

# **Investment and competitiveness: A strategic management perspective for Ukraine**

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## Introduction

Ukraine's economic resurgence over the last two years has been accompanied by some recovery in gross investment. Increased investment levels are critical to continue and expand economic growth. At the same time, gains in investment *levels* must be accompanied by gains in investment *productivity*, as measured by value added per unit of capital, or by the economy-wide equivalent of "shareholder value" which describes the ability of assets to generate an income stream over time.

The key to raising investment productivity is the ability to compete in increasingly global markets, both at home and abroad, and to build competitive advantage in key sectors. In fact, the need to innovate constantly in order to achieve and sustain a competitive position is the central challenge to managers of individual companies as well as to local, regional and national economies. Fortunately or unfortunately, that argument has been so widely accepted that "competitiveness" has become something of a buzzword. That, however, should not detract from its importance as central concern of policies aimed at improving conditions for investment. Fostering the emergence of competitive firms and sectors is becoming a key challenge of structural economic policy. This challenge is universal, but assumes even greater importance in countries that are not performing up to their real potential. For Ukraine, a Presidential Edict (19 November 2001) has underlined this crucial role of competitiveness as a guiding principle for economic development policies.

I argue here that the most effective approach to designing and implementing investment policies to help companies, sectors and clusters build competitive advantage draws on strategic management principles. Reduced to basic principles, strategic management (unfortunately in many respects another "buzzword," which again should not detract from its importance) defines a systematic approach to articulating and pursuing goals or directions when many stakeholders are involved. It emphasizes participation by all stakeholders in establishing goals and priorities, in defining measurable objectives and benchmarks, in forging a strategy and mobilizing needed resources to reach these objectives, in carrying out the activities, and in monitoring achievements and revising and adjusting goals, objectives and strategic activities as needed. In the present context, the goal is of course an improved investment climate and a more competitive Ukrainian economy, with objectives and benchmarks being defined in terms of both "hard" (observations) and "soft" (perceptions) indicators.

## Levels of competitiveness

Many observers, including Michael Porter and Paul Krugman, have pointed out that only firms, not nations, compete.<sup>1</sup> Ultimately, it is up to the management of each firm to ensure competitiveness and gain *competitive advantage* through continuing innovation. However, success in the quest for competitive performance depends also on forces in the firm's environment. Understanding competitiveness at the firm, or *micro level*, therefore requires a broader view, taking into consideration both economy-wide factors at the *macro level*, and forces that shape the firm's immediate environment at the intermediate, or *meso level*.

A firm forms part of a *value chain*. For example, the food processing value chain includes soil preparation, cultivation, harvest, post-harvest handling (storage and transport), processing, packaging, marketing, and consumption.<sup>2</sup> Even "vertically integrated" operations usually link

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<sup>1</sup> Even so, Porter's work actually seems to assign greater weight to country competitiveness, thereby blurring this distinction. His 1990 book on the determinants of the competitive performance of industry clusters is entitled *The competitive advantage of nations* (emphasis added); he also has taken a leading role in ranking the competitiveness of countries in the *Global competitiveness report* issued by the World Economic Forum.

<sup>2</sup> In most industries, the value chain should also include the post-consumer phase, that is, disposal or recycling.

into other activities, for example, through their use of social or physical infrastructure services. How successful individual firms are in achieving competitive performance depends therefore not only on their own ability to innovate, but also on the performance of both upstream and downstream links of their respective chains. These linkages, which are not captured in the traditional concept of an economic sector, have become a major focus of development policies in many countries. The *industrial clusters* defined by these linkages are critical to understanding and promoting competitiveness and building competitive advantage in an economy.

Both the macro and meso level perspectives on competitiveness are critical to effective policies to promote growth and development. At the macro level, policies focus on the creation of an attractive investment climate especially for small and medium-sized enterprises to spur innovation and competitive performance. At the meso level, focused policies and effective private-public sector partnerships promote innovation and facilitate competitive performance.

### **Macro level: The investment climate**

While there may be agreement at one level that firms, not nations, compete, there appears to be a growing interest in assessing the competitiveness of countries. Several sources are compiling country rankings or “benchmarkings” on the basis of indicators that describe the investment climate and the competitive performance of the economy as a whole. These rankings can be of great help to the policy maker, since they in effect provide a ready tool for the strategic management approach to investment and competitiveness policies. These rankings, and in particular the indicators they use, can be used for:

- **tracking the position** of the country vis-à-vis competitors: it is important to know where the country is seen in a global context, even if there is disagreement about some of the measures – in particular any “soft” criteria or perceptions;
- **setting priorities**: by understanding the relative strengths and weaknesses of the country’s investment climate, as seen by outsiders, better targeting of policies can leverage strengths and mitigate weaknesses more effectively;
- **keeping score**: using indicators related to country competitiveness rankings, it becomes easier to assess the effectiveness of policy initiatives in improving the overall investment climate;
- **making the case**: understanding the perceived strengths and weaknesses of the country as seen by outsiders can provide valuable guidance in designing more effective outreach and information strategies.

The attempts to compare macro level competitiveness across countries – competitiveness competitions – include initiatives like the *World Competitiveness Yearbook* (WCY) or the *Global Competitiveness Report* of the World Economic Forum (WEF). The WCY, for example, uses 286 criteria (118 “hard” criteria used in rankings, 62 “hard” criteria used for background information, and 106 criteria from survey data) to rank 49 countries, including 30 OECD members and 19 newly emerging and transition economies. The rankings do not include Ukraine. The competitiveness factors comprise several groups: economic performance (68 criteria), government efficiency (84), business efficiency (60), and infrastructure (74). The *Global Competitiveness Report* covers a broader range of countries (75 in its 2001 edition), including Ukraine (ranked No. 69 in growth competitiveness and No. 60 in current competitiveness for the year 2000). Table 1 shows these rankings for the 75 countries included in the *Global Competitiveness Report*. Other studies have used smaller sets of criteria to establish competitiveness benchmarks for a range of countries.

**Table 1: Country rankings by growth competitiveness (GCI) and current competitiveness (CCI)**

	GCI ranking	CCI ranking		GCI ranking	CCI ranking
Finland	1	1	China	39	47
United States	2	2	Slovak Republic	40	39
Canada	3	11	Poland	41	41
Singapore	4	10	Mexico	42	51
Australia	5	9	Lithuania	43	49
Norway	6	19	Brazil	44	30
Taiwan	7	21	Jordan	45	44
Netherlands	8	3	Uruguay	46	46
Sweden	9	6	Latvia	47	42
New Zealand	10	20	Philippines	48	54
Ireland	11	22	Argentina	49	53
United Kingdom	12	7	Dominican Republic	50	59
Hong Kong SAR	13	18	Egypt	51	45
Denmark	14	8	Jamaica	52	40
Switzerland	15	5	Panama	53	48
Iceland	16	16	Turkey	54	33
Germany	17	4	Peru	55	63
Austria	18	13	Romania	56	61
Belgium	19	14	India	57	36
France	20	12	El Salvador	58	64
Japan	21	15	Bulgaria	59	68
Spain	22	23	Vietnam	60	62
Korea	23	28	Sri Lanka	61	57
Israel	24	17	Venezuela	62	66
Portugal	25	31	Russia	63	58
Italy	26	24	Indonesia	64	55
Chile	27	29	Colombia	65	56
Hungary	28	26	Guatemala	66	69
Estonia	29	27	Bolivia	67	75
Malaysia	30	37	Ecuador	68	72
Slovenia	31	32	Ukraine	69	60
Mauritius	32	52	Honduras	70	74
Thailand	33	38	Bangladesh	71	73
South Africa	34	25	Paraguay	72	70
Costa Rica	35	50	Nicaragua	73	71
Greece	36	43	Nigeria	74	67
Czech Republic	37	35	Zimbabwe	75	65
Trinidad and Tobago	38	34			

Source: *Global Competitiveness Report 2001*.

A related example are the international business environment rankings carried out by the Economist Intelligence Unit (EIU), using a model that “seeks to measure the quality or attractiveness of the business environment and its key components by using quantitative data, business surveys and expert assessments. The EIU used this model recently to assess business environments in 27 transition economies, including Ukraine, both retrospectively for the period 1996–2000, and prospectively for the period 2001–2005. The prospective ratings served as a basis for projecting foreign direct investment (FDI) inflows. As it turns out, while the rankings for Ukraine are somewhat sobering, there is some encouraging news: the country occupies only rank 19 (out of 27) for the period 2001–2005, but it shows the best relative improvement in the EIU’s business environment score from 1996–2000, after the special case

of the Federal Republic of Yugoslavia. This relative improvement is projected to raise foreign direct investment from a paltry \$12 per capita for 1996-2000 to \$21 for 2001-2005, which amounts to less than 20 percent of the projected average for the 27 countries. In fact, only the Kyrgyz Republic, Tajikistan and Uzbekistan are projected to have lower per-capita FDI over the period 2001-2005 than Ukraine.

**Table 2: EIU ratings of business environment**

	2001-05	1996-2000	% change
Estonia	7.40	6.86	7.9%
Hungary	7.26	6.42	13.1%
Poland	7.07	6.22	13.7%
Czech Republic	7.01	6.18	13.4%
Slovenia	6.96	6.08	14.5%
Lithuania	6.95	5.74	21.1%
Latvia	6.88	5.87	17.2%
Slovakia	6.57	5.46	20.3%
Croatia	6.33	5.23	21.0%
Bulgaria	5.94	4.03	47.4%
Kazakhstan	5.59	4.30	30.0%
Russia	5.49	4.12	33.3%
Armenia	5.34	4.50	18.7%
Azerbaijan	5.28	4.35	21.4%
Romania	5.24	4.10	27.8%
Yugoslavia, FR	5.23	2.79	87.5%
Macedonia	5.21	4.47	16.6%
Albania	5.09	4.01	26.9%
<b>Ukraine</b>	<b>4.95</b>	<b>3.27</b>	<b>51.4%</b>
Georgia	4.87	4.01	21.4%
Moldova	4.78	4.04	18.3%
Kyrgyz Republic	4.77	3.75	27.2%
Bosnia & Herzegovina	4.66	3.98	17.1%
Belarus	4.16	3.91	6.4%
Tajikistan	3.55	2.81	26.3%
Turkmenistan	3.46	3.05	13.4%
Uzbekistan	3.18	2.80	13.6%

Source: Economist Intelligence Unit, as reported in *Transition*, Oct/Nov/Dec 2001.

### **A SWOT analysis for competitiveness rankings**

Overall country rankings on competitiveness average scores across a wide range of indicators. By digging a little deeper to understand the makeup of overall competitiveness rankings, Ukrainian policy makers can develop a better sense of policies priorities. In a strategic management context, the data on the country's relative position for the different indicators used provide a basis for an analysis of strengths, weaknesses, opportunities and threats (SWOT).

In addition to the overall rankings in terms of current and growth competitiveness, the *Global Competitiveness Report* presents component indices that summarize subsets of indicators. Its growth competitiveness index incorporates indices for technology, public institutions and the macroeconomic environment. Not surprisingly, Ukraine is doing better on the technology index, where it ranks 63<sup>rd</sup>, than on public institutions or macroeconomic environment, where

it ranks 71<sup>st</sup> and 73<sup>rd</sup>, respectively, producing the overall rank of 69<sup>th</sup>.<sup>3</sup> It is likely that the gains in overall economic performance in 2001 would improve rankings with respect to macroeconomic environment. In the case of the current competitiveness index, the two component indices reported, “company operations and strategy” and “quality of the national business environment,” are close together for a 62<sup>nd</sup> and 60<sup>th</sup> rank, respectively, yielding an overall rank of 60<sup>th</sup>.

In a very basic sense, policy priorities aim at building on strengths and mitigating weaknesses. But policies also need to take into account specific opportunities and threats. With respect to threats, the fact alone that Ukraine ranks significantly higher on current competitiveness than on growth competitiveness raises concerns for the future.

Disaggregating the more favorable score in the area of technology, for example, shows more specific threats that can undermine future performance. Ukraine ranks relatively high on measures such as the level of new technology development, quality of research institutions and their activities, and quality of exact science education. However, it scores low on factors shaping prospects for building on these strengths, such as the extent of the “brain drain,” procedures for licensing new technologies, level of intellectual property protection, or potential for investing in education and research activities. For example, any strategy stressing technological innovation as a key to growth places a premium on effectively protecting intellectual property rights – aside from obligations under, say, WTO accession standards.

Conversely, the individual indicators can also serve as a guide for identifying or clarifying *opportunities*. Real gains in terms of building competitive advantage in Ukraine’s economy require a clear sense of priorities, both with respect to macro level measures and with respect to industrial clusters or value chains. Obviously, clusters that take advantage of strengths (and are capable of reinforcing those strengths) or are less affected by particular weaknesses in the business environment should become a particular focus of strategic management approaches to improving investment climate and performance.

## Strategic elements

An effective competitiveness strategy needs to combine macro-level efforts to improve the investment climate with initiatives aimed at building competitive in key industrial clusters. Efforts at the macro level can draw on the types of country competitiveness rankings discussed as both a handy scorecard for monitoring and a tool for strategic analysis. Complementing these with cluster-oriented development policies demands new tools for analysis and innovative approaches to economic policy making that cross traditional sectoral and administrative boundaries. The concept of an industrial cluster is central to such approaches.

The intellectual roots of the industrial cluster concept extend across several academic disciplines. Business economics, especially Michael Porter’s work, has stressed that local factors matter greatly in establishing and maintaining competitive advantage in the global economy. Geographic proximity of competitors and complementors remains an important element. Mainstream economics has contributed a new body of growth theory built around models of increasing returns. Paul Krugman’s work on trade and geography has highlighted the importance of economic clustering as a source of increasing returns. Related econometric studies have shown that innovative activity tends to cluster as a result of knowledge spillovers.

Regional science has of course long been interested in clusters as networks of innovation, as evidenced by the growth pole literature of the 1960s and 1970s. This interest has been rekindled by the recent industrial district literature — to some extent harking back to

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<sup>3</sup> Differences in component indices can be even more pronounced. Korea, for example, ranks 9<sup>th</sup> in technology and 8<sup>th</sup> with respect to the macroeconomic environment, but 44<sup>th</sup> for its public institutions, for an overall rank of 23<sup>rd</sup>.

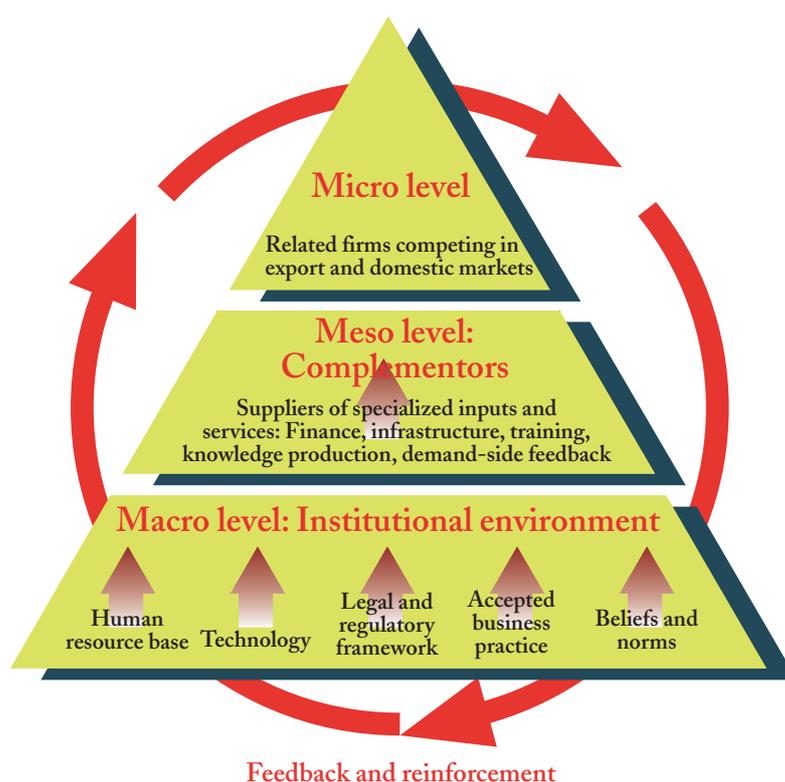
Marshall's analysis of industrial districts in 1890 — which focused initially on Italy and then on many other countries in Europe and elsewhere. Finally, the literature concerned with technological development has focused not only on the individual firm, but has also stressed the importance of interactions with customers, complementors (suppliers) and competitors, where competition does not exclude strategic, tactical or incidental cooperation. Both innovation and diffusion depend on networks of institutions that often define regional systems.

While geographic proximity matters because it facilitates both cooperation and competition, cluster-based policies operate at different levels. A 1998 OECD report summarized the experience with cluster-based policies focuses on the role of clusters as mechanisms of innovation and knowledge mobilization:

... networks of production of strongly interdependent firms (including specialised suppliers), knowledge producing agents (universities, research institutes, engineering companies), bridging institutions (brokers, consultants) and customers, linked to each other in a value adding production chain. The cluster approach focuses on the linkages and interdependence between actors in the network of production when producing products and services and creating innovations.<sup>4</sup>

Figure 1 illustrates the concept of a cluster, with a focus on the regional dimension, and stressing exports. “Leading firms,” however, can also compete in domestic markets with imports.

**Figure 1: Illustration of the cluster concept<sup>5</sup>**



<sup>4</sup> Roelandt, Theo J.A. and Pim den Hertog (eds.), *Cluster analysis and cluster-based policy in OECD-countries. Various approaches, early results & policy implications*. The Hague/Utrecht, May 1998; p. 5.

<sup>5</sup> This illustration borrows from a similar pyramid focusing on regional clusters copyrighted by the Economic Competitiveness Group.

The experience of OECD countries and others with cluster-based policies demonstrates that these approaches can (successfully) target increased competitiveness at different levels of aggregation. Countries in Europe, for example, have pursued policies that revolve around “mega clusters” like services (Netherlands) or forestry and telecommunications (Finland). At the same time, local and regional institutions have adopted cluster-based approaches to promote regional development.

Whatever the scale, successful cluster-based policies share certain features. The most important element is the creation of a focused public-private partnership. Such a partnership, in whatever institutional form, needs to work diligently to understand both strengths and weaknesses in the respective value chain, and to commit to a joint strategy to leverage strengths and address weaknesses. Such a public-private partnership has to transcend the traditional thinking of seeking advantages for a particular sector through direct and indirect subsidies. For the government, cluster-oriented competitiveness policies are *not* designed to achieve artificial and transitory cost advantages, but to complement efforts by the private sector to improve performance in key markets. Such policies focus on improving social capital and physical infrastructure in ways that support a clearly articulated strategy for building competitive advantage.

A focus on industrial clusters also provides specific strategic guidance across the full range of policy making. For example, it can serve to build a sound strategic context for privatization policies, initiating a shift away from the traditional focus on individual transactions. Cluster-based approaches would view the enterprise to be privatized in the context of the value chain(s) to which it belongs, and formulate strategies accordingly.

Finally, cluster-based approaches need to be understood as real alternatives to traditional industrial policies. Their basic rationale is to complement special efforts and initiatives in flexible and coherent manner. Adopting such policies recognizes both the dismal track record of governments in betting on industrial winners, and the need for clear criteria in making choices. Government policies simply cannot be neutral with respect to their impact on industrial (and geographic) clusters. Not making choices is therefore making choices – with unintended consequences.<sup>6</sup>

### **Cluster criteria**

The selection of industrial clusters as focal points for development policies is a complex process. Ultimately, it needs to be demand-driven, if it is to be an effective public-private partnership, but both intuition and analytical approaches can provide some direction. Intuition, based on a general knowledge of the economy and investment and performance trends, can be valuable. For example, in the case of Ukraine, virtually anyone familiar with economic trends and prospects is likely to cite the food processing cluster as a likely candidate for cluster-based development policies. Both investment trends, in particular foreign direct investment, and relative performance in terms of output growth patterns, provide some support for this view. But these points should be seen as strictly indicative. There are many factors that have shaped the performance of this cluster, including levels of protection inconsistent with an open economy. For articulating an effective strategy, the notion of food processing as a mega cluster will need to be broken down further to focus on individual value chains.

Other sectors generally thought to have competitive potential include pharmaceuticals, information technology and software development, and tourism. These indications may warrant further exploration, especially a more intense dialogue with the private sector, to gauge the suitability of these clusters as focal points for development policy.

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<sup>6</sup> Michael Fairbanks and Stace Lindsay, *Plowing the sea*. Boston, 1997.

Figure 2: Food processing is the prime target for FDI ...

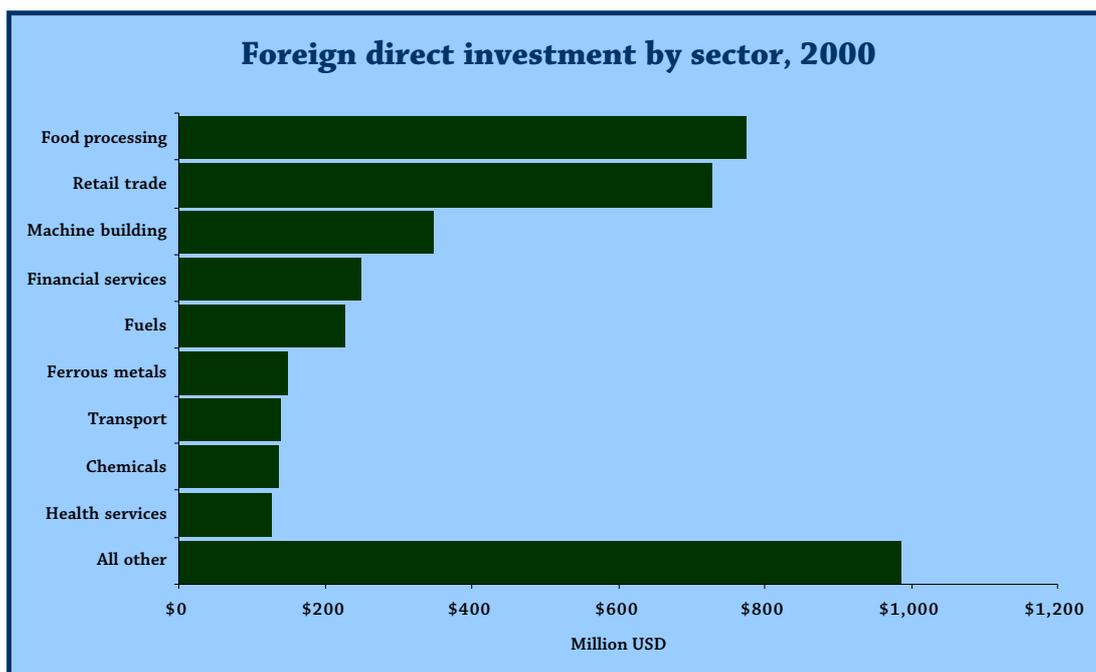
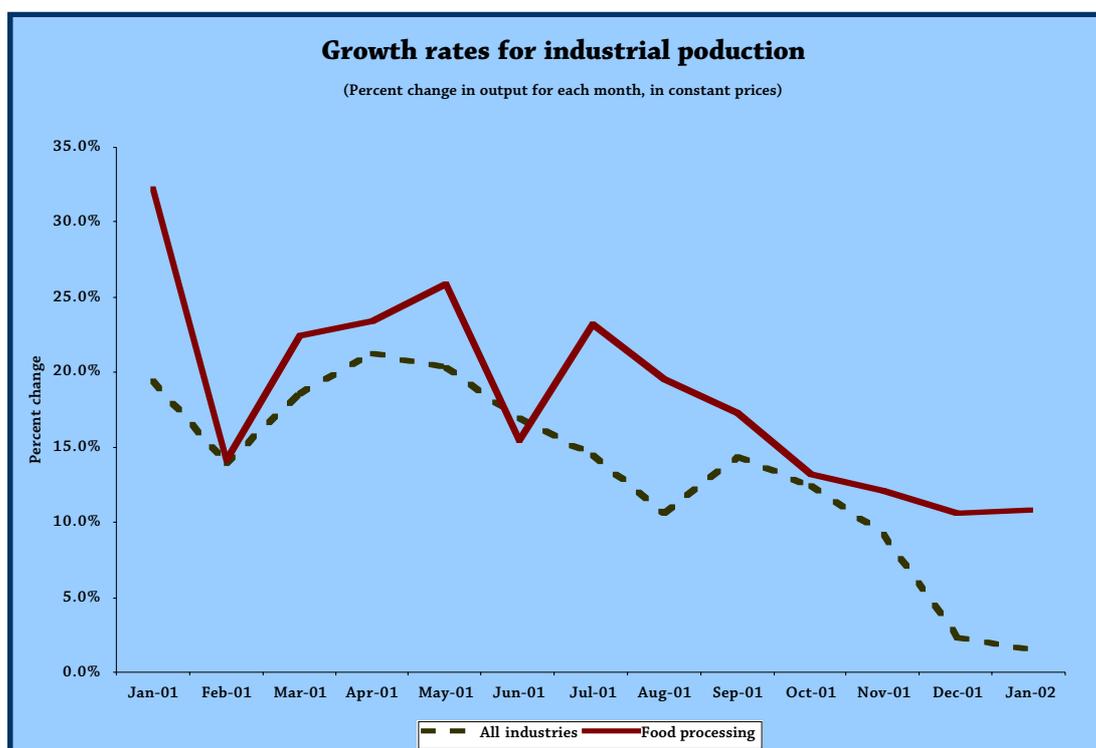


Figure 3: ... and it outperformed other industries



Source: State Statistics Committee

A more systematic approach to the initial assessment of competitive potential focuses on prospects in export markets. It is encapsulated in the “competitive analysis of nations (CAN)” method developed by the UN Economic Commission for Latin America and the World Bank. The method involves an adaptation of the venerable market positions analysis matrix (the “Boston matrix”) which combines market growth rate and relative market share (relative

to the largest competitor) to define opportunities and threats. The CAN looks at the growth rate for various products in key export markets and links it to such measures as the exporting industry's growth in market share. Applying a variant of this approach to the relative performance of Ukrainian exports to the European Union, for example, suggests additional clusters for further exploration, such as wood products or leather goods.

While the competitiveness challenge looms large, a careful assessment of the situation and prospects at both the macro and the meso level can help in identifying priorities. A clear sense of priorities as the basis for building consensus is the precondition for a strategic management approach to improving Ukraine's investment climate and building competitive advantage in the economy.