

The Impact of the Eurasian Customs Union on Foreign Direct Investment in Kazakhstan

Ryan Dalrymple

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Judith Thornton

Maria Perez

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Ryan Dalrymple

University of Washington

Abstract

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Ryan Dalrymple

Chair of the Supervisory Committee:
Professor Judith Thornton
Department of Economics

This paper adds to the literature that examines the costs and the benefits of the Customs Union between Russia, Kazakhstan, and Belarus by measuring the impact of the Customs Union foreign direct investment in Kazakhstan. To evaluate the Customs Union's impact on foreign investment in Kazakhstan I develop a difference in difference model using data from the World Bank's World Development Indicators. While most empirical research has shown that the Customs Union negatively impacted Kazakhstan, this paper shows how the Customs Union contributed to increased flows of foreign direct investment into Kazakhstan. This result contradicts many western views that Kazakhstan gained nothing from the Customs Union, although it does not provide an overall net economic impact assessment. Because the Customs Union was just the first step of a larger regional economic integration project, this paper presents Kazakhstan with four policy options relating to future integration.

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Introduction

Kazakhstan is approaching a major decision point. On May 29th the leaders of the three Customs Union member countries, Kazakhstan, Russia, and Belarus, will meet in Astana with the intention of signing an agreement to establish the Eurasian Economic Union (EEU) by 2015. With Belarus and Russia already committed to the project Kazakhstan's President Nazarbayev must decide if he will lead his country into this union. History created strong ties between these countries, however critics question why Kazakhstan is a part of the project. The situation in Ukraine is adding to the uncertainty that already existed in the political climate. Should Kazakhstan further integrate its economy with a country that is entering a recession and is being isolated from the western world? Contrary to what many western analysts argue my analysis shows that the Customs Union has some positive impact on Kazakhstan by increasing foreign direct investment (FDI). Although this analysis does not show that the net economic benefit of the Customs Union has been positive, there are reasons for Kazakhstan to continue with the integration process.

The EEU is the next step in the integration process that began with the formation of the Customs Union in 2010. It is intended to push the region towards a single economic space similar to the European Union. While a region may benefit greatly from a single economic space, for Kazakhstan the benefits of integration have been questionable to date. In order to establish the Customs Union, Kazakhstan had to raise tariffs, which led to price increases on some goods within Kazakhstan. Looking just at the tariff increases will show that trade flows have changed. Trade with China has decreased while trade with Russia increased

(EBRD, 2012). Although this may have caused lower income levels, one should consider more than just tariffs and prices when evaluating the long-term economic impact.

I add to the literature on the Customs Union by measuring the Customs Union's impact on FDI flows to Kazakhstan. I develop a model based on a difference in difference framework that shows how the Customs Union began positively impacting FDI flows in 2011 and the impact increased in 2012. The Customs Union's positive impact on FDI flows to Kazakhstan could be the result of better access to a larger market in Russia. Kazakhstan has better business climate rankings than Russia. My model also shows how FDI flows to Russia decreased. Some FDI could be moving from Russia to Kazakhstan as the Customs Union opens up market access between the two countries. These results add to the discussion on the value of integration to Kazakhstan. Understanding how these results relate to Kazakhstan's goals of integration will help inform Kazakhstan's leaders as they decide on a policy.

This paper is divided into the following sections. The next section provides the historical and economic background of Kazakhstan. I then present the general theoretical purposes of customs unions and trade agreements. The following section reviews past research on the Customs Union and foreign investment. Then I explain reasons why Kazakhstan may have joined the Customs Union. These sections are followed by a description of my empirical model and the results of the model. I devote the last portion of this paper to a discussion of the results and the policy options available to Kazakhstan. The conclusion reviews the paper's findings.

Background

In the early 1990's, with the complete unraveling of the political and economic cohesion of the Soviet Union, Kazakhstan's economy collapsed. Kazakhstanian leaders were not eager for independence from Kazakhstan¹ because they realized that Kazakhstan received much more as a member of the Soviet Union than it contributed. Supply chains were completely integrated with Russia and were controlled from Moscow. Under Soviet control Kazakhstan had developed as just a single part of a larger economy, but by 1992 it was taking steps to transition into an independent market economy.

Although national borders between Soviet republics appeared overnight, a mechanism to sustain, regulate, and monitor cross-border trade did not. Before 1992, 90 percent of Kazakhstan's trade happened within the Soviet Union (Olcott, 2002). Factories received raw materials from Russia and shipped the finished products back. If any products were exported to other Soviet republics they often went through Russia first. Most industries were devastated when Kazakhstan became independent. The defense industry is a prime example. Over 50 military production factories closed in the early 1990's (Rutland & Isataev, 1995) in Kazakhstan because the Soviet army no longer existed. Factory closings meant massive job losses.

Kazakhstan was fortunate that it had an abundance of relatively unexploited natural resources.

The Soviet Union had not fully developed Kazakhstan's oil and gas fields. Even before the collapse Kazakhstanian leaders were negotiating with western oil companies to develop these fields

¹ Kazakhstan was one of the last Soviet Republics to declare independence in December 1991, nearly 4 months after the attempted coup that splintered the Union.

(Matzke, 1994). Discoveries of huge oil deposits during the 1990's created hope that foreign companies would invest in Kazakhstan and provide the government with a source of revenue for decades. For Kazakhstan exporting oil was easier than other goods because much of the oil flowed through pipelines. The large majority of Kazakhstani oil was exported through the Russian pipeline system, or by rail to Russian refineries. The use of pipelines prevented delays at customs controls stations that normally slowed the export of other goods. The oil and gas industry soon became Kazakhstan's strongest economic sector.

Monetary problems further complicated Kazakhstan's economic situation. As part of the transition to a market based economy Kazakhstani authorities liberalized prices in early 1992. This led to an immediate 300-500 percent rise in prices. In 1993 Russia liberalized its prices. When other Soviet republics began abandoning the Ruble, Soviet Rubles began flowing into Kazakhstan from the other Soviet republics. Russia then also abandoned the Soviet Ruble in favor of a new Russian Ruble leaving Kazakhstan without a functioning currency. Rather than give up its gold reserves for a supply of Russian Rubles, the Kazakhstani government introduced its own currency, the Tenge, in November of 1993 (Rutland & Isataev, 1995). Having separate currencies complicated trade across borders and increased transaction costs. Prices of goods had to be converted from one currency to another, which was particularly challenging when currencies were so volatile during the 1990s. Prices changed weekly and sometimes even daily. Not surprisingly cross-border trade collapsed (Olcott, 2002) .

Kazakhstan opened up to international community cooperating in many policy areas from security to trade and market liberalization. It gave up its nuclear weapons and championed the

idea of a nuclear free world. It also opened up to foreign companies eager to extract the precious metals and oil that lies beneath the ground. Kazakhstan's multi-vector foreign policy has been fairly successful in producing positive relationships with all the countries it encounters. Despite the difficulty of balancing relations with countries that are not friendly with each other, Kazakhstan has friendly relations with China, Russia, India, the European Union, the United States, Iran, Turkey, and nearly any other country with which it has had relations (Some expected that Uzbekistan could become a foe, but real tensions between the neighbors have not materialized).

Because Kazakhstan had not initially developed as an independent economy, it immediately began suggesting ideas for various levels of reintegration after the break up of the Soviet Union. Many of the former Soviet Republics were cautious about giving up economic powers to Russia, which made achieving any level of integration difficult. As early as 1994 President Nazarbayev suggested the idea of an economic union (Sarbaeva, 2012). Russian leaders also suggested the idea of a Eurasian Union modeled on the European Union. In March 1996 Kazakhstan, Russia, and Belarus signed a treaty forming a customs union (de Souza, 2011), however this treaty was never fully implemented. The three countries failed to implement a common external tariff, one of the primary features of a customs union. In October 2000 Russia, Kazakhstan, Belarus, Kyrgyzstan, and Tajikistan all signed a treaty creating the Eurasian Economic Community in order to better achieve the integration that previous treaties had tried to achieve. Ukraine showed interest in joining the Eurasian Economic Community until its Orange Revolution in 2004. Uzbekistan was a member from 2004 until 2006. Discussions achieved very few real results until 2009 when Russia, Belarus, and Kazakhstan agreed to enter a customs union with a common

external tariff effective January 1, 2010. The three countries agreed that this customs union would be administered from Moscow by the Eurasian Economic Commission (Isakova & Plekhanov, 2012).

Theory and Purpose of the Customs Union

Trade, in theory, makes all trading partners better off. A country's comparative advantage or its ability to produce a good at a lower opportunity cost than other countries, allows countries to increase their wealth and resources by exchanging goods with other countries. However, technology can change a country's comparative advantage. Structural change often occurs much slower than technological change. As a result, trade will cause some people to suffer when comparative advantages change, but trade should still increase total aggregate well-being.

In this section I first briefly describe the theory and purpose of tariffs and other types of trade regulations. I then explain the basic theory of a customs union and how it differs from a free trade agreement. Next I provide examples of existing customs unions and finally I give a description of the Eurasian Customs Union.

Trade Regulation

International trade today involves navigating free trade agreements (FTA), Customs Unions, Bilateral Investment Treaties, and a host of other international agreements. Tariffs are only one of the factors restricting trade. Non-tariff barriers are significant and may actually be overtaking tariffs as the primary way to regulate international trade (Baldwin, 2011). Countries, including

Kazakhstan, regulate the flow of goods into and out of their countries because of structural, technological, and economic differences between countries. Trade agreements attempt to remove inefficient trade barriers in ways that benefit both countries. Regional trading blocks are becoming more and more important (Baldwin, 2011). The Customs Union in Eurasia is just one example of a regional trade agreement.

Tariffs have been one of the more common ways to regulate trade. A tariff raises revenue for the government and raises the price of a good within the country by taxing it at the border. Higher internal prices of a good usually mean that foreign companies will sell less and their profits will be smaller. This is of course bad for the foreign companies, but shields domestic producers from competition.

Countries often use tariffs to protect domestic industries that might not be able to compete on the international market. If the domestic industry cannot afford to sell its products at the world market price the country can put a tariff on foreign goods to raise prices to a level the domestic market can afford. A country might do this if an industry employs a large portion of the workforce. A potential negative consequence is that the domestic industry will not innovate to meet international standards. In transition economies such as Kazakhstan slowly reducing tariffs over several years can give industries time to gradually adapt. Sometimes tariffs are used as political tools to respond to another country's tariffs' or harmful trade practices.

Non-tariff trade barriers can also be used as political tools (especially in Russia), but may simply be a product of bureaucracy. Governments want to know what is entering and exiting their

country so they require documentation. This documentation slows trade. Sanitary and safety regulations are usually meant to protect consumers, however they can be major barriers to trade. Such regulations are most problematic when they are not harmonized across countries. Producers have trouble making sure that their product meets each countries' standards.

Trade agreements and trade organizations provide rules on how a country can set its tariffs and often attempt to remove non-tariff barriers. Members of the World Trade Organization (WTO) must use a most favored nation (MFN) tariff rate. The MFN rate is the tariff rate that a country charges to all other countries. A country cannot charge another country a tariff rate higher than the MFN, although it can raise its MFN. The caveat is that the WTO allows for free trade agreements and customs unions. WTO members that form free trade agreements may charge a lower tariff to its partner, but still may not charge any country more than the MFN tariff rates.

Customs Union Theory

A customs union is one way for countries within a specific region to coordinate their international economic activity. A customs union usually consists of a common external tariff between all the member countries and tariff free trade among member states. So a firm importing a good into a customs union would have to pay the same tariff no matter which member country it imported to, but firms within the union could export to other union members tariff free. The common external tariff is important because the customs union is internally also a free trade zone. Without the common external tariff a company could import goods wherever the tariffs were lowest and then ship the goods to other countries through the free trade zone tariff free. A customs union may also reduce non-tariff barriers by synchronizing regulations and removing

customs processes that impact international commerce, but each international agreement is unique.

A customs union is more complex than a free trade agreement. Free trade agreements typically regulate the tariffs that countries charge those with whom they make the agreement. They do not regulate tariffs charged to countries not in the trade agreement. Free trade agreements may also regulate non-tariff barriers such as sanitary regulations and border control mechanism. Bilateral investment treaties frequently accompany free trade agreements as a way to ease regulation to promote investment and collaborative commerce between two countries. Customs unions usually include all aspects of free trade agreements and more.

So why would a country seek to form a customs union rather than just a free trade agreement? Often customs unions are motivated by regional efforts to integrate or at least coordinate economies. Countries that are close together geographically tend to trade more with each other. This is called the gravity principle (Krugman, 2009, 13). On average the closer two countries are the more they will trade with each other all else equal. For example Kazakhstan trades more with China and Russia, two countries it borders, than with the European Union (EU). It trades more with the EU than with the United States. So countries that are close together could mutually benefit from free trade with each other.

The higher levels of trade that come with proximity only increase the level of economic integration of neighboring countries. Such countries may have similar industries, or integrated industries where different stages of production are performed in different countries. Collectively

they may want to protect these industries from foreign competition. A common external tariff is one way these countries could jointly protect an industry from foreign competition.

Protectionism often has a negative connotation, but governments understandably will try to support the major industries in their countries. Countries that are neighbors may also want to coordinate their economies to increase overall output. A customs union could create conditions that would lead to more coordination across countries in the union. Geographically close countries may have similar economic goals and may be in similar stages of economic development.

Existing Customs Unions

The most prominent and successful example of a customs union is the European Union.

European Union is much more than a customs union but it has taken a long time to develop into what it is today. Six European countries first made an agreement to form a common economic market in 1957 with the goal of complete market unification. The purpose of the European integration project was always more than just economic integration. After two world wars integrating economically and politically would, they hoped, maintain peace and stability.

Although the economic agreement was signed in 1957, the six countries did not implement an actual customs union until 1968 when they established a common external tariff and removed all internal customs duties (European Union, 2014). Over the next 40 years the European Union increased integration by harmonizing economic regulations, allow free movement of people across borders, and implementing a common currency. The union also took on significant non-economic policy issues.

Europe's long integration process has benefitted the continent tremendously. In Europe, the union is useful because of the relatively large number of small states in a small geographic area that all rely on each other economically. Now European firms have free access to markets all across Europe rather than in just their own small country. A single currency simplifies transactions and a common external tariff for Europe simplifies trade with other nations.

Mercosur is another major example of a customs union. In 1991 several South American countries began working to create a unified economic market (the Andean Community is another customs union in South America) by establishing a customs union. This union includes Brazil, Argentina, Venezuela, Uruguay, and Paraguay, with plans to expand to other South American countries. Although these countries vary widely in both size and economic structure (Brazil makes up over 75 percent of Mercosur's total GDP according to Klonsky, (2012)), they have been able to implement a common tariff on over 80 percent of the tariff lines. Because of the major differences in these countries, completely coordinating their economies has been challenging. Although Mercosur's purpose was initially economic integration, recently there have been proposals on other types of policy coordination. Political disputes have complicated economic integration efforts. Despite the challenges Mercosur has faced, the EBRD (2012, 66) has recognized significant benefits that have accrued to Mercosur's members.

Eurasian Customs Union

After a decade and a half of talks on economic integration Kazakhstan, Russia, and Belarus agreed to a common external tariff in 2009 and began implementing this tariff January 1st, 2010. The common external tariff was just the first step of integration efforts. Beginning in July 2011

all customs control stations between Russia, Belarus, and Kazakhstan were abolished moving the union closer to its goal of a single economic space. In February 2012 the Eurasian Economic Commission became the administrator of the Customs Union, meaning member governments no longer controlled customs stations at their own borders. The Eurasian Economic Commission began collecting and distributing customs duties. Headquartered in Moscow, the Eurasian Economic Commission is also working to establish the institutions necessary for the customs union member states to become a single economic space. The customs union is on scheduled to become a single economic space called the Eurasian Union in 2015 as long as the countries sign this agreement in June 2014. The single economic space will allow for the free movement of goods people, and capital among the three countries. The commission has discussed a common currency, but the member countries have not yet agreed to this. After more than a decade of discussions Kazakhstan, Russia, and Belarus and are making significant progress toward integration of their economies (with several other former Soviet Republics preparing to join). The significant question for Kazakhstan, which had significantly liberalized its economy by 2010, is whether or not this Economic Union will bring any economic benefit.

Previous Research

Evaluating a new policy, although difficult, is important in understanding the future value of the policy. The customs union is meant to be only the first stage of economic integration. The integration effort is ongoing with the Eurasian Economic Union set to go into effect in 2015. The long-term effects of the Customs Union are still unclear. Currently Kazakhstan is only four years into its customs union membership, which is not much time to measure the impacts to date partly

due to the time required to get accurate trade and investment data. In 2012 the World Bank published a comprehensive impact report. This report is so far the most rigorous evaluation of the economic impacts of the Customs Union to date. Other banks and professional service firms have also tried to evaluate the impact of the Customs Union and its expected impact on their clients. Overall the international literature presents a slightly negative view of the customs union, while the Russian view is more positive.

World Bank

The World Bank's (2012) critical view of the Customs Union is a result of its estimations showing a negative impact on the economic welfare of Kazakhstan. Using a computable general equilibrium model with 57 industry sectors, the report shows that Kazakhstan's income is .2 percent lower as a result of the customs union. It is important to remember that the report was published only two years after the common external tariff went into effect. Although the amount that income decreased is significant, it is also small. Of course Kazakhstani officials would hope to see positive economic effects immediately, but a .2 percent reduction is not enough to warrant a dramatic shift in policy this early in the integration process. The benefits of customs unions and other economic integration efforts usually accrue in the long term.

Unfortunately for Kazakhstan, according to the World Bank income was not the only indicator negatively impacted by the customs union. Wages in Kazakhstan also decreased by .5 percent. The change in wages is a more accurate measure of the Customs Union's impact on the average Kazakhstani because income includes factors that may not directly impact normal Kazakhstanis. Although .5 percent is small, people will likely notice when they earn even a small amount less.

Investors in Kazakhstan have also been negatively affected by the Customs Union. The World Bank estimated that the return on capital decreased .6 percent. While this is also a small percentage, it is concerning because a customs union should improve country's attractiveness to foreign investors. The .6 percent decrease is an average that includes all capital in Kazakhstan. It is not clear from the World Bank's estimations if foreign investment in the country has been affected any differently than domestic capital. If the Customs Union is going to attract investment in Kazakhstan in the long-run, it cannot continue depressing returns on capital.

Although the Customs Union may have depressed returns on capital in Kazakhstan, WIIW (2013) notes how profits on foreign direct investment (FDI) in Kazakhstan were over 24 percent in 2012. The .6 percent that the Customs Union reduced returns on capital is small compared to 24 percent. Additionally, WIIW showed that profit on FDI in Russia was only 14 percent in 2012, or barely half the return in Kazakhstan. FDI to East Europe and Central Asia rose 8 percent in a year when total world FDI was decreasing. For Kazakhstan this means that although the Customs Union may slightly decrease returns to capital in the short-run, profits on FDI are still high enough to appeal to investors.

The impact on investment is what the World Bank criticizes most about the Customs Union, but not directly because of the depressed return on capital. The World Bank suggests that diverting trade from outside the Customs Union to union members will lead to less technology transfer from technologically advanced countries. Their reasoning likely follows the logic that more trade also leads to more investment, but that is not how a customs union works. In theory foreign

investment in manufacturing could replace some trade and maintain technology transfers. Nevertheless, assuming the World Bank's logic is correct regarding technology transfers, less technology will reduce Kazakhstan's long-term productivity. It may be reasonable to suggest that diverting trade will have an impact on foreign investment as well, the World Bank's analysis does not address how investors in Kazakhstan will be affected by increased market access. The Customs Union's much larger market is one of the main theoretical drivers for increased foreign investment.

A possible reason the World Bank did not address the market access issue is because the Customs Union's impact on market access is ambiguous. Because Kazakhstan already had tariff free trade with Russia and Belarus, the gains in market access will only come from removing non-tariff barriers. The Customs Union did not include legal requirements to reduce non-tariff barriers, but as the World Bank put it, it "energized" efforts to reduce these barriers. The Customs Union was just the first step of an integration process that is planned to continue for many years. All customs control stations at internal borders were abolished in July 2011. In 2015 it will become the Eurasian Economic Union, which will move it closer to being single economic space and should eliminate most non-tariff barriers.

Not all of the World Bank's results were negative. Many industry sectors expanded in the first two years of the Customs Union. These sector included apparel, furniture, machinery, motor vehicles, and transport equipment. These sectors expanded because of the higher tariffs Kazakhstan charged on imported products. The tariffs shield Kazakhstani producers from foreign competition. The expansion of these sectors could help diversify Kazakhstan's economy away

from the oil and gas sector (although machinery and transportation equipment were likely used in the oil and gas sector). Tariffs are often justified as a way to protect local industries, although reduced competition has harmful long-term effects. The expansion of these industries also indicates that increased foreign investment might be increasingly likely in these sectors whereas most investment has flowed to the oil and gas industry, which traditionally has dominated Kazakhstan's FDI flows.

The World Bank's overall analysis shows how the Customs Union had a net negative economic impact on Kazakhstan in its first two years. The negative impact is small and it is still early in the implementation of the Customs Union, so the long-term economic impact is unclear. In the World Bank's most optimistic projections the Customs Union will have no negative (and no positive) economic impact. The pessimistic projections suggest a significantly more negative impact than the current results show.

In late 2012 Tarr also wrote for the World Bank that regulation is a major issue within the Customs Union. Manufacturers now have to negotiate regulatory standards with the Customs Union Commission instead of their own government. Tarr claims negotiating with the Customs Union Commission is more burdensome for business owners than negotiating at a national level, but does not go into detail on how it is more burdensome. He does admit that trade costs between the union members has decreased, especially with the removal of customs controls in 2011, but also notes trade costs with non-union members have increased.

EBRD and EY

Two years have passed since the World Bank evaluated the Customs Union. Evaluations since then have not been computationally as comprehensive as the World Bank's report. The European Bank for Reconstruction and Development (EBRD) and Ernst and Young (EY) have analyzed investment conditions in Kazakhstan. The EBRD is itself a major investor in Kazakhstan, and EY advises its clients on the investment opportunities in Kazakhstan. Both organizations are less critical of the Customs Union focusing more on opportunities than on a computational evaluation of the policy.

The EBRD in its 2012 transition report emphasized that it is still too early to evaluate the success of the Customs Union (the 2013 transition report does not discuss the Customs Union or integration). The EBRD's stance on the Customs Union is understandable considering the Customs Union's purpose and lengthy implementation process. The report states that the goal of the Eurasian Economic Community is "the free movement of goods, capital, and people, as well as the harmonization of macroeconomic and structural policies" (pg. 65).

Comparing the Eurasian Customs Union (or Economic Community) to other economic unions around the world, the EBRD outlines several potential benefits for Kazakhstan give the purpose of this Customs Union. The EBRD suggests that the Customs Union could actually help promote trade of the Customs Union bloc with non-union members, although these benefits would mostly accrue to Belarus and Russia. Belarus and Russia already export a diverse range of products to non-union members whereas oil and gas dominate Kazakhstan's exports to non-union members. For this reason Kazakhstan would not see as much of a benefit from the export promotion.

According to the EBRD the Customs Union could benefit Kazakhstan by allowing for better cross-border infrastructure integration. Cross-border infrastructure improvement would improve supply chains, facilitate trade between the countries, and allow for increased investment between Customs Union members. Better market access that would come from improved infrastructure would make Kazakhstan more attractive to international investors.

In contrast to the World Bank's report the EBRD does not see evidence that trade between Customs Union members has increased much. It does recognize a decrease in trade from China due to higher tariffs, but from the rest of the world it shows trade has not changed. A possible reason for the difference between the EBRD and the World Bank's analysis is in the modeling. The EBRD's uses trade flow statistics to measure changes in trade while the World Bank does a sector analysis using a computable equilibrium model.

EY looks at Kazakhstan from the investor's perspective. One would expect FDI flows to depend on investor perceptions. It surveyed investors from around the world, including investors already established in Kazakhstan, and asked what their perceptions of Kazakhstan are. The varied responses underscore how the Customs Union is only one of many things that shape investors' perceptions of Kazakhstan. EY's results are useful in understanding how investors viewed Kazakhstan 3 years after the Customs Union was first implemented.

In general investors already established in Kazakhstan had a much more favorable perception of the investment climate than those with less knowledge of the country. The majority of all

investors worldwide said Russia was the most attractive investment location in the CIS; however, a much higher proportion of investors in Kazakhstan said it is the most attractive location for investment. As part of the survey investors listed the first thing that comes to mind when thinking of Kazakhstan. Thirty-one percent of respondents said natural resources, 17 percent said a rapidly growing economy, 12 percent said political stability, 10 percent said a favorable location, and 9 percent said the Customs Union. Obviously Kazakhstan has a reputation for having rich supplies of natural resources. Most of the foreign direct investment into Kazakhstan has gone to natural resource sectors. The Customs Union was only fifth on the list suggesting that it is likely not yet a major factor in most investor decisions. The surprise on the list was a favorable location because Kazakhstan's location makes it fairly expensive to export to world markets.

As part of the survey EY asked investors specifically about the Customs Union. Forty-seven percent said the Customs Union would improve investment appeal, seventeen percent said the investment appeal would not change, and only eight percent said the Customs Union would decrease Kazakhstan's investment appeal. This is a positive sign for Kazakhstan as it continues to integrate. With some advertising of the advantages of the single economic space, further integration could strengthen Kazakhstan's investment appeal.

Domestic Perspectives

Kazakh and Russian authors in general tend to be less critical than the World Bank. These authors focus less on computing the overall welfare gains or losses in the initial years of the integration and focus more on what they see as the goals of integration. Although there are critics

of the integration process within Kazakhstan, the Customs Union still has significant popular support.

The Eurasian Development Bank (EDB) in Almaty included an evaluation of the Customs Union in its 2013 yearbook. The analysis in the yearbook deals primarily with the Kazakhstan-Russia border region. EDB emphasizes five significant benefits that the Customs Union has brought to the border region, especially since the abolition of customs control stations. It asserts that both Kazakhstani and Russian companies have better access to each other's markets. Transportation time has been reduced for both goods and people. New opportunities for collaboration between Russian and Kazakhstani companies now exist. There is now greater capacity for energy and power infrastructure integration. Lastly the EDB mentions that the Customs Union created prerequisites for improving the investment climate. While most would see these points as success of the integration process, the World Bank might ask if they have really led to real economic benefits. Although the World Bank's estimations show that there has not been real economic welfare gains, EDB might counter that it is still too early to be able to measure economic impacts of integration. EDB's indicators suggest that integration will lead to long-term economic benefits.

EDB also measured public support for the Customs Union with surveys that it published in its *Integration Barometer*. Seventy-three percent of Kazakhstani's view the Customs Union positively and only 6 percent view it negatively. This is somewhat of a surprise considering that the Customs Union has led to increases in prices. Perhaps the average Kazakhstani does not attribute price increases to the Customs Union. Public support of the Customs Union appears to

be a win for the government of Kazakhstan as it participates in the integration process, although support did decrease seven percent in 2013. In 2012 80 percent of Kazakhstani's viewed the Customs Union positively.

Often authors in Russia or Kazakhstan will defend the Customs Union by pointing to positive macroeconomic indicators. Dodonov (2012) presents a positive view of the Customs Union showing how Kazakhstan's exports grew 61 percent since the Customs Union was implemented. Exports to Russia and Belarus made up a significant portion of this growth. He also notes the increase in investment between Russia and Kazakhstan. Dodonov suggests that the Customs Union played some part in the growth of these indicators, but his implication is flawed. Many different factors could have led to improving indicators. Really all he can say is that the Customs Union did not completely prevent growth of these indicators.

Measures of success from Russian authors measure primarily integration and not economic welfare gains. If the goal is integration and trade accelerates integration (Zevin, 2010) then more trade between Kazakhstan and Russia is a success. Authors from the World Bank claim that Kazakhstan already trades too much with its Customs Union partners.

Determinants of Foreign Investment

The literature on determinants of FDI is vast with papers usually focusing on specific cases². Using Mercosur as an example, Ozden and Parodi (2004) show how regional trade agreements including customs unions affect foreign investment. They find that regional trade agreements can

² For an overview of the literature see Blonigen, 2005

produce welfare improving gains in FDI flows. The increase in FDI is primarily the result of a larger market. Jaumotte (2004) focuses on the market size effect of regional trade agreements on FDI. She shows that increasing the market size through trade agreements has a positive affect on average, however, not all countries within a trade agreement benefit equally. FDI flows to the countries with the best business climate. This suggests that Kazakhstan could benefit more than Russia and Belarus because it consistently ranks higher in the doing business rankings.

There is also considerable research on FDI determinants specific to the Eurasian region. Deichmann et. al (2003) find that proximity to both Russia and the EU are positive determinants. Not surprisingly trade linkages, transportation infrastructure, and natural resources had positive impact on FDI flows. Corporate taxation and business regulations had negative influences on FDI. Likewise, Campos and Kinoshita (2003) found that trade openness was a significant determinant of FDI, although not as important as market size and natural resources. These indicators suggest that Kazakhstan could benefit from the Customs Union because its market size would increase and its business climate and tax policy ranked better than Russia and Belarus.

Kazakhstan's Motivation in Joining the Customs Union

Initially Kazakhstan's decision to enter a Customs Union was puzzling to western analysts. While integration discussions continued for years Kazakhstan had slowly been opening its economy up to the world. By 2009 when the three countries finally agreed to implement a customs union Kazakhstan's trade regulations were much more liberal than Russia's. To join the

Customs Union Kazakhstan had to raise many of its tariffs³. Western analysts focused on this rise in tariffs. Many give Nazarbayev credit for the idea of the Customs Union, referring back to his 1994 speech in Moscow where he coined the term Eurasian Economic Community, and explain that the Customs Union is simply a way for Nazarbayev to build his legacy. Legacy building may have been a factor, but is not the main reason Kazakhstan entered the Customs Union. There may not be one single reason, but this section outlines a few factors that likely contributed to Kazakhstan's decision to go forward with economic integration with Russia.

Russian Influence and Heritage

While it was probably not the main reason Kazakhstan established a customs union with Russia and Belarus, its Soviet heritage is a factor. Russian is the language of business in Kazakhstan. While Kazakhstan prides itself on being independent, most Kazakhstani leaders speak Russian better than Kazakh. There are still cultural ties that link the three countries together.

Having a common language and culture eases expansion into the Russian market for Kazakhstani businesses. Kazakhstan likely envisioned an expansion of its businesses into the Russian market once the Customs Union had been implemented.

This common heritage still manifests itself in infrastructure. Soviet planners decided locations of cities and towns. Much, though not all, of the infrastructure was also developed by Soviet planners who did not expect there to be national borders between the two countries. Kazakhstani

³ The World Bank (2012) estimated Kazakhstan's tariffs increased 75 percent on a trade weighted basis. The EBRD (2012) estimated that 50% of Kazakhstan's tariffs lines were affected, mostly upwards.

leaders may have believed that reintegration provided an opportunity to exploit and rebuild aging infrastructure that was once the backbone of Kazakhstan's Soviet economy.

Beyond the common heritage, Russia has significant control over Kazakhstani exports.

Maintaining positive relations with Russia is important in order to maintain the export routes of Kazakhstani oil and gas. While Russia would not have threatened Kazakhstan with retribution for not joining the Customs Union, Kazakhstani leaders understand the reality of the situation.

Russia's past difficulties exporting gas through Ukraine and the current situation in Ukraine show the value of maintaining an economic alliance with Russia. Kazakhstan has pursued a course different than Ukraine (although Kazakhstan did not have the options that Ukraine had).

Entering a Customs Union with Russia was an important step in maintaining positive economic relations with Russia.

East-West Gateway

Kazakhstani leaders are trying to take what has traditionally been a hindrance to international trade, its geography, and turn it into a strength. A single economic space between with Russia and Belarus will help Kazakhstan do this. Kazakhstan is a landlocked country that is far away from all of the world's developed economies. Although it neighbors China, China's population and commercial centers are thousands of kilometers away in the eastern part of the country.

Kazakhstan ranks 186 out 189 in the indicator trading across borders in the World Bank's Doing Business rankings (2014), sandwiched between the Central African Republic and South Sudan.

Part of the reason it ranks so poorly in this category is because it takes longer to export and it is more expensive to export products because of the distance to world markets.

To try and turn its geography into a strength Kazakhstan has been trying to market itself as a gateway between Europe and Asia. In an address to the nation in 2009 Nazarbayev announced increased investment in infrastructure that would allow increased transit from China to Europe (Kazinform, 2012). Air Astana, Kazakhstan's award winning national airline, has been adding direct flights to both Europe and Asia envisioning Kazakhstan as a stopping point for travelers going between the two continents (Air Astana, 2014). In June 2013 a direct rail route opened between Chongqing, China and Germany passing through Kazakhstan. Although its more expensive than sea routes, containers can move between China and Germany in 15 days compared to 45 days by sea (Nurshayeva, 2013). Kazakhstan happily uses the buzzword "Silk Road" as it markets its self as a gateway between Asia and Europe.

The single economic space is crucial to the success of the overland east-west transit route. Without the Customs Union and soon to be Eurasian Economic Union, a train traveling from China to Germany would have to pass through customs control stations at two Kazakhstani borders then pass through three more countries before arriving in Germany. As a single economic space the train enters Kazakhstan from China and then travels all the way to European Union as if it were a single country. Additionally the same body, the Eurasian Economic Commission, administers the customs controls at the Kazakhstan-China border and the Belarus-Poland border. Cargo can travel from China to Germany simply by passing through the Eurasian Union into the European Union. Kazakhstani leaders probably saw economic integration as a way to streamline the transit process and attract more cargo and passengers to Kazakhstan. The government continues to invest billions of dollars into infrastructure projects around the country. Not surprisingly around the same time the three countries finalized agreements on the first stage

of integration in 2009, President Nazarbayev was speaking about making Kazakhstan a major transit point between the east and the west. The idea of a new “silk road” significantly impacted Kazakhstan’s decision to join the Customs Union.

Increasing Investment

In theory a customs union has potential to increase foreign investment due to the increase in size of the consumer market; however, some have questioned this as a motivation for Kazakhstan to join the Customs Union because it already had free trade with Russia. Even though Kazakhstan and Russia had tariff free trade there were still significant impediments to trading across borders. Significant delays at border crossings because of differences in regulations and an abundance of paper work slowed trade between the two countries. Although the Customs Union did not legally require reductions of non-tariff barriers, it facilitated discussions the removal of all trade barriers. Removing all trade barriers between the three countries had the potential to make Kazakhstan a more attractive location for international investors. Kazakhstan’s population is about 17 million whereas the combined population of the Customs Union members is 170 million (World Bank, 2014).

Additionally, Kazakhstan’s Doing Business rankings have been much higher than Russia’s. In 2009 Kazakhstan ranked 70th and Russia ranked 120th. That gap widen in later years as Kazakhstan’s business climate improved and Russia’s worsened relative to the rest of the world. Kazakhstani leaders may have believed they could market Kazakhstan to foreign investors as the best location for business within the Customs Union. As the Customs Union becomes a single

economic space this could become even more of a strength as it becomes easier for business to operate across the union.

Natural resource extraction, specifically oil and gas, dominate foreign investment in Kazakhstan. Oil and gas provides a steady flow of revenue to the government, but Kazakhstani leaders understand a healthy economy is cannot be based on a single commodity. Shocks in the prices of that commodity could shatter the country's economy. Also mineral resources do not last forever. Technical challenges can delay oil production and government revenue flows as Kashagan shows. Diversification promotes long-term economic stability. Kazakhstani leaders may have intended for the Customs Unions to help diversify the economy away from the oil and gas industry.

Oil and gas were largely excluded from tariff harmonization and Customs Union regulation. Continuing discussions on the harmonization of oil regulation are progressing slowly. Because the Customs Union excludes oil and gas for the most part, investment opportunities that come from the Customs Union will likely be focused in other sectors, even though most FDI in Kazakhstan goes to the oil and gas sector. If the Customs Union results in improved infrastructure this would improve Kazakhstan's oil export options and potentially increase FDI to the oil sector. Increasing investment in other sectors would lead to greater diversification of Kazakhstan's economy.

Many factors likely played a part in Kazakhstan joining the Customs Union. To say it was just to build a legacy for Nazarbayev is too simplistic. One may ask if Kazakhstan's participation in the

Customs Union has helped it achieve any of these goals. In the next section I evaluate how the Customs Union has affected foreign investment in Kazakhstan.

The Model

The purpose of this analysis is to determine whether or not the Customs Union had any impact on FDI flows into the Kazakhstan. Because increasing investment is one of the motivations for joining the Customs Union, understanding its impact on foreign investment will help determine of the success of the policy so far. Many factors affect FDI flows and investor perceptions. Has the Customs Union had a strong enough impact on investor perceptions to spur new investment projects or has it reduced investment in Kazakhstan? Although the integration process is in its early stages, this analysis will show any early changes in FDI that may be attributed to the Customs Union and integration process.

Preliminary Models

Taking the implementation of the Customs Union as an exogenous shock to the investment climate⁴, I used a difference-in-difference framework to compare FDI flows to Kazakhstan and a control country before and after implementation of the Customs Union. The major assumption of this difference-in-difference model is that FDI flow trends should be the same before the implementation of the Customs Union. This Customs Union was an exogenous change that impacted FDI flows to the country.

⁴ The Customs Union may be considered an exogenous shock to investment because investors would not have been able to predict the policy prior to 2009. Previous integration discussions had been unsuccessful for decades. Additionally FDI flows did not impact the signing of the agreement in 2009.

The challenge with this before and after comparison is finding an appropriate control country. The control country would have to have an FDI flow trend that nearly matched FDI flow trends in Kazakhstan before implementation of the Customs Union. Without looking at the data, Azerbaijan seems like the obvious choice for a comparison country. Like Kazakhstan its economy is heavily dependent on the oil and gas industry. Also like Kazakhstan, the same authoritarian regime has controlled the country's economy since the early 1990's. Both countries have a common Soviet heritage. One might expect FDI to flow to both countries from the same sources.

The International Trade Centre (2004) (ITC)⁵ provided a data set showing the FDI by source country to both Kazakhstan and Azerbaijan. Although I ran regressions comparing Kazakhstan and Azerbaijan, the results were not significant. An analysis of the data shows that the FDI trends were not actually similar prior to the Customs Union. There were several problems with the data in this model so I also tried comparing Kazakhstan's FDI to total world FDI by source country. While the trends, at first glance look the same, a closer analysis shows that total world FDI trends are not similar enough to produce meaningful results. The weaknesses of the data make inferring anything based on the model's results almost impossible⁶.

Next I turned to the International Monetary Funds (IMF) Coordinated Portfolio Investment Survey (CPIS) to solve some of the data problems. This survey provides data on portfolio and debt securities investment by country and year. I chose comparison countries based on the similarity of trends in their investment stocks. South Korea and Ukraine both had somewhat

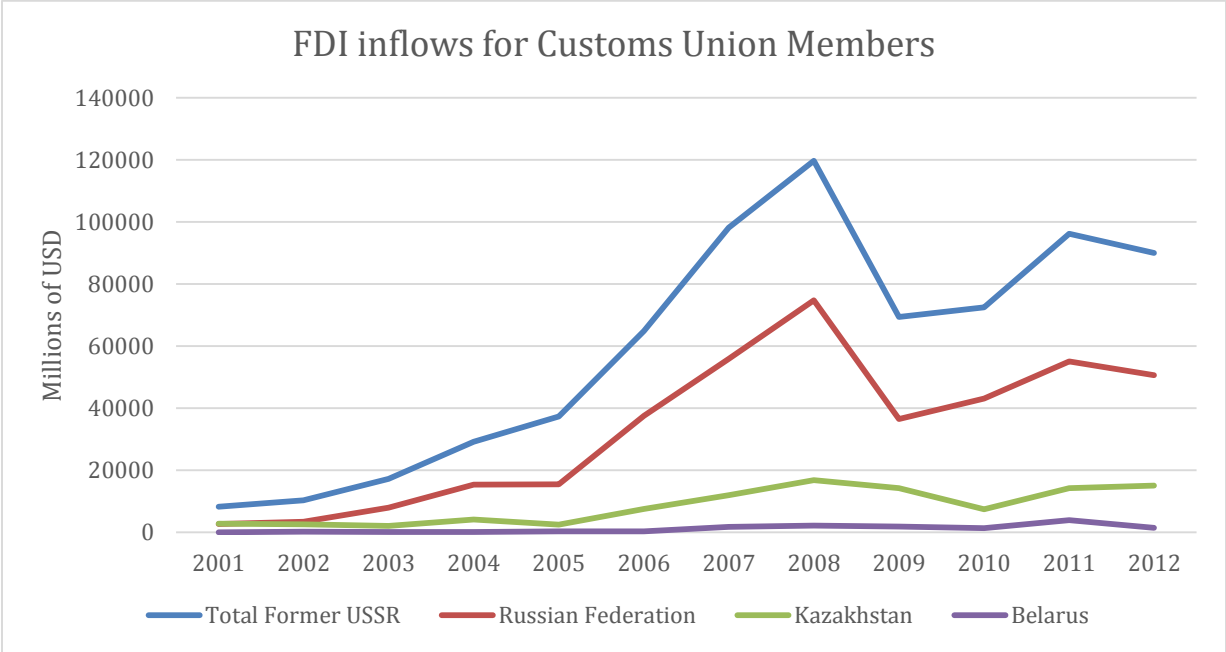
⁵ The International Trade Centre is a collaboration of the UN and the WTO. They take FDI data directly from Kazakhstan's and Azerbaijan's central banks.

⁶ See appendix A for a full description of the methodology and results of the model using ITC data.

similar investment trends, however the trends may not have been similar enough. The results of the Ukraine comparison were the most significant and showed that the Customs Union had a positive impact on investment in Kazakhstan⁷.

A weakness in the previous models is that it is simply a before and after comparison without control variables. The lack of an appropriate control country is a major challenge to the difference-in-difference framework. Because of the volatility of FDI flows, there is simply not a country with FDI trends that match Kazakhstan. Adding control variables to the model could account for much of the variation in the trends while still measuring the before and after changes. While the ITC and IMF data did not provide any control variables, the World Bank’s World Development Indicators (WDI) provide many relevant controls. Below I describe the WDI data and the methodology I used in the difference-in-difference model.

Figure 1: FDI flows to Customs Union Members



Source: World Bank World Development Indicators

⁷ See appendix B for a full description of the methodology and results of the model using the IMF CPIS.

Data

The benefit of the World Bank's WDIs is that it includes much more than just FDI flows and stocks. The additional data allows one to control for other factors besides the Customs Union. The controls are especially important because of the lack of a perfect comparison country. The World Bank does not track the source of investment by country, so I use total FDI flows to Kazakhstan and the control countries for each year in the dataset. I use data for the years 2001-2012. I include the 15 countries of the former Soviet Union in the dataset. Figure 1 shows the total FDI flows to each Customs Union member compared to total FDI flows to the former Soviet Union.

Methodology

The availability of different variables and many years in the World Bank's World Development Indicators database allows one to do a descriptive analysis of the foreign direct investment. My initial model based on World Bank data analyzes total FDI flows in the countries of the former Soviet Union. Although these countries have many economic differences, no country exactly matches Kazakhstan's pre-2010 FDI growth trends. A common Soviet Heritage provides at least some degree of similarity in institutions and economic history. Also the countries are all geographically and economically close to Russia. The model takes the following form:

$$FDI_{it} = \beta_0 + \beta_1 * GDP_{it} + \beta_2 * GDP_{growth_{it}} + \beta_3 * pop_{it} + \beta_4 * natresource_{it} + \beta_5 * airpass_{it} + \beta_6 * CU + X + \epsilon_{it}$$

Here FDI_{it} is total FDI flows into country i in year t . GDP_{it} is the gross domestic product of country i in year t , $GDPgrowth_{it}$ is the growth of GDP of country i in year t , pop_{it} is the population of country i in year t , $natresource_{it}$ is natural resource rents as a percentage of GDP in country i in year t , and $airpass_{it}$ is the number of air transportation passengers in country i and year t . CU is a dummy variable for the member countries of the Customs Union in years after the Customs Union was implemented. So CU is one for Russia, Belarus, and Kazakhstan from 2010 onward. X is a vector of dummy variables for the years 2001-2012 and ϵ_{it} is the error.

In this model CU is the variable of interest, showing the relationship of Customs Union participation with FDI flows. Its coefficient will be the difference between the average FDI of the Customs Union countries while the Customs Union was in place and the average FDI of the rest of the former Soviet countries. Note that Russia receives the large majority of total FDI (and Kazakhstan receives the second most FDI as of 2012) in this region, which could bias the CU coefficient upward.

The other variables control for differences in FDI flows. GDP_{it} and pop_{it} control for the size of the economy and market respectively. $GDPgrowth_{it}$ controls for the rate of economic growth. Countries rich in natural resources tend to have high levels of FDI flows, in the extractive industries. $natresource_{it}$ controls for natural resource focused FDI. The $airpass_{it}$ variable controls for several factors that could influence FDI. First it can be related to logistical development of the country. More airports will lead to a higher numbers of air passengers. This suggests a higher level of logistical development. It also partially shows how connected a country is to the rest of the world. The stronger the connection a country has to the world, the greater the number of air

passengers that country will have. Also a higher number of air passengers could suggest a more developed modern economy, which would positively impact FDI.

Although this model is insightful, it does not show the impact of the Customs Union on FDI flows to Kazakhstan specifically. To determine the impact of the Customs Union on Kazakhstan I replace the variable CU with difference-in-difference estimators. The regression equation changes to this:

$$FDI_{it} = \beta_0 + \beta_1 * GDP_{it} + \beta_2 * GDP_{growth_{it}} + \beta_3 * pop_{it} + \beta_4 * natresource_{it} + \beta_5 * airpass_{it} + \beta_6 * KZ2010 + \beta_7 * KZ2011 + \beta_8 * KZ2012 + X + \epsilon_{it}$$

Here KZ2010, KZ2011, and KZ2012 are interactions between a Kazakhstan country dummy variable and year dummy variables. The coefficients of these variables measure the difference-in-difference. The first difference is the between the pre and post Customs Union years and the second difference is between Kazakhstan's FDI and the average of FDI in other countries. Each of these variables shows the impact of the Customs Union (and any other unidentified exogenous shocks) in their respective year. Having a separate variable for each year is important because the Customs Union was implemented in phases over several years. The impact on FDI could change at different phases of implementation.

Extending the model further, I add similar difference-in-difference variables for Russia and Belarus. So along with KZ2010, KZ2011, and KZ2012 I include RU2010, RU2011, RU2012,

BL2010, BL2011, and BL2012. This separates out the impact of the Customs Union on each member of the Customs Union.

Results

The results of this model are more interesting and meaningful than the models I previously used (see appendices for previous results). Because no country is a perfect comparison, having control variables accounts for some of the differences in FDI flows that were affected by exogenous shocks. In the first regression all of the control variables are significant except GDPgrowth. CU has a value of -1.43 billion which would suggest that Customs Union member countries received on average \$1.43 billion less per year than their non-Customs Union neighbors. However, this result is not statistically significant. These results are reported in the first column of table 1.

In the next regression replacing CU with the Kazakhstan difference-in-difference estimators improves the significance of the results. KZ2011 and KZ2012 are both significant and have values of 5.3 and 6.1 billion respectively. KZ2010 is positive, but not significant. This suggests that the impact of the Customs Union had not yet impacted FDI flows in 2010. The impact grew from 2011 to 2012 as integration increased. The magnitude of the coefficients are surprising considering Kazakhstan had only \$15 billion of FDI flows in 2012⁸. The Customs Union did not attract 27% of 2012 FDI. So in addition to the Customs Union the explanatory variables are likely accounting for other factors. It is also surprising that the sign of the KZ variables were the opposite of the CU variable. These results are reported in the second column of table 1.

⁸ The World Bank calculates FDI based on the IMF's balance of payments data rather than taking it directly from the National Bank of Kazakhstan. So these FDI totals are different than those listed by ITC.

Table 1: World Bank WDI Regressions
FDI flow comparison across the former Soviet Union (dependent variable is FDI_{it})

Coefficient	(1)	(2)	(3)	Two-way FE
GDP	.068** (.003)	.067** (.003)	.065** (.002)	.065** (.002)
GDPgrowth	3.16e7 (3.67e7)	3.39e7 (3.57e7)	3.79e7 (2.98e7)	3.68e7 (2.93e7)
POP	69.2** (12.8)	71.6** (12.2)	2.88 (13.2)	3.12 (15.6)
natresource	3.21e7** (8.68e6)	2.76e7** (8.03e6)	2.96e7** (7.1e6)	2.80e7** (8.21e6)
airpass	-1551** (123.5)	-1514** (121)	-1045** (118.4)	-1036** (135.3)
CU	-1.43e9 (9.26e8)	--	--	--
KZ2012		6.08e9** (2.22e9)	4.79e9* (1.85e9)	4.07e9* (1.80e9)
KZ2011		5.33e9* (2.22e9)	4.31e9* (1.85e9)	3.61e9* (1.80e9)
KZ2010		1.28e8 (2.21e9)	-6.74e8 (1.85e9)	-1.38e9 (1.80e9)
RU2012			-2.1e10** (2.83e9)	-2.09e`10** (2.95e9)
RU2011			-1.77e10** (2.46e9)	-1.75e10** (2.45e9)
RU2010			-1.22e10** (2.24e9)	-1.21e10** (2.21e9)
BR2012			-2.25e9 (1.84e9)	-1.69e9 (1.79e9)
BR2011			4.00e7 (1.8e9)	6.03e8 (1.79e9)
BR2010			-2.25e9 (1.85e9)	-1.69e9 (1.79e9)

Standard errors in parenthesis
* 5% significance level
**1% significance level

Adding Russian and Belarusian interactions into the model shows what may have caused CU to be negative in the first regression. With these additional variables the significance and sign of the KZ variables does not change, although the magnitude drops slightly. All three Russian interaction terms, RU2010, RU2011, and RU2012, are highly significant and negative. The

Belorussian variables are not significant. In this regression the control variables are still significant with the exception of pop and GDPgrowth. These results are reported in the third column of table 1.

In order to account for differences in countries that were not accounted for in the control variables I run a two-way fixed effects regression. In addition to the year dummy variables in the previous model I also include country fixed effects variables. The results of this model are nearly the same as in the previous regression. The significance level of all the variables is the same. The magnitude of the KZ and RU coefficients is slightly lower, but the conclusion is the same. FDI flows to Kazakhstan increased and while FDI flows to Russia decreased. While the Customs Union is likely not the only factor impacting these results, as a significant exogenous shock at least part of the impact uncovered by this model can be attributed to the Customs Union. These results are reported in the last column of table 1.

These results are surprising because they show the opposite of what many would have expected. The Customs Union contributed to increases in FDI flows to Kazakhstan and decreases to Russia. Although the magnitudes may not be completely explained by the Customs Union, the control variables in this model make it more valid than my previous models.

These results support the theory that the Customs Union increased the market size available to firms operating in Kazakhstan. As the borders became more opened and non-tariff barriers were removed FDI continued to increase. This also supports previous research that suggests that increased market size will lead to higher levels of FDI.

Discussion

The Customs Union's positive impact on FDI flows is important for future policymaking because it shows the Customs Union did have benefits for Kazakhstan. The World Bank's (2012) results are mostly negative, but they do not show how the Customs Union impacted foreign investment. My results challenge the idea that the Customs Union has been completely bad for Kazakhstan by showing the Customs Union's positive impact on FDI flows.

While my results indicate that the Customs Union positively impacted foreign investment, they leave several questions unanswered. My results do not show how the Customs Union is increasing foreign investment. Understanding how the Customs Union might be increasing investment will help one understand if further integration will continue to boost foreign investment. Also, while the results show the magnitude of the impact on foreign investment, it does not show what the overall economic benefit of this investment is. Finally given these positive results, how should Kazakhstan proceed with further integration?

Why FDI Increased

There are several explanations as to how the Customs Union may be increasing investment. Previous research⁹ has shown that customs unions and regional trade agreements have the potential to increase foreign investment by increasing the market size available to investors. Taking Kazakhstan as an example, investors that have production facilities within Kazakhstan

⁹ See Jaumotte, 2004 and Ozden & Parodi, 2004

got greater access to a much larger market after Kazakhstan joined the Customs Union. The larger market is an incentive to invest more.

Kazakhstan has ranked much higher than Russia on the World Bank's Doing Business ranking for years. Investors who want access to the Russian market may choose to locate in Kazakhstan because of its better business climate. The economic integration could make it easier for investors to operate in both countries. Additionally, Kazakhstan's lowest indicator among the ranking criteria is trading across borders. If the Customs Union improves this indicator it could entice foreign investors in Russia to move to Kazakhstan. My results support this idea by showing decreases in investment in Russia and increases in investment in Kazakhstan.

A few factors complicate the market-size explanation for increases in FDI. One could claim that market access did not change much because Kazakhstan already had tariff-free trade with Russia. The increased market access came not from tariff reductions, but from the elimination of non-tariff barriers. One of the major steps of integration was the removal of customs stations at borders within the Customs Union in 2011. This and other efforts to reduce non-tariff barriers did actually improve access and increase the flow of goods across the border.

Another complication is the oil and gas sector. The majority of FDI flows into Kazakhstan are connected to the oil and gas industry. Oil and gas were one of the big exceptions within the Customs Union. Tariffs and export duties on oil and gas were not harmonized when the Customs Union was implemented. Much of the Kazakhstani oil flows through pipelines and was not

affected by changes in customs controls. So foreign investment in the oil and gas sector was probably not affected by changes in market access.

Foreign investors may have been anticipating greater development of cross-border infrastructure, which would benefit the oil and gas sector. Infrastructure development could come in the form of pipelines, railroads, and power grid integration. This was one of the major potential benefits that the EBRD found would result from the Customs Union.

These results correspond to Ernst and Young's report that shows that most investors believed the Customs Unions would improve the investment climate of Kazakhstan. Investment decisions are largely based on investor perceptions. The increases in investment show that investors saw opportunities in Kazakhstan after the Custom Union was implemented.

Although the results indicate a positive impact on Kazakhstan, one cannot attribute all of this to the Customs Union. The magnitudes of the coefficients are too high. There were likely other exogenous impacts on FDI that are not controlled for in this model. One such example could be expropriations of oil assets in Russia in 2008 and 2009. Although this occurred before the Customs Union it may have had lasting effects on FDI flows. A variety of other factors could have impacted investor perceptions and decisions. Its impossible to control for all of them, but the results do suggest that the Customs Union impacted FDI flows in the direction of the coefficients.

Economic Benefit of FDI

The literature on the benefit of FDI is substantial, however the economic benefit of FDI in Kazakhstan is unclear. FDI could benefit Kazakhstan in several ways. It could provide employment to citizens, capital to businesses, and technology transfers. The magnitude of the economic benefit of these FDI increases could be the topic of a future paper. Such a paper would be a valuable addition to the World Bank's 2012 report in showing the costs and benefits of the Customs Union.

Policy Options

Kazakhstan will face significant challenges no matter how it chooses to continue with the integration project. When considering the impact FDI on future policy, Kazakhstan's decision makers should notice the increasing positive impact of the Customs Union on FDI flows. In 2010 there was not any statistically significant impact on FDI flows, but the coefficient for Kazakhstan in 2010 was positive. In 2011 the impact was significant and in 2012 it increased. This increasing FDI could be the result the integration steps taken in 2011 (removal of customs stations at internal borders) and 2012 (Eurasian Economic Commission took over administration of all external customs stations). Further integration could lead to improved cross-border infrastructure which would likely lead to further increases in FDI flows.

Note on Ukraine

The conflict in Ukraine significantly complicates Kazakhstan's decision on how to proceed with integration. While some fear Russian aggression in Kazakhstan, the real danger is to

Kazakhstan's economy. The United States and the European Union are attempting to isolate Russia economically by applying sanctions. For the most part the sanctions apply mostly to individuals and few banks. The economic impact in Kazakhstan will be indirect, but could still be significant. Russia's actions in Ukraine are clearly hurting its own economy (Wall Street Journal, 2014). As Kazakhstan's largest trading partner, a recession in Russia will lead to reduced output in Kazakhstan. This is just one example of the economic impact of Russia's actions on Kazakhstan. Stronger sanctions, which the U.S. and the E.U. are threatening, will worsen the situation.

Entering any lasting agreement such as the Eurasian Economic Union (EEU) would be extremely risky for Kazakhstan. There is a lot of uncertainty about the outcome of the conflict in Ukraine and how the West will treat Russia. Recently, the economy has not been a priority for Russia's decision makers. If Kazakhstan forms an economic union with Russia it may be subject to the same sanctions that Russia faces.

In the unlikely event that the West sanctions Russia's oil sector, the sanctions could threaten Kazakhstan's major oil export routes even if it does not join the Eurasian Economic Union. Nurshayeva (2014) reported that the Kazakhstani ministry of oil and gas is investigating alternative export routes. Kazakhstan currently exports the majority of its oil through Russia. Cutting off or altering those routes would be disastrous for Kazakhstan's economy. Although the EEU may have positive impacts on FDI flows to Kazakhstan, given the uncertainty in the current political climate Kazakhstan should refrain from taking on any significant policy obligations.

Policy Options

Kazakhstan faces an immediate decision on further integration with Russia and Belarus. The three countries plan to sign an agreement forming the Eurasian Economic Union on May 29 as long as Kazakhstan agrees. Several options are available to Kazakhstan.

- Drop out of the Customs Union

This option is unlikely because Putin and Nazarbayev have been allies for a long time (Standish, 2014). Dropping out of the Customs Union would end their relationship and isolate Kazakhstan. Kazakhstan would then have to rely almost entirely on China as an economic partner. Kazakhstan is afraid of Chinese domination and additionally is not structurally ready to rely on China. Additionally, this would increase the likelihood of Russian provocation of unrest and intervention in ethnically Russian dominated areas of Kazakhstan. Dropping out of the Customs Union at this point would be unwise.

While this policy is feasible it would require some effort to reverse tariffs and reestablish control over customs stations. It would also require the establishment customs stations between Russia.

- Delay the EEU agreement indefinitely

Delaying the EEU agreement would essentially be maintaining the status quo. While there are problems with the status quo, it might be better than other alternatives. This option also allows time for a resolution of the situation in Ukraine. It would allow

Kazakhstan to maintain a working relationship with Russia without getting more entangled in Russia's problems.

It's unclear how much pressure Russia is putting on Kazakhstan to sign the EEU agreement. This policy may cause some tension between the countries' leaders, but Kazakhstan has plenty of reasons for delaying the agreement.

- Join the EEU agreement with exceptions

Kazakhstan might be able to get exceptions in the EEU agreement in its economically important sectors. The Customs Union made exceptions in the oil and gas sector. By getting exceptions in its economically important sectors Kazakhstan could maintain a close alliance with Russia while limiting the risk to its own economy.

Russia seems to want to make a deal at any costs. Russia agreed to provide Belarus with duty free oil and let Belarus keep some of the oil export duties (Makhovsky, 2014).

Kazakhstan also might be able to reach an agreement with Russia before agreeing to join the EEU.

- Complete economic integration

Seeking complete integration with Russia would mean a stronger push for harmonization of regulations and the free movement of all goods and people within the Union. It would be a push for the creation of a single market space. This could hurt Kazakhstan because it would have to significantly raise export duties on its oil exports. The uncertainty of

Russia's economic policy and its Ukraine policy also makes this a very risky option.

Benefits might include better cross-border infrastructure and lower transaction costs that would come from a single currency in the future. Although Russia would likely welcome this option, Kazakhstan is not economically or politically ready for this option.

Although the best option for Kazakhstan would be to postpone further integration until the economic situation becomes more clear, the most likely option is that Kazakhstan will sign the EEU agreement increasing integration but with some exceptions such as oil and gas duty exemptions and regulation exemptions. It could also try to get actual monetary value out of the agreement like Belarus received in the form of oil subsidies. Leaving the EEU will be harder than establishing the EEU. Maintaining the status quo could give all parties more time to evaluate the benefits associated with the Union, and the many risks currently threatening the region's economy.

Conclusions

Although Kazakhstan was once entirely integrated with Russia and the rest of the Soviet Union, after two difficult decades of reform it had developed into an independent functioning economy. Kazakhstan's President Nazarbayev originally floated the idea of an economic union in 1994, but that idea did not turn into any meaningful result until 2010. In 2010 Kazakhstan, Russia, and Belarus formed a customs union as the first stage of a project intended to integrate the region into a single economic space.

Finding reasons to criticize the Customs Union is not hard. Prices went up because Kazakhstan had to raise tariffs. The World Bank found that the Customs Union had a negative impact on income and wages. But the results are not all negative.

I add to the research on the Customs Union and foreign investment by showing that the Customs Union had a positive impact on flows of foreign direct investment to Kazakhstan. My difference-in-difference analysis also shows that the Customs Union had a negative impact on FDI flows to Russia. These results may surprise some critics. The Customs Union has not been entirely bad for Kazakhstan as the World Bank suggests. The Customs Union contributed to increases in FDI flows to Kazakhstan, which could lead long-term economic gains.

Kazakhstan could gain from further integration, however, the current economic and political environment of Eurasia makes major policy decisions risky. Kazakhstan should delay future integration decisions until the economic situation becomes more clear.

Appendix A

ITC

At first glance, Azerbaijan appears to be a good comparison country because both countries rely heavily on oil and gas. Additionally, both countries oil comes either from the Caspian Sea or the surrounding region. In fact, Kazakhstan exports a small portion of its oil through the Baku-Ceyhan pipeline. One might expect similar types of investment from similar areas of the world to be entering in both Azerbaijan and Kazakhstan.

Further impacting the investment climate of both countries is the involvement of the government in the economy. Both countries have had the same authoritarian regime in power since the early 1990's. Both states' exercise significant influence in the economy. This does not mean their institutions are the same, but it likely influences the perception of foreign investors in similar ways. Investors in both economies realize they must satisfy the countries elite in order to get a return on their investment.

The difference-in-difference regression model has the following structure:

$$FDI_{ijt} = \beta_0 + \beta_1 * KZ + \beta_2 * KZ2011 + X + \epsilon_{ijt}$$

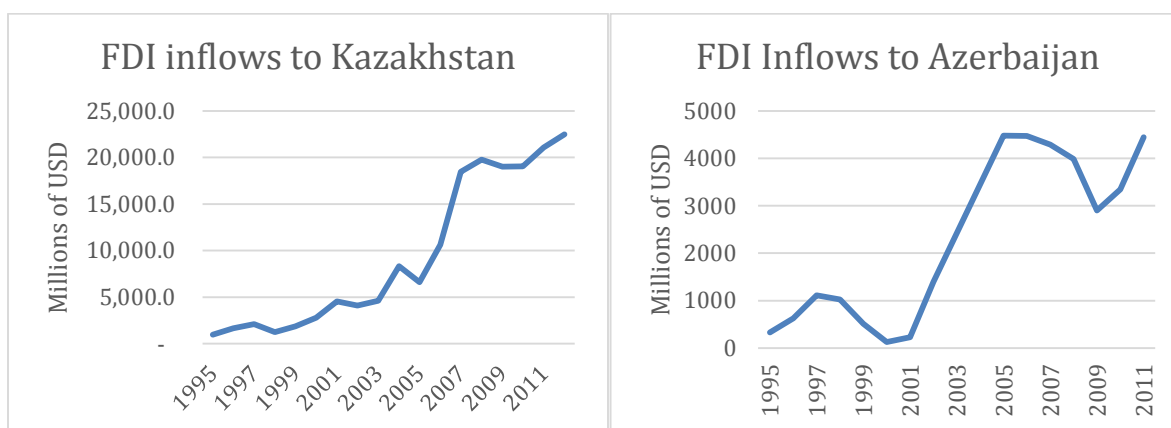
The dependent variable, FDI_{ijt} , is FDI flows in year t from country j , to country i . In this case i can be either Kazakhstan or Azerbaijan. KZ is a dummy variable that is 1 for Kazakhstan and 0 for Azerbaijan. X is a vector of year dummy variables for the years 2005-2011. $KZ2011$ is the

interaction of the dummy variables for Kazakhstan (KZ) and 2011. This interaction term is the difference-in-difference estimator. ϵ_{ijt} is the error term.

This model is more limited than other models in that it only includes 6 years of data. 2010 is excluded from this regression¹⁰. The effects on the investment climate had likely not yet been realized. The level of integration gradually increased suggesting that any impact on investment would be great after 2010. Also Azerbaijan's FDI data for 2012 was not available as of April 2014, so the model includes only one year after the Customs Union had been implemented.

The main assumption of a difference-in-difference model is the common trend assumption. In this case both Kazakhstan and Azerbaijan have to have similar FDI trends before the Customs Union, and would have had similar trends after if not for the exogenous shock provided by the Customs Union. If FDI trends are not the exactly the same, adding more years to the model could help, but the trends still must be similar. Additionally, just because Kazakhstan and Azerbaijan have similar types of economies does not necessarily mean their FDI trends will be similar.

Figure 2: FDI flows to Kazakhstan & Azerbaijan



Source: International Trade Centre

¹⁰ This is an error in the specification that I did not take the time to correct because of other weaknesses in the data.

In addition to the Azerbaijan comparison, I also compare Kazakhstan's FDI flows to total World FDI flows. The variables are all the same although i in this case is either Kazakhstan or the World (not Azerbaijan). This regression includes the years 2003-2012, and again 2010 is excluded. This model also includes two difference-in-difference estimators, KZ2011 and KZ2012, which are the interactions of Kazakhstan with the years 2011 and 2012. These estimators individually show the impact of the Customs Union in each year.

Another assumption of this model is that no other exogenous shocks to the investment climate are impacting FDI flows in these years. Other unknown exogenous shocks would bias the results.

In another alteration of this model I measured on FDI from Russia. So for FDI_{ijt} , j is Russia for every observation. I did this for both the Azerbaijan and World comparisons.

Because the Customs Union is part of the process to integrate Kazakhstan with Russia and Belarus, one might expect that FDI from Russia would change. Stronger economic ties might increase investment, however Russian firms would have easier access to the Kazakhstani market. They would not need to invest in local production. Realistically the amount of Russian owned production in Kazakhstan is very small, so this would be unlikely to cause a decrease in investment. Increasing investment is much more likely as Russian firms invest in better supply chain operations in Kazakhstan.

Data

ITC is a collaboration of the World Trade Organization and the United Nations. They provided FDI flow data sets for both Kazakhstan and Azerbaijan between 1995-2011 by source country. ITC acquires unpublished FDI data directly from the National Bank of Kazakhstan and the Central Bank of Azerbaijan. Also, available on ITC's investment map is total World FDI flows between 2003 and 2012.

One of the issues with this FDI data (and most other FDI data) is that the source country is not always the actual source of the capital. Many countries recognized as offshore tax havens are top suppliers of FDI to Kazakhstan. Also, there is a significant portion of FDI that comes from unspecified countries¹¹. This is only a problem if the sources of FDI into Kazakhstan and Azerbaijan do not follow similar trends. So if both have the same level of unspecified FDI relative to total FDI then the model will still work. The veracity of this assumption depends on the similarities of data collection techniques of Azerbaijan's and Kazakhstan's central banks. Because of these weaknesses I also include several other data sources.

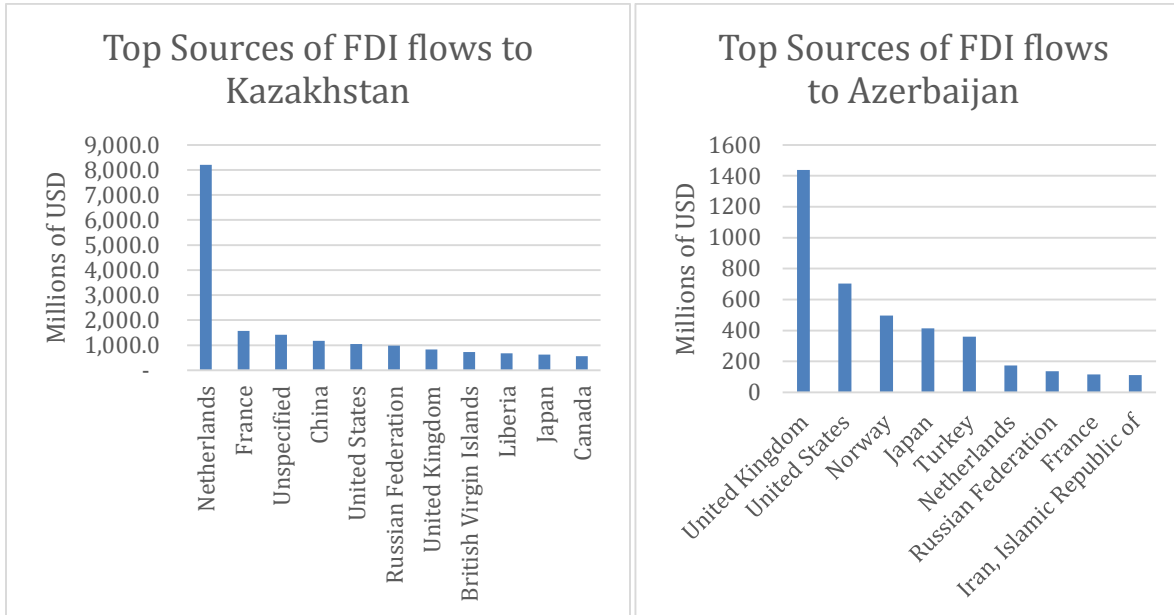
Table 2: ITC Summary Statistics

Country	Number of FDI source countries	Sources in Common with Kazakhstan	Minimum Total FDI	Maximum Total FDI	Mean FDI
Kazakhstan	136	NA	4,583	22,469	15,000
Azerbaijan	97	76	2,899	4,475	3,987
World	201	112	514,226	1,619,829	1,369,416

FDI amounts are in millions of USD

¹¹ Since 2005 FDI from unspecified countries has ranged from 5-8 percent of total FDI inflows.

Figure 3: Sources of FDI to Kazakhstan & Azerbaijan



Source: International Trade Centre

Results

The results of the ITC data model are inconclusive. In the Azerbaijan comparison the coefficient on KZ2011 (the difference-in-difference estimator) is 69.34, which suggests a positive impact of \$69 million on Kazakhstan. However, this coefficient is not statistically significant. The dummy variable coefficient for Kazakhstan is significant at the 1 percent confidence level and has a magnitude of 134.34. In other words on average the difference between Azerbaijan's and Kazakhstan FDI was 134 million dollars. The year dummy variables were positive, but not statistically significant.

The reason for the insignificance of key variables in this model is likely the failure of the main assumption of the model. FDI trends in both countries need to be similar before the implementation of the Custom Union. Although there are good reasons why Kazakhstan and

Azerbaijan should have similar FDI growth trends. A quick analysis of the two trends shows that they are not the same and actually diverge before the implementation of the Customs Union. This divergence makes these results less helpful.

The results of the World-Kazakhstan comparison are not much more helpful. The results contradict those of the Azerbaijan comparison. The coefficient on KZ2011 (interaction of KZ with 2011) is -6169 and is statistically significant at a 5 percent confidence level. This would suggest that Kazakhstan's participation in the Customs Union reduced FDI flows by \$6.1 billion, which would be incredible if true. It would represent over a quarter of Kazakhstan's \$21 billion of FDI in 2011. The KZ2012 variable was not significant, which makes the true impact of the Customs Union questionable. Integration has increase with time, so one would expect the effect to increase, not to disappear.

The coefficient on KZ is indicative of why KZ2010 had such a negative value. KZ was -9728 and was significant at the 1 percent level. So simply being Kazakhstan reduced FDI flows by \$9.7 billion when compared to the world. This makes sense considering how much greater total world FDI is. Again the assumption of similar trend lines does not hold well enough for these results to be particularly helpful. Although the trends look similar when plotted separately, the level of total world FDI is so much higher, that annual increases in percentage terms in FDI are much different than in Kazakhstan. The difference in scaling can make the graphs look similar but actual trends are not close enough. The high magnitude and negativity of the coefficient is due to Kazakhstan having much lower levels of FDI than the world.

The year dummy variables were all positive and all except 2004 and 2005 were statistically significant.

Using percent change in FDI instead of total FDI might be a way to solve the problem of scaling, but because of the volatility of FDI from year to year and the limited number of years available it produces no significant results. The percent changes of FDI flows do not follow similar paths. It was this lack of meaningful results that led to the next phase of analysis using a different data source.

As a follow up I compared FDI flows from Russia to Kazakhstan, Azerbaijan, and the World. In the comparison to the world the difference-in-difference estimators were significant at a one percent level and were negative, but the magnitudes were not believable. The model suggested that in 2012 the customs union decreased investment from Russia to Kazakhstan by \$35 billion. In the context of Kazakhstan's FDI total of \$22 billion in 2012 these magnitudes do not make sense. The difference-in-difference estimator in the Azerbaijan comparison is positive but not significant. Similar problems exist in this "Russia FDI only" model as in the previous model. Also this regression had only 18 observations, which limits the power.

Table 3: ICT
FDI Flow comparison (dependent variable is FDI_{ijt} in millions of USD)

Coefficient	Azerbaijan-Kazakhstan	Azer-Kaz from Russia	World-Kazakhstan	Wrld-Kaz from Russia
KZ2012	--	--	-2758 (2908)	-35280** (8461)
KZ2011	69.3 (87.6)	293 (303)	-6169* (2908)	-38364** (8460)
KZ	134** (35)	546* (123)	-9728** (1028)	-15742** (2991)

Standard errors in parenthesis
 * 5% significance level
 **1% significance level

Appendix B

IMF Coordinated Portfolio Investment Survey (CPIS) Data

The IMF CPIS provides the country and year of foreign portfolio investment stocks and foreign debt security stocks. I compare Kazakhstan's investment stocks to both South Korean and Ukrainian investment stocks for the years 2001-2012.

In contrast to the ITC data, which came from the central banks of the respective countries, the IMF compiled this data set by surveying investors and firms around the world. It provides a perspective different from the National Bank of Kazakhstan.

Table 4: IMF Summary Statistics

Country	Type of Investment	N	Minimum investment	Maximum investment	Mean investment
Kazakhstan	Portfolio	12	1.41e9	6.29e10	2.28e10
	Debt	12	9.00e8	1.34e10	4.91e9
South Korea	Portfolio	12	8.03e9	1.59e11	7.49e10
	Debt	12	4.44e10	1.63e11	9.51e10
Ukraine	Portfolio	12	1.05e7	1.21e8	5.15e7
	Debt	12	2.00e9	2.11e10	9.76e9

Investment amounts are in USD

Methodology

Using the IMF's coordinated portfolio investment survey data, I construct a similar difference-in-difference model. In this model, rather than looking for economically similar countries, I compared investment trends over time to find comparison countries. The comparison countries

(South Korea and Ukraine) have similar levels of investment and similar investment trends (although the trends were still not exactly the same). The model had the following specification:

$$\text{Investment}_{ijt} = \beta_0 + \beta_1 * \text{KZ} + \beta_2 * \text{KZ2010} + \beta_3 * \text{KZ2011} + \beta_4 * \text{KZ2012} + \text{X} + \epsilon_{ijt}$$

Investment_{ijt} is stocks of foreign investment to country i , either Kazakhstan or the comparison country in year t . j is the type of investment, either debt securities or portfolio investment. KZ is a dummy variable that is 1 for Kazakhstan and 0 for the comparison country. KZ2012 , KZ2011 , and KZ2010 are the interaction of KZ and year dummy variables. X is a vector of dummy variables for the years 2001-2012. ϵ is the error term.

This model looks at types of foreign investment rather than the source of investment, which limits the number of observations in each regression to 48.

I use this model for two comparison countries. The first is South Korea. South Korea is not an obvious choice based on economic structure; however, the growth trends of these two types of investment are more similar than any other country. The second comparison I used was Ukraine, which also had similar investment growth trends and overall levels of investment. Additionally, Ukraine is a former Soviet country like Kazakhstan, and its economy is partially integrated with Russia. After Russia and Kazakhstan, Ukraine has the third largest economy in the former Soviet Union (World Bank, 2014).

Results

A major difference in the IMF data model is that it compares foreign investment stocks based on the IMF's CPIS survey. It is a simple difference-in-difference comparison without control variables because of the data availability.

In the South Korea-Kazakhstan comparison only the KZ2012 coefficient is statistically significant. It has a value of \$-51.1 billion, suggesting that Kazakhstan had \$51 billion less foreign investment stock in 2012 as a result of the Customs Union (and any other exogenous shocks in 2012). The KZ2011 and KZ2010 coefficients have a similar magnitude but are not statistically significant. Also the KZ variable is significant the 1 percent level and has a magnitude of \$-60.3 billion. This shows that Kazakhstan on average has a much lower stock of foreign investment than South Korea. This result is not surprising considering South Korea's economy is much larger and more developed.

Something interesting happens when using the log of foreign investment as the dependent variable. The variable for KZ is still significant with an even higher t-statistic, but none of the difference-in-difference variables are significant. So reducing the volatility of the data eliminates any significance of the explanatory variables.

Next I compared Kazakhstan's foreign investment stock to Ukraine's. In this regression KZ2012 was 23.2 billion at a 10 percent significance level. KZ2011 was 21.9 billion at a 5 percent significance level. This suggests that the Customs Union was increasing investment stocks in Kazakhstan when compared to Ukraine. Neither KZ2010 nor KZ were statistically significant.

The fact that KZ was not significant suggests that levels of investment stock in Kazakhstan and Ukraine were similar.

Just as with South Korea, when logging the investment of Kazakhstan and Ukraine none of the explanatory variables have statistically significant coefficients.

The contradictory results of the South Korea and Ukraine comparisons make the overall impact of the Customs Union ambiguous. It could mean that the underlying assumptions of the model are not correct and that the results are more of an indication of general levels of investment in particular years. Although both economies are very different than Kazakhstan's, Ukraine might be a better comparison because of its history and proximity to Russia. The insignificance of the KZ variable also suggests the levels of investment are closer. It still has a significant level of economic integration with Russia as does Kazakhstan. In general these results, like the previous results are inconclusive.

Table 5: IMF CPIS
Portfolio/Debt Security Investment (dependent variable is investment_{ijt})

Coefficient	South Korea-Kazakhstan	Log(FDI) Kor-Kaz	Ukraine-Kazakhstan	Log(FDI) Ukr-Kaz
KZ2012	-5.11e10* (2.51e10)	.811 (.763)	2.32e10 [§] (1.2e10)	.706 (2.47)
KZ2011	3.69e10 (2.51e10)	.693 (.763)	2.19e10* (9.64e9)	2.04 (1.98)
KZ2010	4.16e10 (2.51e10)	.500 (.763)	1.00e10 (1.2e10)	.755 (2.47)
KZ	-6.03e10** (7.94e9)	-2.44** (.241)	4.36e9 (3.74e9)	2.19** (.769)

Standard errors in parenthesis

[§] 10% significance level

* 5% significance level

**1% significance level

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