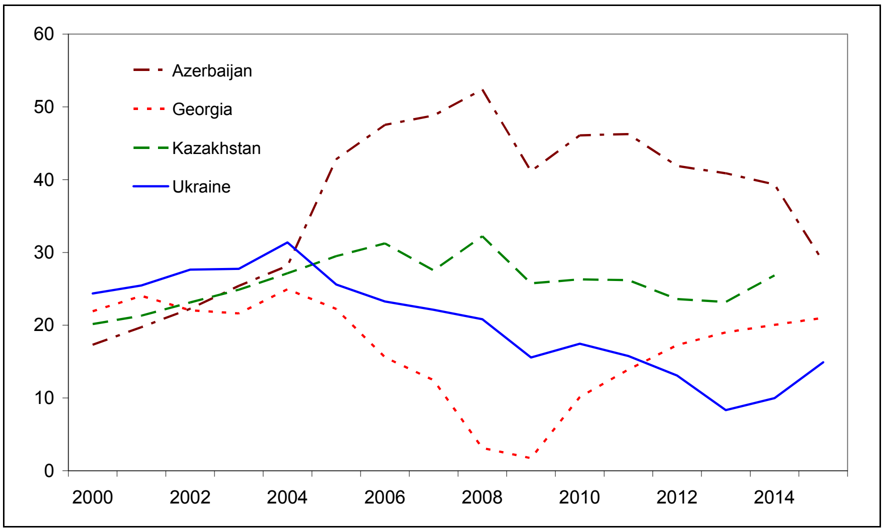
Final Consumption Expenditures of Households,
% GDP

	2000	2010	2014
Azerbaijan	69,2	38,1	46,3
Georgia	81,6	76,9	71,1
Kazakhstan	61,9	49,3	51,8
Ukraine	54,4	62,9	71,4

One of the most important factors helping the country to maintain a sustainable level of well-balanced growth and development is **a level of national savings** (in the GDP structure) which is defined by a share of household income which is not consumed (and therefore has a potential **to become an investment source**). Mind you, that low level of domestic savings, *on the one hand*, can become a factor of reduction of investments and investment capacity (in a medium-term already) (a display of misbalance "*savings-investments*"[51]), *on the other hand* – lead to a worse of the current account of the balance of payment which already in a short-term would require broader access to external borrowings with further deepening of the country's indebtedness.

The level of savings in AGKU countries varies substantially. In the first half of 2000s all countries made use of markets enlargement and global positive economic development that is why levels of savings in all countries had a sustainable trend to grow (Diagram *"Savings in the GDP structure"* [52]).

Savings in the GDP structure,
% GDP



But since middle of the last decade the investments in AGKU acquire high volatility, meanwhile real GDP growth to a large extend is consistent with the level of investment in the GDP structure. In the first half of 2000, Georgia which in 2003-2008 engaged into bold transformations and also suffered from Russian military actions (which substantially weakened investment incentives), saw the biggest investment losses.

Azerbaijan (and to lesser extend Kazakhstan), as it was said, having actively used positive situation in mid 2000s, rapidly increased the country's revenue and managed to implement broad investment programs (first of all related to extraction industries and mineral resources export, as well as infrastructure development). Recent years level of investment somehow

[51] It is accepted that (with rare exceptions) the higher is the savings level in a national economy the higher is a level of domestic investment.
[52] [WBI].

reduced both in Azerbaijan and Kazakhstan, but it still remains quite acceptable (around 30% of GDP) for well-balanced development of countries.

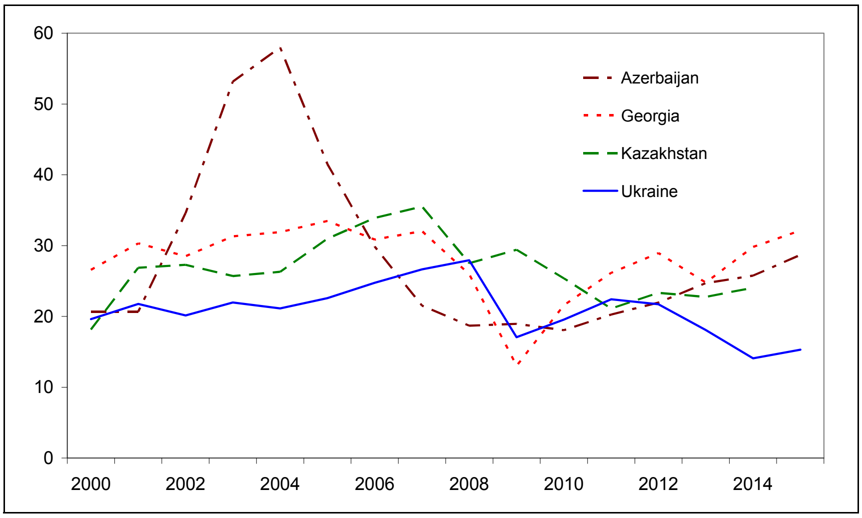
In general, Ukraine has suffered the biggest investment losses – as a consequence of domestic contradictions and Russian aggression – therefore investment attractiveness of the country is very low today and the level of national investment remains disastrously low – in 2012-2015 it was less than 15% of GDP.

We reiterate that nations with **high level of savings** as a rule **have no problem** with access to financial recourses (first of all internal ones), which allows to **maintain both high level of investment and sustainable economic development**. In most cases, if there are no serious institutional restrictions on capital mobility, these countries are also exporters of capital.

Investment components. General relations between savings and investments fully agree with dynamics of investments in fixed capital in the structure of GDP formation of AGKU countries. But while level of savings shows significant fluctuations, level of investment has more stable character in all countries – mainly 20-30% of GDP (except for Ukraine)[53] (Diagram *"Fixed investments"* [54]).

Such relative sustainability at the period of growing savings (first of all in Azerbaijan and Kazakhstan) is conditioned by the authorities' focus on broadening and improving consumption after 1990s crisis years (and sharp reduction of living standards in all post-Soviet states). Another factor of relative stability of investment level (under a significant growth of savings) is related to lack of reliable investment projects which would be beneficial and profitable for investors.

Fixed investments,
% GDP



Among others most important impacts of savings on macroeconomic characteristics of emerging countries are the following.

Emerging countries which managed **to maintain investment attractiveness** and avoided significant investment losses (sharp reduction of the Investment-GDP ratio) at the crises period, demonstrated better growth **in post-crisis restoration**. Countries which lost investment attractiveness, showed much worse results in post-crisis period.

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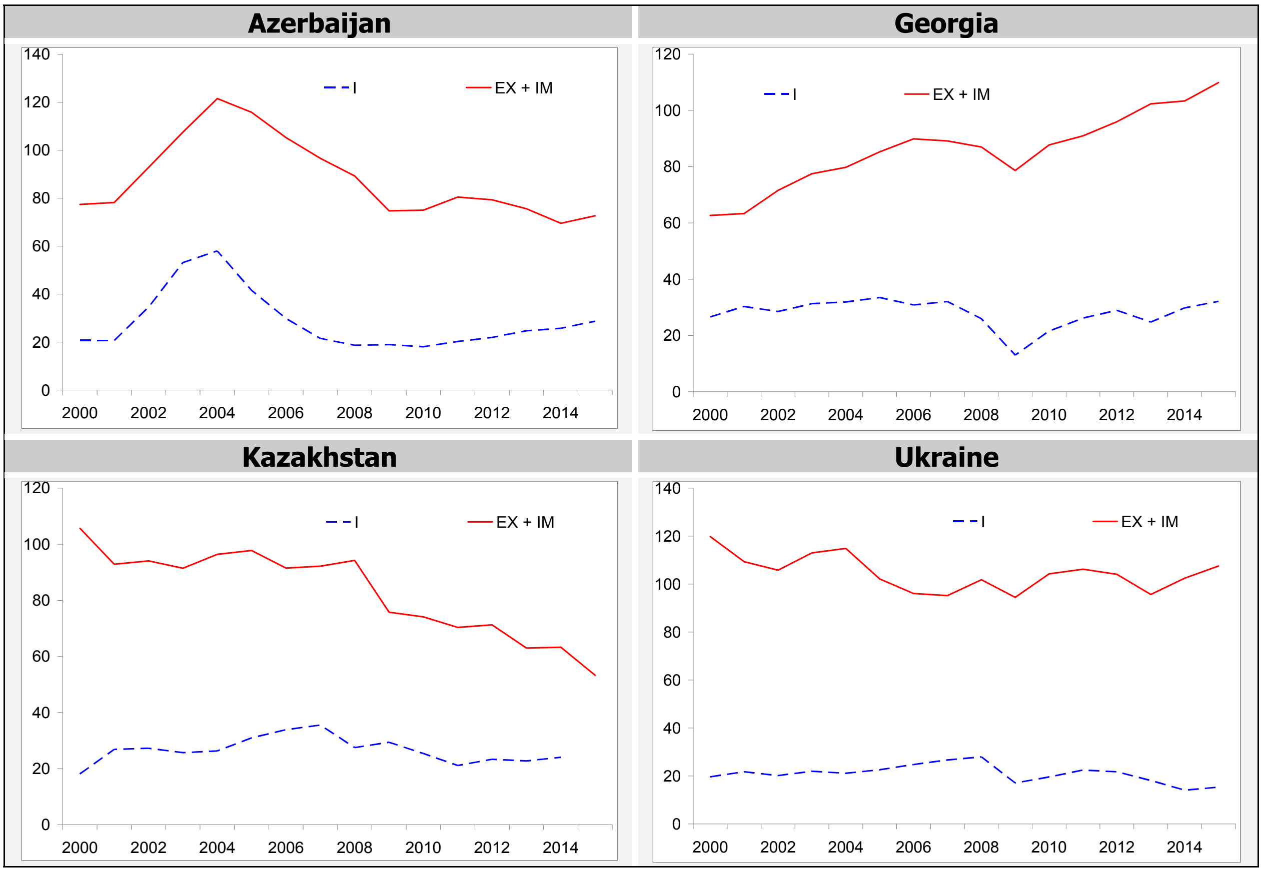
[53] Even in Kazakhstan, though recent years there has been a reduction of investment level, the above mentioned level remains relatively high – around 25% of GDP.
[54] [WBI].

Another important macroeconomic link is inter-dependence of the **level of investment** in an economy and the level of savings, budget deficit and foreign trade balance, in particular, through so-called "crowding-out effect"[55] or **openness of economy**[56]. The reason for this is that growing openness of economy (including through broadening of exports and imports, first of all because to their diversification) allows a country **to attract more recourses and use them more efficiently** (both internal and external) and this way to strengthen investment and economic environments.

AGKU nations have different levels of openness (Georgia and Ukraine have foreign trade turnovers bigger than their GDPs) but in general they maintain positive relation between investment dynamics and openness (Diagram "*Level of investment and openness of economy*"). The situation is complicated by the fact that AGKU nations' foreign trade structures are not competitive enough which complicates a task of economic and social development. Therefore, raising competiveness will give these countries more confidence in improving investment processes which is especially important under condition of integration expansion. Note that investment component acquires a special importance in case of a country which is not much inclined towards savings or has poor access to external borrowings.

Level of investment (I) **and openness** (EX+IM) **of economy,**
% GDP



55 … according to which the **level of private investment has negative dependence on budget deficit and positive dependence on the level of private savings and external trade deficit** (i.e. trade deficit can be a component of private investment growth and hence – speeding up economic development).
56 which is characterized by a foreign trade turnover (a sum of export and import of goods and services) in a GDP.

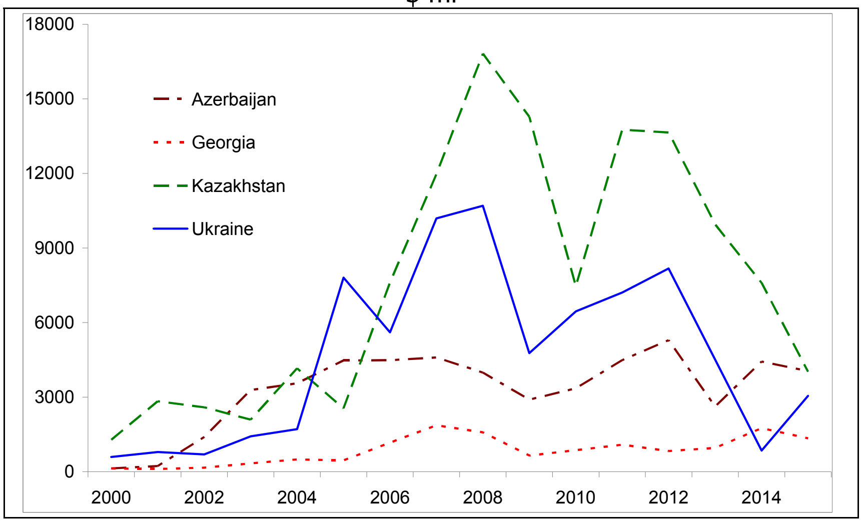
It should be remembered that globalized world is characterized by **growing capital mobility** (including investment ones). Meanwhile, such freedom in some countries may lead not only to positive changes but also create unpredicted complications. First of all it is about the so-called "hot money" which can easily and quickly come to a country (often through the government bond markets or stock markets) but also quickly exit the country leaving in the wake a weakened banking system with currency imbalances.

Usually, **foreign direct investment (FDI) is the most desirable and expected capital** for a country (among different capital flows), and they help not only to get access to modern technologies "quickly" but also to become more active participant of global labor markets, upgrade governance, more efficiently use recourses (including human capital). The most important components of public policy as a rule include measures and mechanisms to attract foreign capital, especially FDIs which bring long-term stable benefits.

Naturally, **FDI inflows depend** on the size of an economy, population, geography, and on institutional structure of economy, incentives and mechanisms of investment attraction to a country. Here Kazakhstan is the leader (Diagram "*Net FDI inflows*"). The country managed to create favorable conditions for foreign investors in extracting industries (oil and gas), which made possible to create a long-term development environment which lead to investment inflow to technology sectors.

Ukraine also could have claimed the investment leader position before crisis. But inflow of FDI into Ukraine (which increased only after 2005) was not sustainable and today Ukraine holds one of the lowest positions in Europe and has the worst results among AGKU in terms of FDI per capita. In 2000-2015 stock of FDI per capita reached in Azerbaijan – $5,6 thnd, in Georgia – $2,8 thnd, in Kazakhstan – $7,4 thnd, in Ukraine – only $1,5 thnd.

Net FDI inflows,
$ ml



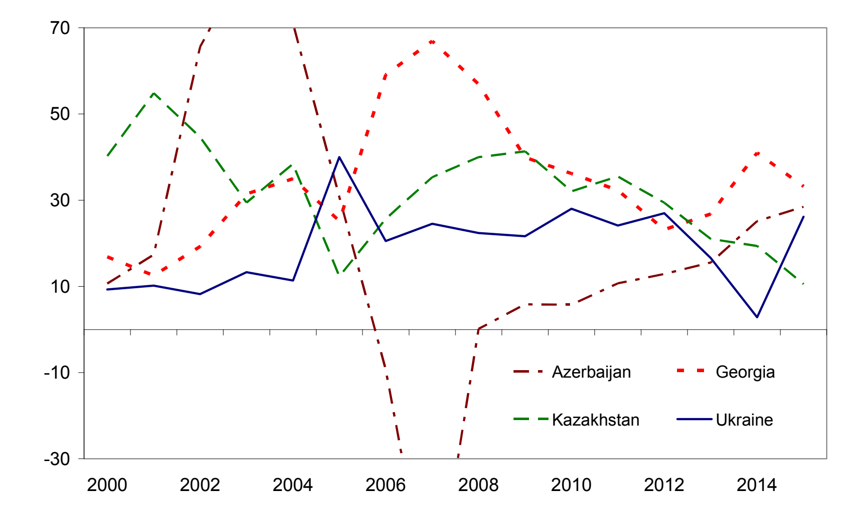
The importance of FDI for the development of AGKU countries is clearly demonstrated by their level in the **gross fixed investments** – before the crisis the share of FDI in such investment was highly volatile which to a large extend was cause by low investments and unclear long-term policy of countries towards investors (Diagram "*FDI inflow as a share…*")[57]. Especially serious were fluctuations of FDI inflow in Azerbaijan in the first half of 2000-s which correlated with the dynamics of general level of investments into energy

[57] World Investment Report (different years). – *http://unctad.org/en/pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx*. [WIR]

extracting industries (Diagram "*Fixed investments*" above) and, accordingly, with economic development (Diagram in the previous chapter "*Real GDP growth*").

Therefore, **savings and maintaining high level of FDI is a decisive factor** of positive economic dynamics, *first*, thanks to increased foreign investment and its share in the GDP (by expenditures), and *second*, by raising productivity and competitiveness of businesses which are importers of those investments[58].

FDI inflows as a share of gross fixed investment, *%*



Note that investment strengthening of the AGKU nations also means (like with overwhelming majority of successful emerging countries) **their broader participation in the investment capital export** (not only as FDI beneficiaries). If in 2000s total value of inward investments exceeded value of outward ones by dozens and hundreds of times (except for Georgia, where total volume of investment was insignificant), in 2014 relevant figures of FDI import prevailing over their export substantially reduced (Table "*FDI inward and outward stocks*"[59]).

FDI inward and outward stocks,
$ ml

	2000	**2014**	**2000**	**2014**	**2000**	**2014**
	Inward		*outward*		*inward / outward, times*	
Azerbaijan	1 791	18 179	1,0	12 235	1791	1,5
Georgia	762	12 769	118	1 738	6	7,3
Kazakhstan	10 078	132 744	16	25 539	630	5,2
Ukraine	3 875	63 910	170	9 704	23	6,6

Unconditional **investment leader** (in inward and outward FDI stocks) is **Kazakhstan**, which has been implementing a consistent policy of investment promotion and support.

Alongside the investment support, **Kazakhstan** has one more natural and **unique geostrategic benefit** which helps the long-term growth. The country keeps the **key position in formation and implementation of the New Silk Road**. These times, Kazakhstan itself has initiated a number of projects in neighboring Central Asia countries to

[58] Hanousek J. Direct and Indirect Effects of FDI in Emerging European Markets: A Survey and Meta-Analysis / Economic Systems. – 2011 – №3 – pp. 301-322. – http://www.sciencedirect.com/science/article/pii/S0939362511000367.
[59] [WIR].

upgrade logistics of cargos transit from China borders to the Caspian Sea and formation of a new network of access to the Gulf states[60].

Today, despite some economic difficulties, there are reasons to state that investment attractiveness of Kazakhstan remains high and countries which will get involved into production and infrastructure megaprojects in Kazakhstan will get significant long-term benefits (box *"Benefits for Ukraine from more active cooperation with Kazakhstan»*).

BENEFITS FOR UKRAINE FROM MORE ACTIVE COOPERATION WITH KAZAKHSTAN

There are grounds to state that today **economic significance of Kazakhstan for Ukraine is growing substantially**. Bearing in mind that traditional trade and economic ties between two countries are seriously disrupted following large-scale limitations on transit of Ukrainian goods through the Russian borders, Ukraine is to look for new ways and opportunities to enter the Kazakhstan economic space. Why is it so important?

Ukraine desperately needs free access to markets of Central and East Asia as well as markets of the biggest economies of China, India and Iran, to strengthen and broaden integration capabilities which were formed over the recent decades. Russia's cutting out trade and economic routes from Ukraine to Asian countries significantly disrupted Ukraine's Asian vector of presence and seriously undermines economic revival of the country and its opportunities to enter Asian business networks.

Currently, **Ukraine very little engaged into the transcontinental project of the NSR**, which means potential loss of billions of dollars in a strategic perspective (especially in view of dynamic development of Asian countries). That is why attention should be paid to economic strengthening of Ukrainian producers, their approach to Asian markets. It could be based on the **investment entry of Ukraine into Kazakhstan**.

Though today **Ukraine needs restoration of investment potential** and active inflows of foreign investment into the national economy, even **more important is to speed up** the country's integration into global production, trade and financial networks which will allow to keep up with the global trends. Modern investment and infrastructure projects may let Ukraine rise to the new integration level and this way to strengthen competitiveness and long-term growth and development prospects.

Moreover, today Ukraine's FDI into Kazakhstan can provide sustainability to Ukrainian producers. Ukrainian industries still poses significant resources which can meet the needs of Kazakhstan. As it was mentioned above, **the level of country's development to the large extend depends on investment flows** – enlargement of both inflows and outflows of capital (the list of the biggest investor countries is practically identical to the list of countries which receive the biggest foreign investments).

Besides, investment in a form of transposition of some Ukrainian production capabilities to Kazakhstan can help mitigate employment problem in Ukraine. Foreign investors in Kazakhstan have significant rights in terms of hiring foreign labor not only for the period of commissioning investment facilities but for some additional time after implementation of a project (without accounting for a "regular" quota on foreign employees). And mind you, salaries in Kazakhstan are twice as big as in Ukraine.

And finally, investment in Kazakhstan mean **"approximation" of**

[60] Between East and West: Kazakhstan's development along China's new Silk Road. – *http://www.osce-academy.net/upload/file/Between_East_and_West.pdf.* Kazakhstan modernizes transit infrastructure. – *http://www.investkz.com/journals/.*

Ukraine to Asia, that is, they will support direct access of Ukrainian businesses to dynamic Asian markets, first and foremost of giant economies, and further joining of Ukraine (first of all via Kazakhstan partner businesses) to Asian transcontinental projects.

That is why today, besides attraction of FDI, it is necessary to **develop mechanisms and instruments for investment export support**, and Kazakhstan in this context can be a good starting point.

There is about a hundred documents signed between two countries, including the Friendship and Cooperation Treaty between the Republic of Kazakhstan and Ukraine of 20 January 1994. The major directions of cooperation in economic area are discussed in the framework of the Interstate Kazakhstan-Ukraine Commission for Economic Cooperation. Bilateral official documents indicate a need **to strengthen cooperationin the most promising areas**, in particular: in oil and energy, agriculture and related industries, mining and metallurgy, heavy machine-building, aircraft industry, chemical industry[61]. In general, **the list is quite full**, but we will indicate the **most important and topical** areas of cooperation in view of Ukraine's investment in Kazakhstan which can really grow in a new geostrategic region:

- aircraft building (emerging countries are interested in medium-size and reliable machines such as the Ukrainian Antonov aircraft "family" offers);
- armaments and military equipment (power, reliability and quality of which have grown substantially and was tested in the process of repelling Russian aggression);
- pharmaceutical industry (scientific and technological capabilities of Ukrainian businesses combined with plentiful natural chemical and biological resources);
- nuclear energy (energy elements, enrichment systems which are very important for development of rich Uranium storage in Kazakhstan).

Foreign trade. One of the peculiarities of the AGKU countries positive development was extraverted economic policy which was somehow justified by population's poverty as a result of crisis during transformation in 1990s and by a need to have access to hard currency. Significant increase of exports (naturally, mainly of raw materials or semi-finished products) allowed these countries to get resources for restoration of the economy base, raising competitiveness, etc. Especially big benefits were received by mineral resources (oil and gas) exporting countries – Azerbaijan and Kazakhstan, whose exports grew by dozens of times (Diagram "Export of Goods"[62]).

But since 2011-2012 the world commodity prices have plummeted, and export revenues of the countries in which raw materials and articles with low value added dominated in the trade structure have reduced. The fall of oil prices in 2014-2015 and economic problems in the countries, which for some time played leading roles in integration unions (like Russia), lead to huge sharp of revenues from foreign economic activities and in general significantly deteriorated macroeconomic situations in many countries.

At the same time, it is worth while noting that **exports in GDP structure** for all countries was less volatile compared to their values and in general compares to dynamics of real economic growth of relevant economies (Diagram "Export of Goods and Services"[63]).

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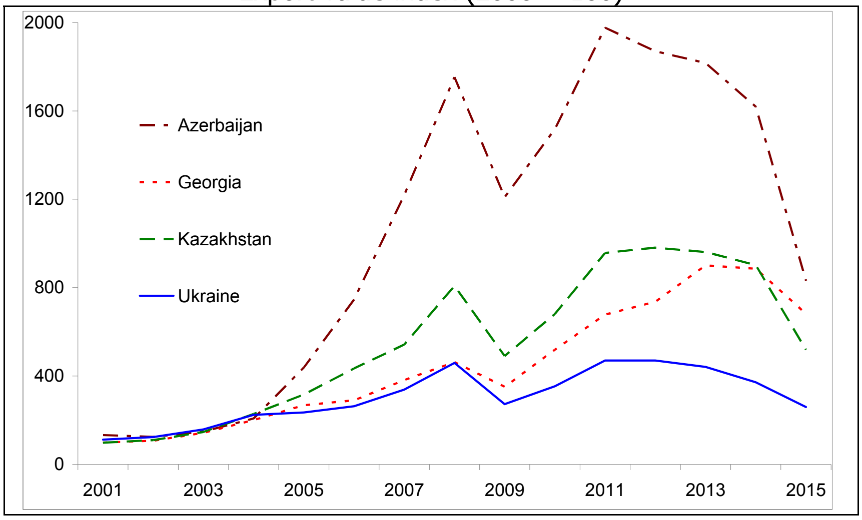
[61] More details in: Cooperation of the Republic of Kazakhstan with Ukraine. – *http://kazembassy.com.ua/show/3036.html.*

[62] WBI.

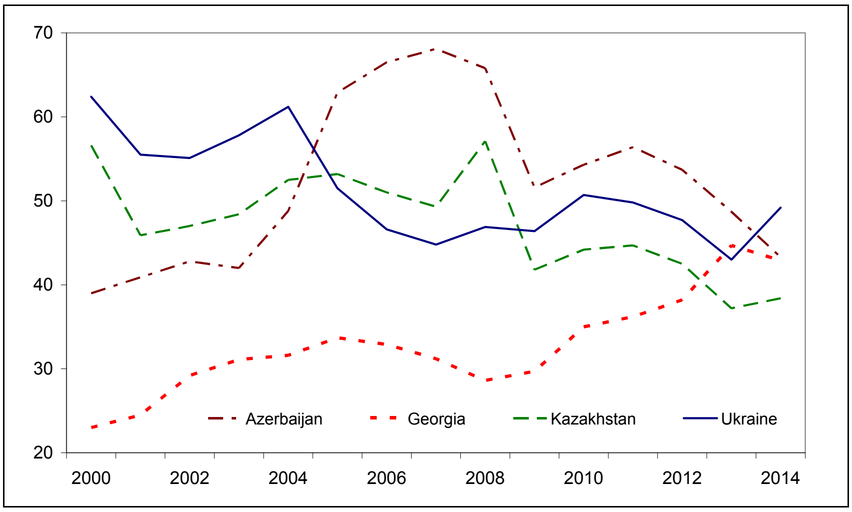
[63] [WBI].

Export of Goods,
Export value index (2000 = 100)



The rapid growth of exports in Ukraine's GDP in a situation when export value has been declining in recent years has a sort of "negative" explanation. In view of dramatic depreciation of the national currency unit (Hryvnia) in 2014-2015, the nominal GDP in dollar-terms reduced substantially (more than twice – from $183 bn in 2013 to $91 bn in 2015)[64].

Export of goods and services,
% GDP



The direct consequence of export "landslide" was sharp degradation of the foreign trade balance as well as current account of the balance of payment (Diagram "*Current account of the balance of payment*"[65]), because many low competitive countries still very much depend on imports (of consumer, long-term, investment goods, etc.).

Probably, fall of export could have been less painful if the AGKU countries had tighter economic ties with China (which managed to put limit to crisis influence within the country). But China so far is not such an important trade partner which it could be in view of its place in global export and import and its proximity to Central Asian and Caucasus countries. In

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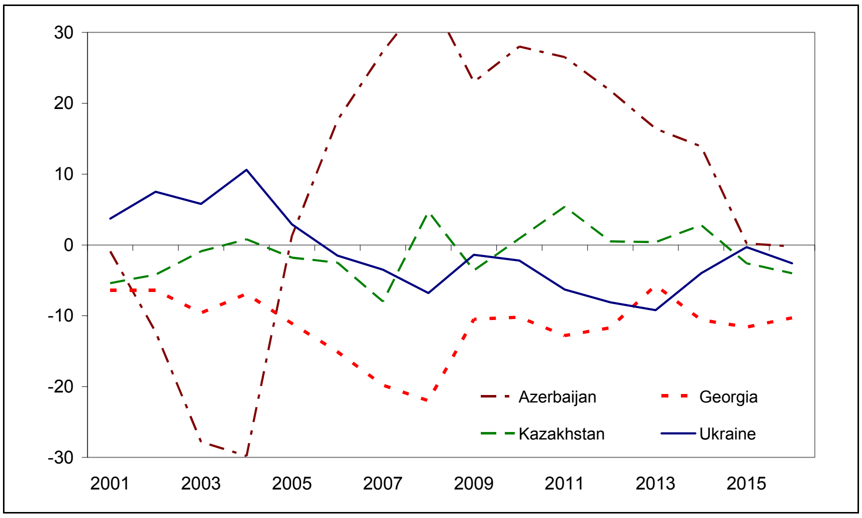
[64] Ukraine still remains an exporter of goods with low value added and not enough engaged into global value added chains. Low investment attractiveness of the country today leads to a situation when the major source of funding of investments and innovations are own resources of enterprises (with limited access to credit resources). That's why, most probably, in a med-term export value and its ration to the GDP will remain roughly at the same current level.
[65] [WEO].

2014 the value of Kazakhstan trade with China was about 22% of total trade turnover, Georgia – 7%, Azerbaijan – around 2%.

Current account of the balance of payment,
% GDP



In a current situation (keeping appreciation of US Dollar and trends to its further strengthening as a result of the FED interest rate policy, political instability and presence of high risks in many countries of the region) most probably, in a medium term, **benefits from raw materials will not be used as an instrument of boosting economy** as it was in 2000s (before crisis). Regarding weak opportunities of rapid expansion of businesses in many countries (including the EU ones), there is no chance of restoration of substantial demand and therefore – higher prices on exchange commodities, which simultaneously leads both to reduction of arbitrage opportunities and strengthening of the global economic environment endurance.

Clearly, **exports** largely **depends on its structure, quality, technology,** etc. If the European post-socialist countries from the first steps along the way of transformations (first as candidates, than as members of the EU) had implemented European standards, upgraded energy efficiency, engaged into global production chains[66], the post-Soviet countries had much fewer institutional opportunities to overcome civilizational economic gaps.

Nevertheless, Kazakhstan (to a lesser extend Azerbaijan), getting major export revenues from mineral resources[67], put a lot of efforts into creation of technological production facilities and on their basis into expansion of technological export in order to strengthen competitive positions. Recent years more than one third of Kazakhstan industrial goods export are high-tech products (Table "*High-technology exports*"[68]).

At the same time, the AGKU countries can relate substantial competitive prospects to development and export of modern services. Today only Ukraine has high level of ICT (information-communication technologies) services export (which fully correlates with high level of education and knowledge indicated in the Human Development Index mentioned above) (Diagram "*ICT service exports*" [69]).

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[66] Hunya G. Mutual trade and investment of the Visegrad countries before and after their EU accession / Eastern Journal of European Studies. – December, 2011. – Volume 2, Issue 2, p.77-91.
[67] For example, mineral resources export makes up 75% of total Kazachstan exports. And oil imported by EU from Azerbaijan makes up 98% of total imports from the country.
[68] [WBI].
[69] [WBI].

High-technology exports,
% of manufactured exports

	2007	2010	2014
Azerbaijan	3,4	1,1	7,0
Georgia	7,5	1,8	3,0
Kazakhstan	21,4	34,2	37,2
Ukraine	3,7	4,3	6,5

ICT service exports,
% of total service exports

	2006	2010	2014
Azerbaijan	23,0	20,1	12,9
Georgia	2,8	4,5	3,9
Kazakhstan	9,3	11,6	11,8
Ukraine	9,0	17,3	30,7

But this good result should not deceive because in general services in Ukraine are underdeveloped. At the same time, it is clear that if the country manages to take part in integration processes, together with general services the growth of modern services will also be boosted, it can become a factor of significant improving of social and economic situation as a whole.

4. Monetary and fiscal measures aimed at stabilization and growth

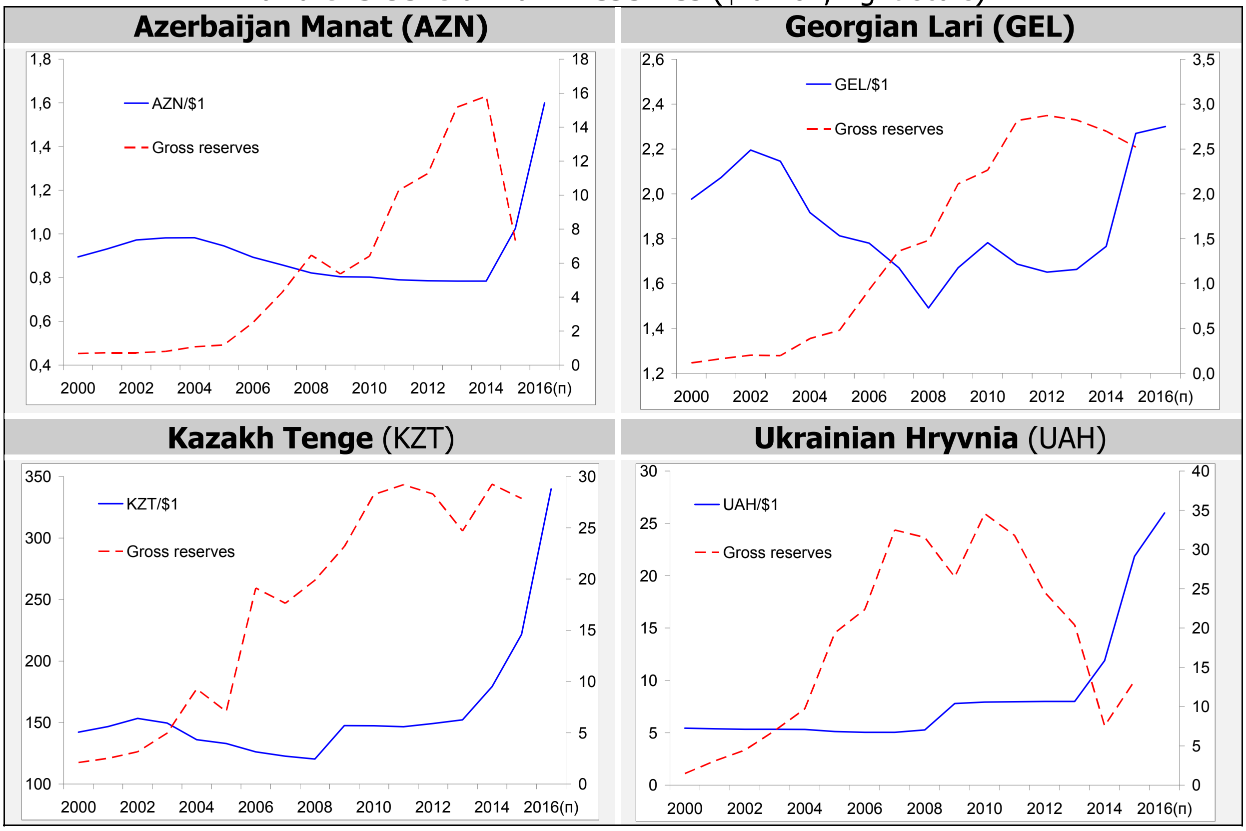
Long-term sustainable growth and development require well-weighted and coordinated monetary, fiscal and trade policies. Importance of such coordination substantially grows at a time of external economic shocks, especially for emerging countries which don't have relevant experience of curbing economic problems. The AGKU countries, as it was mentioned, used external markets' favorable conditions to varying extend. They also took some specific stabilization measures. Fiscal and monetary incentives belong to important areas of government work; some of them we will discuss in more details[70].

Currency imbalances. Favorable foreign economic situation and boosting of raw materials export coupled with FDIs also helped to strengthen national currencies. In Azerbaijan, Georgia and Kazakhstan, in 2003-2013 (a time of significant economic transformations), national currencies **tended to strengthen.** That trend also was supported by relatively "cheap" US Dollar in pre-crisis years. At the same time, macroeconomic and currency stability in all AGKU countries in a pre-crisis period helped inflows of capital and rapid growth of hard currency reserves, which over a decade increased by many times in each of those countries (Diagram "*National currency exchange rate and country's Central Bank reserves*").

But a **situation in Ukraine differed substantially** from other studied countries. In fact, the country practiced a fixed exchange rate regime contrary to the fact that there was no strong macroeconomic foundation for that. It provided visible stabilization benefits but led to macroeconomic losses at a time of worsening external conditions. No surprise that Ukraine was forced, from time to time, to conduct **crash devaluations of its national currency** (Hryvnia), which could not be averted even by large scale interventions.

[70] This Chapter contains some results of analytical research done by Maksym Shulha.

National currency exchange rate (to US Dollar)
and the Central Bank reserves ($ billion, right scale)



Risks related to volatile market conditions of commodities still remain quite high especially in view of probable strengthening of the US Dollar. Therefore, in the near future, most of emerging economies will find themselves under the permanent pressure of **macroeconomic uncertainties** which, in case of erroneous measures, can lead to shock losses in those countries.

Mind you, that in view of a role and place of the US Dollar in global trade and finance, its **strengthening is often accompanied by declining of commodity prices**. Currently, the dominating trend is to keep exchange commodities (first of all oil) price at relatively low levels, which will continue making the US Dollar more attractive for many "raw material" investors as it was observed at a time of global crisis. Hence, the prospects of mineral resource exporting countries dynamic development do not look too optimistic.

Recent years, situations in the AGKU countries only prove this. In 2014-2015 no country avoided significant depreciation. While weakening of the Kazakhstan national currency (Tenge) in the course of 2009 global crisis was moderate (during 2009 Tenge rate had fallen against the US Dollar from 120 to 148), during 2014-2016 it was quite significant – from 180 to 350 Tenge per US Dollar). Similar losses were suffered by Azerbaijan (the national currency – Manat – also lost half of its value). In both cases **devaluations**, to a large extend, **were caused by the fall of oil prices** in 2014-2016.

Ukraine has suffered two currency crashes (fall of the national currency – Hryvnia – in 2009, from 5 to 8, and in 2014-2016 – from 8 to 24 Hryvnias per US Dollar). The **collapse of the Ukrainian national currency** over the last decade to a large extend was caused by **ungrounded populist currency and monetary policy**. In the pre-crisis period Ukraine, **in spite of significant trade imbalances,** maintained practically **stable exchange rate of Hryvnia at the expense of the reserve losses**, which weakened crisis resistance of the country.

Under those conditions, while depreciation had not lead to quick depletion of hard currency reserves (similar situation was in Georgia), Ukraine over those years lost a lion's share of its reserves[71], which complicates its ability to stabilize in the near future.

Economic resilience founded on economic growth in Ukraine **was substituted with a fixed exchange rate support, which was supposed "to demonstrate" a macroeconomic stability** in general. Supporting the exchange rate by interventions and depletion of reserves provoked new arbitrage waves, which further on both "fuelled" depreciation spiral and provoked new arbitrage waves. In 2014 Ukrainian gross international reserves fell down to 5% of GDP and lost the ability neither to support the national currency, nor guarantee foreign payments. That's why the crash depreciation of Hryvnia continued in 2015 and the 1st quarter of 2016.

Note, that long-term maintaining of practically fixed exchange rate in all AGKU countries before crisis indeed **created visible factors of stabilization**, first of all, regarding relatively low inflation rates (which are quite difficult to influence in a situation of dependence from international markets). Timely depreciations (in case of destabilizing factors) allow countries to maintain their competitiveness and export capabilities which means certain level of protection for the national economy. But "the manageable depreciation" can easily get out of control and lead to negative macroeconomic consequences.

Monetary incentives. First of all, let's make a **general remark**. Current situation is characterized by substantial increase of **requirements to the quality of institutions** both in the framework of domestic economic policy, and globally. One of the reasons for this is that approximation of requirements to institutional quality allows for better coordination of macroeconomic policies of different countries and regions. Coordination of monetary and fiscal measures and instruments allows to reduce imbalances and state preferable key macroeconomic figures and indicators, such as interest rates, exchange rates, levels of public expenditures, export profitability or employment levels.

Macroeconomic policies of many emerging economies were characterized by sustainable **growth of money supply**, and the key component was a rapid growth of foreign assets (reserves) of Central Banks of those countries. As a result, level of monetization of the economy grew and firms **got broader access** to resources needed to support economic growth.

Moreover, stable increase of money supply provided for relatively higher speed of economic recovery (real GDP growth) in a post-crisis period. In successful developing economies over the recent decade, the level of monetization of economy grew substantially thanks to rapid increase of money supply. On the contrary, **restrictive monetary policy** which revealed itself in poor money supply **was accompanied by slow growth** or even a fall of real sector. In general, countries with **active monetary expansion had higher speed of economic growth** compared to countries with restricted monetary policies.

AGKU countries not always follow principles of macroeconomic policy. Though in the countries in general, monetary expansion (increase of money supply) took place, but recent years its (expansion's) dynamics has worsened substantially, and therefore level of monetization of national economies remains low (Diagram "*Money supply M2*"[72]).

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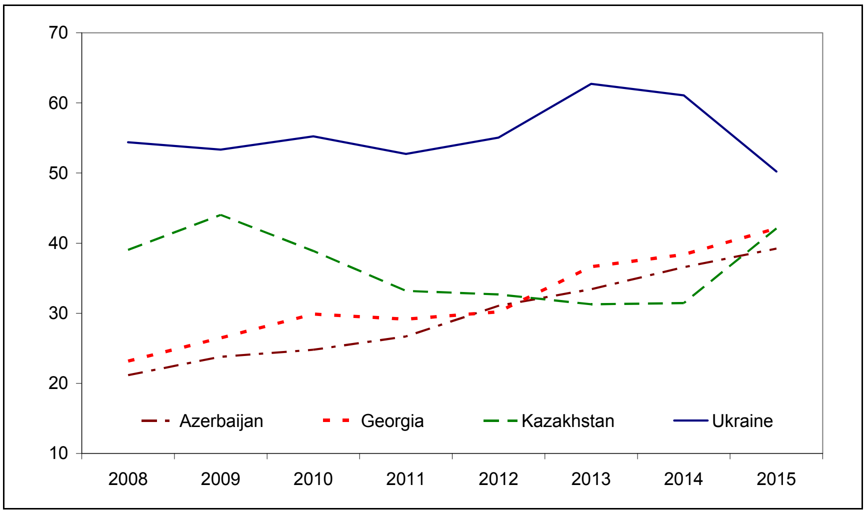
[71] Azerbaijan also suffered significant hard currency losses in 2015 – exchange rate declining by more than two times.
[72] [WBI].

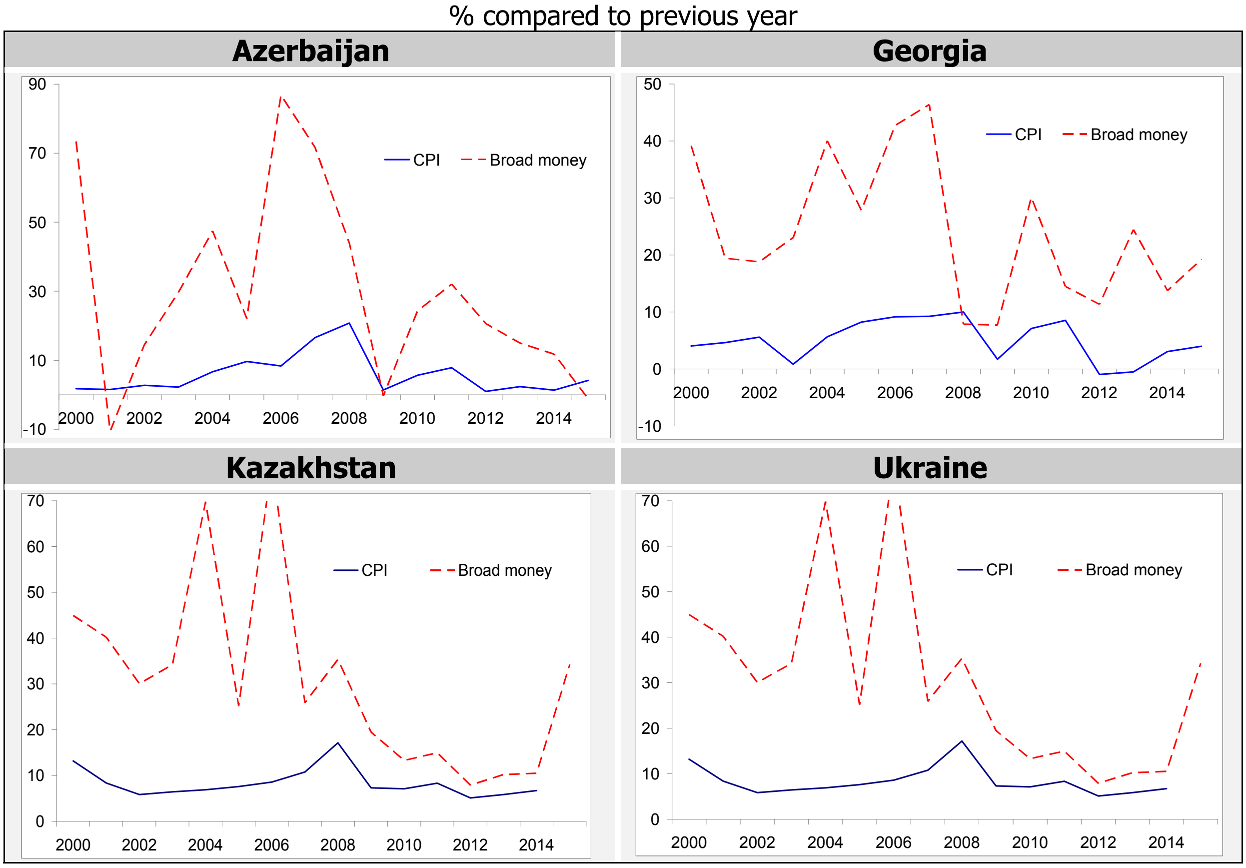
Sure, **monetary restriction**, *on the one hand*, **can really play a role of anti-inflation and stabilizing measures**. But on the *other hand,* it will **limit speed of real economic processes** and stimulation of (private) businesses, and also make **a very negative effect on the development of domestic financial markets**.

Money supply M2,
% of GDP



Before crisis, all AGKU countries substantially increased money supply, which **did not lead to significant inflation** because monetary expansion was accompanied by quite positive economic growth (Diagram "*Consumer price index increase and money supply growth*"[73]). After crisis, money supply slowed down significantly (in every country down to the lowest levels since the beginning of the century).

Consumer price index (CPI) and money supply (M2) growth,
% compared to previous year



73 [WBI].

Let’s make again **a separate note** concerning Ukraine. When successful developing economies were using monetary stimulating, Ukraine (except for 2013-2014) implemented **restricting monetary policy** which lead to substantial reduction of the level of monetization of economy in 2015-2016 and was even lower than a the time of global crisis. Here comes seemingly **paradoxical conclusion**: attempts to counter economic imbalances and crisis phenomena with monetary restrictions lead to opposite result – **significant reduction of GDP**.

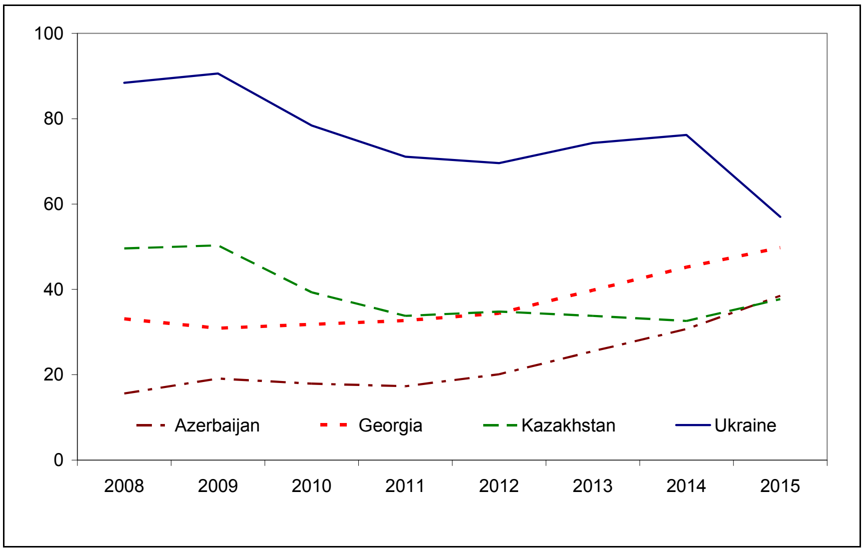
It is an **important conclusion** not only for Ukraine; it is useful for analysis of stabilization tools application in emerging economies in general.

Crises in AGKU countries in 2014-2015 **really showed** that monetary restriction can reduce negative expectations and foster macroeconomic stabilization. But at the same time access to financial (banking) resources can worsen, which will make negative impact on economic revival.

Restrictive money supply reflected in bank loans to domestic private sector. Despite certain increase in credits after crisis, Azerbaijan and Kazakhstan private sectors have quite limited access to banking resources (Diagram "*Domestic credit to private sector*"[74])[75].

Domestic credit to private sector

% of GDP



Accordingly, the number of enterprises in national economy, which use banking resources for investment, correlates with a size of domestic credits (Table "*Firms using banks to finance investment*"[76]), as well as indicators of business-environment (Table "*Ease of doing business*" at the second chapter).

In Ukraine, situation with credits to private businesses and financial sector looked better compared to other AGKU countries (both level of monetization, and credit amounts in GDP structure were quite high). But 2014-2015 crisis resulted in lower level of confidence between economic agents, outflow of significant amounts of deposits, bankruptcy of 1/3 of

[74] [WBI].

[75] Situation in Azerbaijan in terms of access to credit and financial resources is quite special because the sector structure of the economy in the country is definitely ‘pegged’ to extracting industry. The share of extracting industry in the industrial structure reaches 74% of total industrial output. – Azerbaijan Republic economic review. – *http://www.ved.gov.ru/exportcountries/az/*.

[76] [WBI].

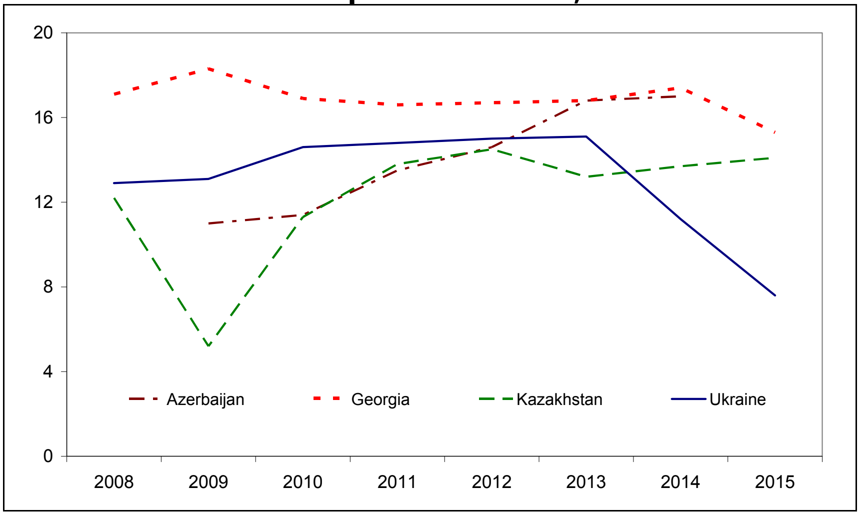
domestic banks and as a result Ukraine's banking system substantially lowered its readiness to credit real sector of the national economy.

Firms using banks to finance investment
% of total firms, 2013

Azerbaijan	17,6
Georgia	27,6
Kazakhstan	13,0
Ukraine	14,8

Mind you, that level of access to credits also went down in many emerging economies, including Azerbaijan and Kazakhstan (Table "*Components of ease of doing business index*" above). Therefore, in the nearest years those countries will have to put a lot of efforts to stabilize financial markets, improving financial discipline, strengthening domestic markets, reducing dependence on foreign market volatilities[77], which, indeed, requires stronger banking sector in general.

Bank capital-assets ratio, %



Though the bank capital-assets ratio has been quite stable (except for crisis period in Ukraine in 2014-2015) (Diagram "*Bank capital-assets ratio*"), the level of the so-called nonperforming assets of the banking system in the AGKU countries remains high (except for Georgia) (Diagram "*Bank nonperforming loans…*"). Naturally, under increased negative crisis pressure a share of nonperforming loans will grow (as in Ukraine), and real sector will be further oppressed (as a result – slumping of production and profits, probable increase of losses, unemployment, restricted access to refinancing, etc.).

Note, that Kazakhstan and Caucasus countries will face **challenges** related to negative processes in **Russian real sector and banking system**[78]. While direct cross-border loans from Russian banks to the Central Asian and Caucasus economies are not significant, a share of Russian banks' assets is already noticeable (up to 10% of aggregate bank assets in some countries)[79].

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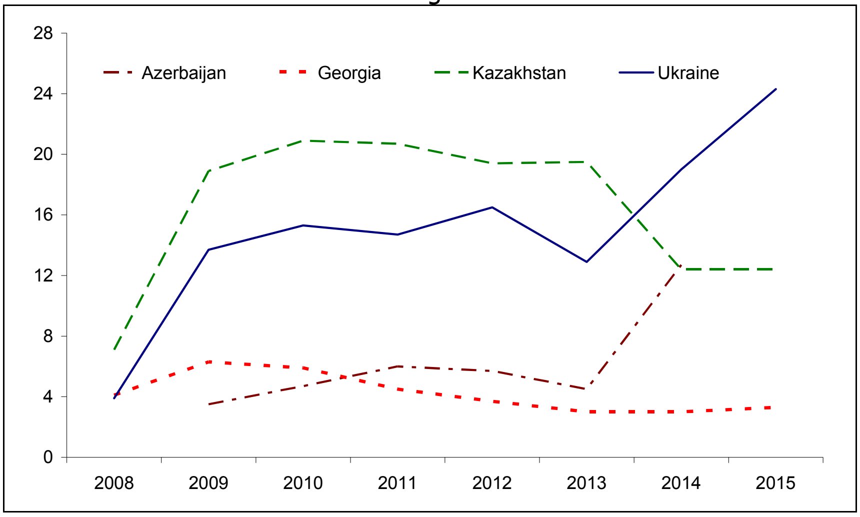
[77] Carrion C.J. Why Azerbaijan needs a strategic reform of its foreign policy towards the European Union? – CESD, April 2016.
[78] Though banks, in which the majority shareholders are residents of Russia, still operate in Ukraine, their influence (as a result of political losses suffered because of Russian aggression) is insignificant.
[79] IMF Regional Economic Outlook (various issues). – *https://www.imf.org/external/pubs/ft/reo/2016/.*

Bank nonperforming loans,
% to total gross loans



At the same time, those countries may suffer significant losses as a consequence of further depreciation not only within their economies but in Russia as well, and more limited access to Russian markets (because of political reasons and competitive losses), as well as deterioration of national bank system balances. Therefore, in the nearest years, Kazakhstan and Caucasus countries will face additional "external" tests.

Fiscal and tax support. AGKU countries quite consistently implemented fiscal support to investment activities, strengthening their positions in competitive global and regional economic environments. First and foremost, recent years these countries have substantially **consolidated and streamlined national tax systems**. In 2014 there were already 5-7 taxes in these countries, but tax rates and their significance for budget tax revenues in the countries are very different. In particular, the lowest tax rates are in Georgia (which is an important element of the high position of the country in the rating of ease of doing business – see the second chapter) (table "*Some tax rates*")[80].

Some tax rates, %

	Azerbaijan[81]	**Georgia**[82]	**Kazakhstan**[83]	**UKraine**[84]
Corporate income tax	20	15	20	18
VAT	18	18	12	20
Capital repatriation tax	10	5	15 / 20	15
Personal income tax	14 / 25	20	10 / 5	18
Social contribution	22%	-	5 / 10	36,76-49,7

At the same time, general redistribution of national resources through budgets has a noticeable trend to decrease. If, in the first years after crisis, consolidated budget revenues in Azerbaijan reached 41-46% of GDP, in 2015-2016 they were 27-28% of GDP, in Kazakhstan – 24-28% of GDP and 21-23% of GDP respectively, in Ukraine – 46-49% of GDP and 43-45% of GDP respectively[85].

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80 In Ukraine, from 2016, rate of the social contribution has been reduced by almost two times.
81 Tax Code of Azerbaijan Republic. – *http://www.taxes.gov.az/uploads/qanun/2016/mecelle_rus.pdf.*
82 Tax Code of Georgia. – *https://matsne.gov.ge/en/document/download/1043717/72/en/pdf.*
83 Tax Code of the Republic of Kazakhstan. – *http://online.zakon.kz/Document/?doc_id=30366217#pos=1;-217.*
84 Tax Code of Ukraine. – *http://zakon2.rada.gov.ua/laws/show/2755-17.*
85 IMF Fiscal Monitor Statistics. – *https://www.imf.org/external/.*

It is natural that tax proceeds have different weight in terms of **budget revenues.** A share of tax proceeds in budget revenues recent years is: in Azerbaijan – about 43%, in Georgia – 75%, in Kazakhstan – 57%, in Ukraine – almost 80%[86].

Total tax rate,
% of profits

	2011	**2013**	**2015**
Azerbaijan	40,0	39,8	39,8
Georgia	16,5	16,4	16,4
Kazakhstan	29,0	28,9	29,2
Ukraine	57,1	54,4	52,2

The taxes on business are also different (table "*Total tax rate*"). Remember, that Georgia was the first to start radical reform of taxation system back in early 2000s (box "*Lessons of rapid tax reforms in Georgia*"[87]).

LESSONS OF RAPID TAX REFORM IN GEORGIA

Tax reform in Georgia was implemented in two stages; new tax law was implemented in early 2005, amendments were approved in 2008. But already back in 2004 business community gave positive assessment to proposed tax changes (including tax amnesty) which lead to improved tax collection and started rapid growth of budget revenues.

The new law reduced the number of taxes from 22 to 7, inefficient taxes and those which were regarded as corrupt ones were cancelled. For major taxes a flat rate was introduced: 20% personal income tax, 15% profit tax (further on – 12%), 1% property tax and 18% - VAT. Customs duties were eliminated. All other beneficial taxes were cancelled. E-tax declarations became functional on-line in 2007.

Despite **reduction of the number of taxes and marginal tax rates**, the new law led to **significant increase in tax proceeds** (Table "*Consolidated Budget Revenues*").

VAT proceeds (as a share of the GDP) in 2006 doubled compared to 2003 (while the tax rate was lowered). The same way, sharp increase was observed in profit tax proceeds. New tax law also created incentives for entrepreneurs to legalize salaries. In 2006 proceeds from the social tax raised by 126%.

Within a few years, the Georgian National Budget revenues raised more than by 5 times (from 0.9 bn Lari in 2003 to 5.2 bn in 2008) (Table "*National Budget*"). Expenditures also grew but not as quickly as revenues, which allowed to reduce deficit significantly, and in 2005-2007 **balanced budget was almost reached**.

Consolidated budget revenues

	Total revenues, Lari ml.	% of GDP					
		Total revenues, including	VAT	Profit tax	Excise duties	Personal income tax	Social contributions
2002	1135,3	15,2	5,4	1,1	1,2	1,9	1,7

[86] In Georgia, Kazakhstan and Ukraine two taxes – VAT and personal income tax – make up the major body of tax revenues. In Ukraine they account for more than 50% of total tax revenues, in Georgia – almost two-thirds, in Kazakhstan – more than two-thirds. In Azerbaijan, where the share of tax proceeds in budget revenues is the lowest, the major source of revenues is the State Oil Fund (more than 52% of state financial revenues).

[87] The data used In the box: Georgian-European Policy and Legal Advice Center (GEPLAC) (different years). – *http://www.cecl2.gr/index.php/en/projects/*.

2003	1272,7	14,9	4,8	1,2	1,2	1,8	2,1
2004	2102	21,4	6,4	1,6	1,6	2,7	3,0
2005	3152,7	27,2	8,5	1,8	2,4	2,5	3,7
2006	4235,6	30,7	9,7	2,5	2,4	2,8	3,7
2007	5915,6	34,8	11,6	3,3	2,5	3,1	4,2
H1' 2008	3260	35,6	11,2	4,2	2,8	6,4	…

National Budget,
Lari ml.

	2002	2003	2004	2005	2006	2007	H1'2008
Revenues	816,1	956	1773	2607,5	3773,2	5159,0	2539,3
Expenditures	1040,7	1118,5	1923,6	2616,5	3821,4	5237,1	2730,0
Deficit	-224,6	-162,5	-150,6	-9,0	-48,2	-78,1	-190,7

The National debt was reducing until 2007 and in **2006 the national budget revenues for the first time reaches, and later exceeded, the national debt** (Table "*National debt*")**.**

National debt

	2003	2004	2005	2006	2007	H1'2008
National debt, Lari ml.	4608	4306,6	4076,1	3855,4	3919,6	4480,6
National debt, % of GDP	53,8	43,8	35,1	28,0	23,1	48,8
including (% of total)						
Domestic	34,0	36,6	37,7	39,2	38,0	32,8
Foreign	66,0	63,4	62,3	60,8	62,0	67,2

In the international context, all four countries have agreements (conventions) on **avoiding double taxation**. Azerbaijan has 51 agreement, Georgia – 52, Kazakhstan – 50, and Ukraine – 71, and these countries also have relevant bilateral agreements between themselves.

Note that important role in the process of integration belongs to the **factor of transportation** of goods through the territory of a country. A cost of export/import of a container is regarded separately. This figure includes total cost of transportation through the territory of the country, customs clearance and other official payments for a standard container.

Recent years, Kazakhstan substantially improved logistics, but still a cost (as of the end 2014) in Kazakhstan is much higher compared to other partner-states (it is more than two times higher than in Ukraine and three times higher than in Georgia) (Diagram "*Cost of a container transportation*"). It is clear, that the country will make a lot of efforts to improve both transport infrastructure, and logistics in general (which has been declared in official strategic documents[88]), including in the context of the Silk Road Initiative[89].

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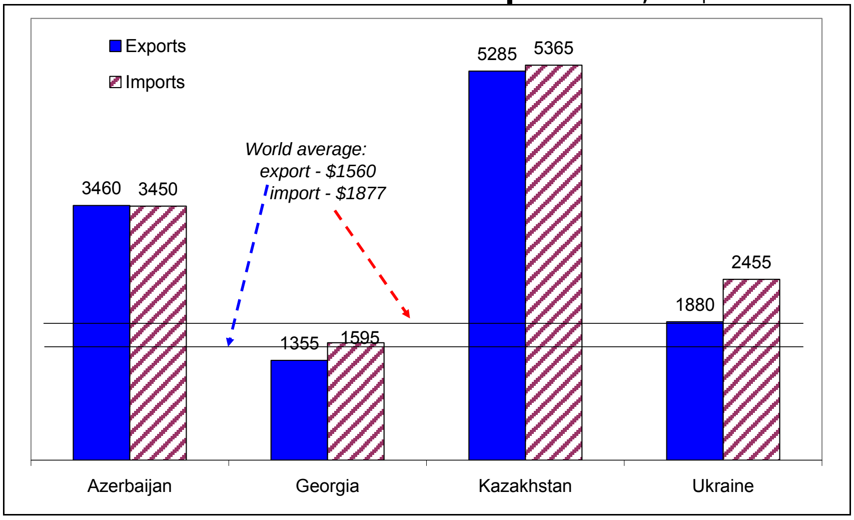
[88] Kazakhstan 2050. – *https://strategy2050.kz/ru/.*
[89] Between East and West: Kazakhstan's development along China's new Silk Road. – *http://www.osce-academy.net/upload/file/Between_East_and_West.pdf.*

Cost of a container transportation, US$



Regimes and instruments to attract investments. Among the most popular instruments to attract foreign investors and investments to the AGKU states were various preferential regimes and management systems. Today the countries introduce fiscal instruments to attract investors, including special legal norms and tax benefits.

In **Azerbaijan** there are **special preferential regimes for industrial and technological parks**[90]. In particular, businesses registered at those parks, the so-called 'park residents', are exempt from VAT on equipment and technologies, profit tax, property tax and land tax for 7 years. From May 2016 residents of parks have been exempt from import duty for 5 years.

Free economic zones in Azerbaijan are in the process of introduction, though since 2009 there has been a Law on free zones which provides for a number of benefits (including exemptions) both in terms of taxes and other duties. The first free economic zone has been introduced on the territory of a new Baku international commercial seaport and includes an international logistic center (total project cost – around $870 ml.[91]).

In Georgia, regimes and instruments to attract investment are more diverse, they include those specifically targeted at transit transportation. In Georgia, they set up some companies which are subject to specific beneficial taxation, in particular:

- The so-called "free warehouse businesses" which are logistic components of international transit transportation. These businesses may be exempt from re-export profit tax as well as from VAT for supplying other VAT payers within the "free warehouse". Sure, these businesses can interest those foreign companies which are engaged into large-scale international transportation or regional distribution;
- International financial companies are exempt from profit tax on incomes which they receive for providing their own services, securities and dividends. This should foster inflow of financial resources to national financial markets.

Currently, there are **two functioning free economic zones** in Georgia – in Poti and Kutaisi. It is important that a company registered in one of those zones is exempt from many taxes depending on its operations. For example:

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[90] Look in: Developing industrial parks. – *http://www.azernews.az/business/90982.html*.
Azerbaijan exempts industrial parks' residents from customs duties on imports. – *http://en.trend.az/business/economy/2530152.html*.
[91] Valiev A. Azerbaijan: Perspectives on Eurasian integration. – *http://www.ecfr.eu/article/*.

- A company which produces goods for export is exempt from all taxes (except for individual income taxes which are paid by a company);
- Shipments of goods imported by businesses from free zones are exempt from VAT and customs duties;
- Operations between free economic zone businesses are exempt from VAT, etc.

Though in Georgia there still has been a **discussion** on **free economic zones, they serve** their **major goal – production of competitive goods for export** using (and reducing price) necessary imported parts and production means[92].

Mind you, that indisputable **investment leader** (in attracting FDI and their export among AGKU states) is **Kazakhstan**, which has been pursuing a consistent policy of investment promotion and support including through setting up special investment regimes or investment (tax) benefits. Important **institutional decisions** aimed at further improving of investment climate were promulgated in the Law on Investment and since 2016 they have been present in the Business Code[93].

The preferential investment projects[94] in Kazakhstan enjoy significant benefits, the most important of them are:

- Investors are exempt from corporate profit tax and land tax for 10 years, and from property tax – for 8 years;
- The state compensates up to 30% of capital expenditures after the investment object has been commissioned (the so-called "investment subsidy");
- No limitation on profit repatriation after the taxes have been paid;
- Investors have a right to hire additional foreign labor for the period of construction works and within one year after commissioning of the project;
- The tariff ceilings on services provided by all natural monopolies, as well as a number of other benefits, have been fixed for long-term period (more than 5 years);
- The institute of investment ombudsman had been introduced, which substantially improved dispute resolution, coordination of positions and recommendations concerning further improving of business and investment environments.

Along with that, in Kazakhstan there are 10 special economic zones, each of them aims at development of specific branches (important for the certain region)[95]. In those zones business are exempt from VAT, corporate profit tax, property and land taxes.

In Ukraine, while a number of laws have been adopted with the aim of attracting investment and improve business and investment environment[96], it is recognized that current legislation is too complex, not transparent and mainly not acceptable to investors. For example, **special incentive regimes** are targeted at the branches identified by the Ukrainian Government, but the **selection criteria of those branches are not clear**[97]. The

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[92] Why Invest in Georgia? – *http://www.investingeorgia.org/en/*.

[93] Law of the Republic of Kazakhstan "On Investment". – *http://online.zakon.kz/Document/?doc_id=1035552*.
Code of the Republic of Kazakhstan "Business Code of the Republic of Kazakhstan". – *http://online.zakon.kz/Document/?doc_id=38259854#pos=1;-307*.

[94] … concerns investment projects with a value of more than $20 ml. Which are implemented in priority areas of national economy.

[95] More: Special economic zones in the Republic of Kazakhstan. – *http://www.kaznexinvest.kz/SEZ/economic_zones.php.*

[96] In particular: Laws of Ukraine "On investment activities", "On foreign investment regime", "On incentives for investment activities in priority branches of economy …", etc.

[97] In the list of "priority industries" there is no IT, software development, in which Ukraine has some noticeable achievements. But, at the same time, in Ukraine there is a Law "On innovative activities"

so-called "investment project" which may count on approval must meet a number of demands, among which (besides the amount of investment) there is a number of new jobs directly involved into production, level of salaries, etc.

At the same time, investment projects are to be implemented in the environment with such faults as **unsatisfactory dynamics of macroeconomic processes** (which has been present for a number of years and related not only to Russian aggression), **weak institutional support** (first and foremost in terms of investor protection).

Free economic zones existed in **Ukraine** in 2000-2005 – 11 zones in total (various ones). They did not make any principal positive impact on Ukraine's economy because special regimes in those zones were used mainly to avoid taxes. Currently, the issue of restoring such zones in Ukraine is regarded to be controversial.

Conclusion remarks

The Silk Road Initiative is justly directed to creation and implementation of the global integration projects with the highest future potential. The project may be able to update the system of international trade, investment flows, competitive environments, infrastructure networks, etc.

Ukraine, as other Central Asia and Caucasus countries, should extremely be interested in active development of the cooperation, including due to their prospect to expand economic relations with EU countries.

Location of Ukraine on the strategic cross-roads of North-South (Baltics and Scandinavia – Mediterranean countries) and East-West (Asian and European countries) provides the country with exclusive opportunities and prospects for development and substantial improvement of welfare of population, which in its turn will become an additional factor of strengthening integration processes and growth.

More over, we would emphasize that current Ukraine's investment gap and her free trade agreements with the EU and Canada, create much higher development potential and economic benefits (compare to many other countries) for foreign investment in Ukraine, including that of China.

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which regulates high-tech production, including financial support to investments. – *http://zakon5.rada.gov.ua/laws/show/40-15.*