UNIVERSITY OF MACEDONIA

DEPARTMENT OF BALKAN, SLAVIC AND ORIENTAL STUDIES

Master Dissertation

INVESTMENTS AND INVESTMENT SITUATION IN UKRAINE

by

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The Dissertation is part of requirement of MA in Politics and Economics in Contemporary Eastern and South-eastern Europe

Thessaloniki
October 2009

CONTENTS

ABSTRACT

This dissertation is an effort to present the structure of the investment and analyze it as an economic instrument of the formation of microeconomic and macroeconomic aspect ratio, which determines the rate of economic growth. Regulatory system and its impact on the investment development are examined in this thesis. The legal framework for investments and its progress in Ukraine is of a great importance here in order to determine and conduct an investment strategy for entering the biggest European market with plentiful opportunities, such as Ukrainian.

INTRODUCTION

Studies of investment problems in economy have always been the focus of economic science. This is because investments affect the underlying basis of economic activity. In modern terms they are the most important means of ensuring the conditions for exit from the economic crisis, structural shifts in the economy, technical progress, improving the quality indicators of economic activity at the micro and macro levels. Enhancing the investment process is one of the most effective mechanisms for socio-economic transformation. Furthermore, FDI is a fuel for the developing economies. More firms in more industries from more countries are expanding abroad through direct investment than ever before and virtually all economies now compete to attract multinational enterprises (MNEs).

The prevailing current economic situation in Ukraine along with political instability significantly complicates the development of an adequate market mechanism for investment, organically combining forms of private and public investment, optimize the relationship between different subjects of investment activity, development of appropriate legal and regulatory framework and other measures governing the investment process, as the level of individual firms, companies or industries and at the level of the national economy as a whole.

This thesis is divided into two sections. The first one presents and analyses the FDI place in emerging economies and the second describes the investment situation in particular emerging market, such as Ukrainian.

Particular dissertation on the investments can be used as a supplement to teaching economic disciplines or as a useful benchmark for students. Potential investors in the Ukrainian economy will find it very helpful and it can be used as theoretical instructions or an advisor. It will provide reader with knowledge of the role of investments in the economic growth, especially for the developing economies with the main emphasis on Ukraine. Profound legislative system for domestic and foreign investments with the current investment market situation will be introduced so as to create a complete picture of the Ukrainian investment affairs.

This dissertation was conducted during the global economic downturn, which did not left any economy untouched, no exception Ukrainian, which was preparing for the fifth

presidential elections, since declaring independence, scheduled to be held on January 17, 2010.

I would like to express my sincere gratitude to my supervisor, Dr. Dimitrios Kyrkilis for his advice, guidance and support throughout the course of this work.

October 2009

Nikos Yagubov

SECTION 1. INVESTMENT PLACE IN EMERGING ECONOMIES

Total capital flows to developing economies have escalated from USD104 billion in 1980 to USD472 billion in 2005. The foreign capital has the potential to deliver enormous benefits to developing nations. Besides helping bridge the gap between savings and investment in capital-scarce economies, capital often brings with it modern technology and encourages development of more mature financial sectors. Capital flows have proven effective in promoting growth and productivity in countries that have enough skilled workers and infrastructure.[1] Capital flows come in three primary forms:

- Portfolio equity investment, which involves buying company shares, usually through stock markets, without gaining effective control;
- Portfolio debt investment, which typically covers bonds and short or long term borrowing from banks and multilateral institutions, such as the World Bank;
- Foreign direct investment (FDI), which involves creating long-term relationships with enterprises in foreign countries.

Foreign Direct Investment can be made in several ways[2]. First, and most likely, it may involve parent enterprises inserting equity capital by purchasing shares in foreign affiliates. Second, it may take the form of reinvesting the affiliate's earnings. Third, it may entail short or long term lending between parents and affiliates. To be categorized as a multinational enterprise for inclusion in FDI data, the parent must hold a minimum equity stake of 10 percent in the affiliate. Establishing foreign affiliates usually entails starting new production facilities, in other words Greenfield investments[3] or acquiring control of existing entities through cross-border mergers and acquisitions. Recent years have seen an apparent shift toward international mergers and acquisitions.
From 1990 to 2005, developing economies' share of total FDI inflows rose from 18 percent to 36 percent. In addition, the geographical composition of FDI flows has changed dramatically over the past four decades. Within developing economies, Latin America's share of FDI has fallen from 52 percent in the 1970s to 33 percent since the 1990s. Asia's share of inflows has risen from 25 percent to 60 percent during the same

[1] John H. Dunning, Rajneesh Narula, "Foreign Direct Investment and Governments: Catalysts for Economic Restructuring", Published by Routledge, New York, 1996, pp. 3-4
[2] Dimitrios Kyrkilis, "Foreign Direct Investments", Kritiki, Athens, 2002, p. 17
[3] A Greenfield Investment is the investment in a manufacturing, office or other physical company-related structure or group of structures in an area where no previous facilities exist.

period.[4] Inward FDI flows into South-East Europe and the CIS recorded their seventh consecutive year of growth, reaching an all-time high of USD86 billion in 2007, comparing to the 1990s when FDI did not exceed USD 20 million.

For emerging economies, FDI has significant advantages over equity and debt capital flows. Foreign firms' participation in domestic business encourages the transfer of advanced technologies to the host country and it fosters human capital development by providing employee training. It also strengthens corporate institutions by exposing host countries to developed economies' best business practices and corporate governance. From a macroeconomic perspective, FDI is more stable than other types of capital flows. Equity and short term debt in particular tend to be highly unstable and speculative and their role in deepening financial crises in the 1990s has been closely scrutinized. FDI's relative stability and long term character make it the preferred source of foreign capital for many emerging economies.[5]

Many developing countries pursue FDI as a tool for export promotion, rather than production for the domestic economy. Typically, foreign investors build plants in nations where they can produce goods for export at lower costs. Another way FDI helps boost exports is through preferential access to markets in the parent enterprise's home country. FDI is an important channel for delivery of services across borders for emerging economies as well as developed ones. Services aren't as widely traded as goods, making up only a fifth of world exports. That figure is expected to rise rapidly, as the Internet and other communications make more services tradable and facilitate the spread of outsourcing. In fact, FDI has grown faster in services than in goods in recent years. In most developing nations, service industries have been closed to foreign investment. As countries further open their economies, services can be expected to continue outpacing goods.[6] The pattern of services FDI has also been changing. In 1990, finance made 57 percent of services FDI in developing economies. By 2002, its share had fallen to 22 percent as business services' share rose from 5 percent to 40 percent. As services become increasingly tradable, FDI in these industries can establish a strong link with exports of emerging economies. Multinationals operating in such services as banking, telecommunications and trade enhance the efficiency of domestic

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[4] Ethan B. Kapstein, Branco Milanovic, "Income and Influence: Social Policy in Emerging Market Economies", W.E. Upjohn Institute for Employment Research, Kelamazoo, Michigan, 2003, pp. 27-29

[5] Patricia Brukoff, Bjorn Rother, "FDI May Not Be as Stable as Governments Think", IMF Policy Development and Review Department, IMF Survey Magazine: IMF Research, 29.01.2007,www.imf.org

[6] Klaus Liebscher, Josef Christl, Peter Mooslechner, Doris Ritzberger-Grunwald, "Foreign Direct Invetsment in Europe: A changing Landscape", Edward Elger, Northampton, 2007, pp. 176-177

providers in many ways, contributing to the export competitiveness of these economies' service sectors. With both FDI and trade rising rapidly in services, FDI has an important role in promoting the sector's globalization in other emerging economies.

Foreign investment can finance current account deficits through its effect on investment or compensate other financial transactions, such as increases in reserves or capital outflows. The imported capital may simply result in additional consumption rather than investment. In principle, it needn't always boost the country's productive capital stock. If foreign and domestic companies compete for the same investment pie in the host country, FDI may simply compensate or displace domestic investment. Certainly, FDI may represent a net capital gain or even insert into domestic investment through a number of channels, such as transfers of technology and key expertise that doesn't exist in host countries.

FDI offers attractive benefits that include technology, investments, savings and growth. But emerging economies should exercise caution. The relative advantages of FDI during crises are well reported. In times of extreme financial crisis, FDI may be accompanied by distress sales of domestic assets, which could be harmful. Even in normal times, FDI can be reversed or diminished through domestic borrowing by affiliates of multinational corporations and repatriation of funds.[7] Too much FDI may not be beneficial. Through ownership and control of domestic companies, foreign firms learn more about the host country's productivity and they could overinvest, at the expense of domestic producers. There is a possibility that the most solid firms will be financed through FDI, leaving domestic investors stuck with low-productivity firms. Despite these drawbacks, FDI appears to help emerging economies develop. It completes the host country's institutions and human capital. In many countries, however, barriers to FDI remain. These barriers may range from limits on foreign ownership and control to outright bans on FDI in select sectors, such as services. Reducing them may well be a way to speed up economic development. FDI benefits investors, to be sure, but it also pays dividends to the countries that attract it.

1.1 ATTRACTIVENESS OF THE REGION

Foreign direct investment in emerging economies is booming after a temporary delay in 2001-04. Foreign investors seek local markets and export platforms based on local

[7] Prakash Loungani, Assaf Razin, "How Beneficial is Foreign Direct Investment for Developing Countries?", Finance and Development Magazine of the IMF, June 2001, Vol. 38, Number 2, www.imf.org

resources such as low cost labour or natural resources. Most investors pursue market-seeking objectives, yet resource-seeking investors account for many large projects, given them a large weight in many measures of FDI. Initially, many investors may be motivated by only one of the objectives, but most investors over time develop a range of activities and serve both domestic and export markets.

Globalisation has led to the opening of many markets and thus increased competition not only in emerging markets, but also in developed countries. In consequence, rather than building a strong position in several markets in their home country, more and more companies pursue a global strategy that is focused on one particular industry. In recent years, many TNCs have gone through a process of global orientation, as they have shed peripheral product lines and expanded their core businesses, often by acquisition. As industry-specialists, they aim for global leadership positions in their chosen segment. FDI in emerging economies can serve this objective by extending the market range or by providing a global supply base. For companies aiming to become global leaders in their market segment, competitive interaction with global rivals may bring about early entry in emerging economies in view of first-mover or second advantages.[8] Global competitive pressures may also encourage TNC to find new ways to reduce production costs. These pressures lead to outsourcing to low cost suppliers and investing to exploit location specific assets, for example, natural resources.

The necessity of foreign investments in the transition countries is the result of industrial restructuring in post-socialist Eastern Europe and the Baltic countries. New markets, lower production costs and higher profit rates have been the main motivators in investing to the transition countries. Privatization programs of some of these countries have also facilitated foreign direct investments. A number of Central and Eastern European transition countries are in the middle of process of integration to the European Union now. Economic integration has a direct impact on the flows of the foreign direct investment.

1.2 IMPACT OF FDI ON EMERGING ECONOMIES

The impact of FDI on host economies is complex, as foreign investors interact with and consequently influence many local individuals, firms and institutions. The foreign invested firm or FDI project, is closely interacting with local businesses and most of the impact on the host economy is transmitted trough this interaction. Beyond this, FDI also

[8] Klaus Meyer, "Direct Investment in Economies in Transition", Published by Edward Elgar Publishing Limited, Northampton, 1998, p. 62

impacts on other aspects, including macroeconomic variables, the host economy's institutional framework, as well as, the natural and social environment. Most of these interactions are bilateral. On the one hand, foreign investors adapt to the local institutional, social and natural environment in designing their strategies. On the other hand, they would, intentionally or not, influence the environment through for instance political lobbying, setting good examples of labour standards or polluting the environment. The FDI project in turn is designed by a TNC located outside the country. The structure and strategies of this TNC consequently shape the project and its interactions with the local environment. On a macroeconomic level, FDI influences key variables of concern to policy makers: balance of payment, employment, gross domestic investment and international trade. FDI is commonly believed to have a positive effect on each of these variables, yet theoretical considerations suggest also countervailing effects. However, these effects are often indirect and thus usually measured empirically. In consequence the net effect of FDI on key macroeconomic variables is often hard to establish empirically:[9]

- FDI imports capital, but at a later stage capital is repatriated through profit remittance or project discontinuation and in this way the host country pays for the costs of capital. However, FDI capital is appreciated by hosts because it tends to be less volatile then other forms of capital inflow;
- FDI creates employment, especially if it is invested in Greenfield operations. Moreover, additional jobs may be created in local suppliers. FDI may also compensate local firms that use more labour-intensive methods of production and thus more employment.

Many countries aim to attract inward FDI to accelerate the development of technological capabilities and TNC are often considered a suitable transfer vehicle. Through interaction with local firms, TNCs may generate spillovers[10] that enhance the productivity of local firms:

- Knowledge effects work through the direct contact between local agents and TNCs operating at different levels of technology. After observing an innovation adapted to local conditions, local entrepreneurs may recognize their usefulness and thus strive to imitate them. As local businesses observe existing users, information about new

[9] Yuriy Gorodnichenko, Jan Svejnar, Katherine Terrell, "Globalization and Innovation in Emerging Markets", Working Paper Series, Working paper 14481, 2008, pp. 16-17
[10] Klaus Meyer, "Direct Investment in Economies in Transition", Published by Edward Elgar Publishing Limited, Northampton, 1998, p. 66

technologies and business practices is spreading out, uncertainty is reduced and imitation increases;

- FDI contributes to human capital formation, especially through training and labour mobility. Trained local employees may move to locally owned firms or set-up own entrepreneurial businesses. TNCs typically pay salaries above local standards to discourage highly trained employees from leaving, yet they may not oppose such movements if the new firms become business partners. Many successful local firms trace their origins to entrepreneurs or top managers that had prior links to TNCs;
- FDI may help local firms to access export markets. TNCs are more likely to share general trade knowledge, as it is less industry-specific and not part of their core capabilities and its diffusion to local businesses does not endanger their own competitive advantage. Moreover, foreign investors may help building trade channels and a country of origin reputation that local followers may use for their exports;
- TNCs may make a intentioned effort to improve the quality of local suppliers, especially for components that cannot be cost-efficiently imported due to high transportation costs or where the local industry has a natural cost advantage (e.g. for labour intensive components). These effects benefit also firms in other industries, for instance providers of business services, such as accounting or legal services. Similar, they may support their customers, for instance by providing training in sales and marketing.

However, negative spillovers on local firms are also possible. Foreign investors may gain market share at the expense of local firms. This would leave the local firms, at least in the short run, with excess production capacity and consequently low productivity and low profitability. Moreover, foreign investment may source internationally and thus weaken the local industry's domestic supplier base. On average, it is found that the effect is negative for industrialized countries and positive, but small for developing and transition economies. For instance, infrastructure FDI in transport or telecommunication can greatly enhance productivity in other sectors of the economy, yet at the risk of foreign control, possibly even monopoly, if the sector is not appropriately regulated. Similar benefits and risk arise from financial sector investment. Services such information technology operates in more competitive markets and may benefit a wide range of other business. In manufacturing, major variations arise from the need or

opportunity to produce close to the market due to high transportation costs or low scale economies. An aspect of particular relevance for TNC spillovers is intra-firm knowledge transfer. Knowledge sharing within the TNC is a precondition for knowledge spillovers. Typically investors would transfer "know-how" to their affiliates to enhance efficiency and productivity.[11] They would keep tighter control over their "know why", because such knowledge if diffused to other firms, could threaten the international market position of the firm. Knowledge spillovers would also raise with higher value added activities, such as complex manufacturing processes, such as customized machinery, rather than mass assembly of for example garments or shoes. Greenfield projects create new businesses and thus have direct positive effects on employment and domestic value added, and increase competitive pressures on local competitors. Acquisitions, on the other hand, are at the time of entry fully operating enterprises. The new owners may or may not continue traditional business relationships, possibly drawing on their existing suppliers, which would strongly impact on local industries. However, based on inherited operations, acquisitions are more likely then Greenfield projects to engage in Research and Development.[12] FDI also can act as a stimulus to innovation and discovery. Entrepreneurial activity by individuals leaving a foreign-owned affiliate to establish their own business generates potentially large spillovers. Moreover, large TNCs may stimulate the evolution of industrial clusters. FDI by a lead firm may draw other network members to the same location and consequently create a larger impact than the initial investment alone. For small ambitious firms in emerging economies, access to such production networks is of increasing importance. Government policy thus ought to aim to enable local firms to interact with multinational corporations in ways that benefits both partners. The main consequence of this is that most policies that promote the development of local businesses would also strengthen the abilities of local businesses to make the best out of their interaction with foreign investors, for instance education policy or competition policy.

1.3 FDI AND ECONOMIC GROWTH

Theory provides conflicting predictions concerning the growth effects of FDI. The economic reason for offering special incentives to attract FDI often derives from the belief that foreign investment produces externalities in the form of technology transfers

[11] Klaus Liebscher, Josef Christl, Peter Mooslechner, Doris Ritzberger-Grunwald, "Foreign Direct Invetsment in Europe: A changing Landscape", Edward Elger, Northampton, 2007, pp. 53-54
[12] Klaus Meyer, "Direct Investment in Economies in Transition", Published by Edward Elgar Publishing Limited, Northampton, 1998, p. 68

and spillovers. Firm-level studies of particular countries often find that FDI does not boost economic growth and these studies often do not find positive spillovers running between foreign-owned and domestically owned firms.[13] Unlike the microeconomic evidence, macroeconomic studies using aggregate FDI flows for a broad cross section of countries generally suggest a positive role for FDI in generating economic growth, especially in particular environments. According to several empirical researches, foreign direct investment inflows do not exert an independent influence on economic growth. What is widely believed is that FDI affects positively economic growth under certain national policies, which are unique for each economy. Some studies have detected a positive impact, but only if the country has a threshold level of human capital.[14] This seems to confirm FDI's important role in urging growth in China and India, which have vast technical workforces. China graduates 600,000 engineers every year and India produces 215,000. For countries with high tariff and non-tariff barriers, FDI may simply be the result of multinational corporations trying to access domestic markets because the export route has been closed. In this case, FDI may contribute to economic growth, but the impact will be reduced to the extent high tariffs hold up growth.

Countries also pursue foreign investors with tax breaks and subsidies. Fiscal incentives are doubtlessly a good way to promote FDI. After all, tax havens are prominent FDI recipients. However, researchers have found that such policies aren't effective ways to acquire FDI's economic benefits. Indeed, the policies may create distortions that significantly weaken FDI's efficiency and productivity gains. Tax incentives may prove wasteful because FDI responds more to such factors as labour market flexibility, the cost of doing business and the quality of the infrastructure.

1.3.1 Empirical reports

On empirical grounds, some researches have detected a positive connection between FDI and growth. Blomstrom, Lipsey and Zejan[15] pursue a cross-country analysis of a sample of 78 developing countries. They report that the positive impact of FDI on growth is larger in those countries that exhibit higher levels of per capita income.

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[13] Klaus Liebscher, Josef Christl, Peter Mooslechner, Doris Ritzberger-Grunwald, "Foreign Direct Invetsment in Europe: A changing Landscape", Edward Elger, Northampton, 2007, pp. 78-79

[14] Klaus Liebscher, Josef Christl, Peter Mooslechner, Doris Ritzberger-Grunwald, "Foreign Direct Invetsment in Europe: A changing Landscape", Edward Elger, Northampton, 2007, pp. 89-90

[15] William J. Baumol, Richard R. Nelson, Edward N. Wolf, "Convergence of Productivity: Cross-National Studies and Historical Evidence", Magnus Blomstrom, Robert E. Lipsey, Mario Zejan, "What Explains the Growth of Developing Countries?", Published by Oxford University Press, Oxford, 1994, p. 254

Balasubramanyam, Salisu and Sapsford[16] employ a cross-country procedure to analyze 46 Less-Dedeloped Countries (LDC) in 1970-85. Their results suggest that FDI enhances growth in those cases in which the host country has adopted trade liberalization policies. K. Hussein and De Mello[17] employs time series and panel data analysis over a sample of both OECD and non-OECD countries over the period 1970-1990. According to it, FDI has a positive impact on growth if there is fair distribution between foreign and domestic investment. Bengoa and Sanchez-Robles[18] explore the correlation among FDI and economic growth in Latin America over the period 1970-1999. They also find a positive and significant impact of FDI on the economic growth of the countries of this area.

1.4 GOVERNMENT'S POLICY

Multinational Enterprises undertake FDI if and when it suits their global strategy and they will invest in the type of project they need to achieve their strategic objectives. Government policy may consequently focus on attracting firms that plan to locate attractive projects. Specific incentives schemes designed to attract FDI, such as tax breaks or subsidies, may affect location decisions at the margin, especially between neighbouring regions and especially for independent projects that do not require specific linkages to the local economy. However these are also the least attractive projects in terms of expected local benefits. A conducive business climate may be more important for both Multinational Enterprises seeking investment locations and for local firms and entrepreneurs seeking to benefit from the presence of TNCs. As they pursue common goals Governments and TNCs live in a complex relationship, but also experience some distinct conflicts of interest. According to Robert Grosse there are some ambiguous demands of policy makers towards TNCs.[19] In other words they want:

- To achieve economic growth, but they are not as positive about foreign firms' ownership of parts of the local economy;

[16] Balasubramanyan, M Salisu and David Sapsford, "Foreign Direct Investment and Growth in EP and IS Countries'", Economic Journal, 106(434), 1996, pp. 92-105
[17] K. Hussein, L. De Mello, "International Capital Mobility in Developing Countries: Theory and Evidence", Journal of International Money and Finance, Vol. 18, 1999, pp. 372-373
[18] Bengoa, Marta , Sanchez-Robles, Blanca. "Foreign direct investment, economic freedom and growth: new evidence from Latin America", European Journal of Political Economy, Elsevier, vol. 19(3), 2003, pp. 529-545
[19] Robert Grosse, "Multinationals in Latin America", International Business Series, Routledge, New York, 1989, pp. 43-44

- Economic development, but without environmental damage or social conflict that foreign and local firms might cause;
- The opportunity for local citizens to enjoy products and services from around the world, but still to maintain a national or local culture and values;
- Their sovereignty to pursue national interests, when the increasingly global economy often forces supra-national goals on them.

These double-edged objectives, together with the diversity of interactions across foreign investors, suggest appropriate government policy such as to optimize the received benefits.

In general, policy interventions may be justified if they increase efficiency of resource allocation in inefficient markets, change the distribution of income and wealth in a politically desirable way or enhance the dynamic and long-term processes of accumulation of resources and capabilities in the national economy. The business environment includes some aspects that can be influenced by government policy such as the bureaucracy handling approval or registration of new businesses, or the efficiency of regulatory institutions. Consequently, the first priority for policy makers is to create an infrastructure, such that investing firms can, with limited risk, take up the opportunities offered by the comparative advantage of potential host economies, for example relatively cheap labour or raw materials. A conducive business climate may attract both TNCs seeking investment locations and local firms and entrepreneurs seeking to benefit from the presence of TNCs.[20] A generally conducive business environment can be expected to promote both the efficiency of resource allocation and the dynamic development of capabilities and arguably also creates benefits for weaker income groups. However, policy makers should not overestimate their impact on TNCs. Government policy towards inward or outward FDI generally has negligible effects on these corporate strategies. Government policy may consequently focus on attracting firms that plan to locate attractive projects, rather than try to convince them to do change what they are doing. Incentives schemes for FDI, such as tax breaks or subsidies, may influence location decisions at the margin, especially between neighbouring regions and especially for independent projects that do not require specific linkages to the local economy and hence may create fewer spillovers. However, the competition between regions for specific FDI projects entails the danger, as the investor

[20] Klaus Meyer, "Direct Investment in Economies in Transition", Published by Edward Elgar Publishing Limited, Northampton, 1998, p. 52

may able to internalize most of the social benefits. On the one hand, competition among potential hosts for FDI is good because FDI reacts primarily to "fundamentals" such as political and economic stability, market access and growth, skilled workforce and infrastructure. Investment in "fundamentals" is good for both domestic and foreign firms, such that even if no FDI materializes, this may benefit the host economy.[21]

SECTION 2. STRATEGY FOR INVESTMENT IN UKRAINE

During the economic crisis, investment activity in Ukraine has decreased. The demand for investment fell much faster than the production of gross domestic product. One reason was that high inflation is significantly devaluing the investment funds. This, consequently, indicates the lack of economic incentives for commercial banks lending to productive investment, the presence of high risk in providing such loans and loan portfolios of banks burdening credit policy.

Nowadays, with some confidence we can say that Ukraine, as a democratic state, has formed a monetary and banking system, a solid foundation for financial stabilization, which forms the basic conditions for development investment processes in Ukraine. Ukraine has achieved the normalization of the functioning of the banking system. Ukrainian banking system has switched to international accounting standards and reporting. Stability is one of the key pledges of the foreign exchange market development. In May 1997, Ukraine became the 138th country to sign Article 8 of the Agreement with the International Monetary Fund on a full convertibility of hryvnia in ongoing operations. These problems have been cleared of the repatriation of earnings of investors of any type from the territory of Ukraine.

The most important part of economic reforms is large scale privatization. In late 1997, has nearly completed privatization of small, largely privatized medium-sized enterprises and more than 50% of all state assets, which are subject to privatization have been privatized. Now in the process of sale, except for small and medium-sized enterprises, there are about 300 large enterprises with fixed assets of more than 100 million U.S. dollars. Among them there are some quite attractive objects, with the investment point of view. For example, oil refineries, mining, oil and gas, electricity generation and supply companies, ferrous and nonferrous metallurgy, machine building and other industries.

[21] Mo Yamin, R. Sinkovich, R. Rudolf, "Infrastructure or Foreign Direct Investment: An Examination of the Implications of MNE Strategy for Economic Development", Journal of World Business, Vol. 44, Issue 2, Apr. 2009, pp. 144-157

Priority areas for engagement and support of strategic investors can be identified, where Ukraine has a traditional production, possession of a necessary resource potential and creates a significant market demand for the products, namely: the production of cars and trucks, tractors; aircraft and rocket ; shipbuilding; vicious cycle of production of fuel for nuclear power plant, development of power generating facilities, oil and gas production, particularly in the Black Sea shelf, the introduction of resource and energy-saving technologies, agro-processing, transport infrastructure.[22] Effectively solve the problem of reducing resources and energy can only be through the widespread introduction of new technologies of modern technology, tied together by the interests of research and practice through market demand.

Current conditions for economic development require an active policy to attract foreign direct investment. The Ukrainian legislative framework for the regulation of investment activities has gradually improved. The Law of Ukraine on foreign investment regime for foreign investors in Ukraine, approved in 19 March 1996 has equal conditions for the activities of domestic and foreign investors.[23] The Act gives to the foreign investors guarantees to protect their investments. Important legal instruments that govern the relationship between the government and investors are interstate agreements on the promotion and reciprocal protection of investments. Such contracts are just of the guarantor to make investments and to protect them in the territory of another state. Ukraine has signed such treaties with 53 countries in the world[24]. Bilateral treaties for the avoidance of double taxation are signed by Ukraine with 19 states[25]. Ukraine is a

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[22] Jorge Zukoski, "Ukrainian Investment Perspectives: Credibility and Stability Are Key", American Chamber of Commerce in Ukraine, Marat Terterov, "Doing Business with Ukraine: A Guide to Investment Opportunities and Business Practice", Third Edition, Published in Association with American Chamber of Commerce in Ukraine, 2005, pp. 29-30

[23] Stanley J. Poliwoda, "Investing in Eastern Europe: Capitalizing on Emerging Markets", Addison-Wesley Publishers Ltd, Cambridge, 1994

[24] Bilateral investment treaties for the protection and promotion of investments signed by Ukraine with Denmark 1992, Egypt 1992, Finland 1992, Mongolia 1992, Germany 1993, Kyrgyzstan 1993, Poland 1993, United Kingdom 1993, Uzbekistan 1993, Armenia 1994, Bulgaria 1994, Canada 1994, Czech Republic 1994, France 1994, Greece 1994, Hungary 1994, Israel 1994, Kazakhstan 1994, Lithuania 1994, Netherlands 1994, Slovakia 1994, United States 1994, Vietnam 1994, Argentina 1995, Belarus 1995, Chile 1995, Cuba 1995, Estonia 1995, Georgia 1995, Italy 1995, Lebanon 1995, Republic of Moldova 1995, Romania 1995, Sweden 1995, Switzerland 1995, Belgium and Luxembourg 1995, Austria 1996, Indonesia 1996, Islamic Republic of Iran 1996, Republic of Korea 1996, Turkey 1996, Azerbaijan 1997, Croatia 1997, Latvia 1997, FYROM 1998, Russian Federation 1998, Spain 1998, Turkmenistan 1998, Slovenia 1999, India 2001, Yemen 2001, Serbia 2001, Montenegro 2006.

[25] Netherlands 1993, United Kingdom 1993, Finland 1994, United States 1994, Germany 1995, Hungary 1995, Latvia 1995, Netherlands 1995, Sweden 1995, Canada 1996, Denmark 1996, Estonia 1996, Lithuania 1996, Norway 1996, Austria 1997, Czech Republic 1997, Georgia 1997, Kyrgyzstan 1997, Luxembourg 1997.

part to the plenty of multilateral and regional instruments[26]. Furthermore, a number of draft agreements are under negotiation.

Positive effect on attracting foreign investment cooperation and assistance to Ukraine is provided by the International Monetary Fund and other International Organizations.

In July 1996, the National Agency of Ukraine for Reconstruction and Development[27] was created, the main purpose of which was the creation of an enabling environment for the development of international economic cooperation, cooperation with international financial institutions, relevant intergovernmental and regional organizations, organizations of foreign countries in attracting and using external financial resources.

In order to avoid disputes between foreign investors and the executive authorities and local self-government, to facilitate their rapid extrajudicial regulation by Presidential Decree established the Chamber of Independent Experts on foreign investment under the President of Ukraine.

To help resolve contentious issues that arise during the implementation of investment projects with the participation of American companies, in October 1997 by Presidential Decree established the Ukrainian part of the special rapid response team.

However, despite established a legal framework, institutional infrastructure, the attractiveness of the economic potential of Ukraine (the relatively rich natural resources, favourable geographic location, availability of skilled low-cost labour, advances in scientific research, a large capacity internal market), the income of foreign investments in Ukraine is still slight. Compared with the countries of Eastern Europe, foreign investment, which comes to the economy of Ukraine, is 3-7 times less.

Foreign investors have shown the greatest interest in such sectors of the Ukrainian economy as the food industry; domestic trade; engineering; finance and loans; construction and construction materials, chemical and petrochemical industry,

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[26] Paris Convention for the Protection of Industrial Property of 20 March 1883, as amended and revised; the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 10 June 1958; the Convention on the Settlement of investment Disputes between States and Nationals of Other States of 18 March 1965, signed on 24 Mars 1975, effective 1 June 1991; the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, adopted on 16 November 1977; the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, adopted on 5 December 1980 by the General Assembly of the United Nations (resolution 35/63); the Convention Establishing the Multilateral Investment Guarantee Agency of 11 October 1985, signed on 30 September 1996; the Declaration on International Investment and Multilateral Enterprises, adopted by the Council of the Organisation for Economic Cooperation and Development on 21 June 1976, the Declaration and the Guidelines for Multinational Enterprises attached to the Declaration were revised on several occasions (1979, 1984, 1991 and 2000) and the Energy Charter Treaty of 17 December 1994, effective since 16 April 1998. From May 2008 Ukraine is a full member of WTO.

[27] The Agency for Reconstruction and Development merged with the Ministry of Economy and European Integration in 2000.

representing 67.1% of the total.

The main pillars of the state investment policy in the near future are: the increase in capital investment, strengthening the influence of the state to enhance the investment process through the increase of budget funding of capital construction of major infrastructure facilities and the introduction of a credit basis of budgetary financing of investment creation of conditions for long-term loans to commercial banks, organizing of investment and innovation funds, an increase of investment resources, which are formed in the stock market and at the expense of savings, the introduction of the economic mechanism of the insurance risk of internal and external investment, education respective institutions on the integration of industrial and banking capital, raise funds for effective investment projects in priority sectors of the economy.

In order to facilitate efficient investment and investors in many ministries and departments of Ukraine formed investment banks database across industries and regions (for example, the database includes more than 2000 such objects, under the Ministry of Economy[28]). Based on the information of the embassies of countries, potential investors and materials that come in the government formed a database of foreign investment companies (there are more than 200), which is used by Ukrainian producers to search for foreign investors.

2.2 LEGAL FRAMEWORK AND REGULATORY SYSTEM

Ukraine aims to create a free market economy in which private capital would play role in the economic development of the country. In this respect, it recognizes the importance of FDI and consequently it seeks to create an enabling investment climate for its attraction. To this end, it is increasingly liberalizing its investment regime and while deregulating business and foreign exchange activities. The major piece of legislation governing foreign investment in Ukraine is the Law on the Regime of Foreign Investment from 25 of April 1996. The document contains the following major statements-guarantees:

- Foreign investment is exempted from nationalization, except for cases of natural disaster;
- Guarantee in the event of termination of investment activity, an investor has six months to return its investment in kind (goods, services) or in cash without payment

[28] www.me.gov.ua

of customs duties, as well as any profits earned in kind or cash at their real market value;

- Foreign investors are guaranteed direct and immediate rights to repatriate their profits abroad after complying with the withholding tax regulations;
- Guarantee of compensation and repayment of losses suffered as a result of improper or negligent action of state authorities or their representatives;
- Protection against changes in legislation, in other words, foreign investor is guaranteed protection for 10 years in the event that Ukraine foreign investment legislation is changed.

Ukrainian legislation on foreign investment sets out effective protection for foreign investment in Ukraine against state confiscation except for cases of national emergency. Such cases include evacuation or rescue measures in connection with disasters, accidents or epidemics. Foreign investors are eligible for compensation of losses caused by government bodies with respect to the above cases. The main legislations regulating business and investment activities include the Law on Foreign Investment (1996), Law of Investment Activity (1992), Law on Enterprises, Law on Business Associations, Law on Ownership and Law on Taxation of the profits of enterprises (1995) the main features of which are[29]:

Admission and establishment: Foreign investors may enter in to the market through incorporation of a new company wholly or partially foreign-owned, acquisition of an interest in an already existing one; establishing a wholly-owned subsidiary or a branch, or acquiring an existing company; any kind of real or other property, shares of stock, bonds or other securities; land use rights or concessions for the development of natural resources, whether independently or together with a Ukrainian partner or other property rights. Foreign investment may be undertaken individually as a sole proprietorship or organized as partnerships, corporations, joint stock companies, limited liability companies. Establishment of representative offices and branches is permitted. Foreign investors may carry out investment activities on the basis of Joint Activity Agreements without forming a legal entity. All joint activity agreements are required to be registered. Approval is required for the establishment of a legal entity, mergers and acquisitions.

[29] Mohammed Ishaq, "Foreign Direct Investment in Ukraine since Independence", Center for Economic Reform and Transformation, Heriot-Watt University, Edinburgh, 2007, pp. 3-4

Ownership: An enterprise with foreign investment is any enterprise where foreign investment in the charter fund is at least 10 per cent. Currently, FDI is restricted on several sectors. For instance, investment in the fields of insurance, publishing, broadcasting and the manufacture of weapons and alcoholic spirits is limited to 49 percent. In fields designated as strategic such as television broadcasting services and radio stations foreign participation may no exceed 30 percent. Foreign investors may own, use, lease properties. Nevertheless, foreigner ownership of land, particularly and for non-agricultural and enterprise purposes is restricted.[30]

Operational conditions: There are no performance requirements specific to foreign investors.

Currency: The Ukrainian currency's'[31] convertibility still faces problems, but foreign exchange markets being continually liberalized. Profits, revenues and other proceeds in foreign currency may be transferred without restriction, provided taxes and other mandatory payments are covered first. Profits may be repatriated freely and immediately. Revenues and investments may be withdrawn from Ukraine within six months upon the termination of the investment activity. Non-residents and their representative offices may open current accounts in national and foreign currencies as well as deposit accounts. Foreign investors have the right to invest by using the following forms:

- Hard currency;
- Ukrainian currency as a re-investment into existing or newly established enterprises;
- Any movable or immovable property and property rights connected there with shares, bonds, other securities and other corporate rights;
- Monetary claims and claims under contracts, valued in hard currency and guaranteed by first-rank banks;
- Any intellectual property rights with confirmed estimation in hard currency according to the laws of the investor's country of residence, including copyrights, trademarks, firm names, know-how and others;
- Rights in respect of economic activities, including exploration and utilization of natural resources valued in hard currency and valued under the laws of the investor's resident country.

[30] Valentina Zagalya, Ruslan Shevchuk, "Ukraine: The Legal Environment for Investing in Ukraine", Journal of Ukrainian Law Firms, 25.08.2009
[31] The currency of Ukraine is Hryvnya (UAH), 1 EUR=12.18 UAH

Incentives: Foreign investors are exempt from the customs duties for any in-kind contribution imported into the country for the company's charter fund, subject to backward payment of such duties if the enterprise sells, transfers or otherwise disposes of the contributed property for any reason other than repatriation of foreign investment. The basic rate for corporate income tax is 30 percent, but may vary as the case may be. For instance, the rate for profits from lotteries, casinos and other types of gambling activity is 60 per cent. VAT is 20 percent.

2.2.1 Anti-monopoly regulations

In order to protect Ukrainian markets and their participants, such as suppliers and consumer, from the negative effects of monopolization and abuse of a dominant position, the Law of Ukraine "On the Protection of Economic Competition" of January 21st, 2001 (as amended), requires that an approval be obtained from the Antimonopoly Committee of Ukraine (AMC)[32] for a transaction if that transaction may or will lead to an "economic concentration" in a specific segment of the Ukrainian market. For example, AMC notification and clearance may be required in respect of mergers, consolidations, acquisitions of shares and incorporation of a new company involving a foreign investor, if all three provisions of the following threshold test are met:

- The participants', including control relationships, combined assets or turnover worldwide exceed EUR12 million for the last financial year;
- Each of two participants, including control relationships, has assets or turnover worldwide exceeding EUR1 million as of the last day of the financial year and at least one participant, including control relationships, undertaking, has assets or turnover in Ukraine exceeding EUR1 million as of the last day of the financial year.

The anti-monopoly regulations may be subject to rapid changes and it is very important to consider the potential application of such regulations on a merger or acquisition transaction. The complexity of the antimonopoly issues usually requires the assistance of a professional advisor to ensure compliance with antimonopoly regulations.

2.2.2 Investment Registration Procedure

[32] Antimonopoly Committee of Ukraine is the state authority with special status, aimed at providing the state protection to competition in the field of entrepreneurial activity, www.amc.gov.ua

The foreign investment should be registered with the regional (oblast) state administration, the state administration of the Cities of Kyiv or Sevastopol or the government of the Autonomous Republic of Crimea. In order to have a foreign investment registered, an investor or its authorized representative is required to submit to the following documents to the relevant registration body:

- An informational notification of the foreign investment confirmed by the local state tax administration;
- Documents certifying the form of the foreign investment (e.g. copies of the constituent documents of the Ukrainian company or a copy of a joint activity agreement);
- Documents evidencing the value of the foreign investment;
- Document that confirms the payment of the state registration fee.

2.2.3 Dispute Resolution

In the event of a dispute arising with respect to a foreign investment, a foreign investor may seek recourse through a number of institutions. As a general matter, the Foreign Investment Law provides that a dispute arising between a foreign investor and the state of Ukraine must be settled in the Ukrainian courts, unless otherwise provided by international treaties, while all other disputes involving a foreign investor must be settled in the Ukrainian courts or in courts of arbitration, including international arbitration courts. Corruption continues to lie at the heart of many investor disputes. Laws and regulations are vague, with considerable room for interpretation, providing officials at every bureaucratic layer ample opportunities for corruption. Foreign investors are often seen as competitors to local firms and their government "sponsors".

2.1 UKRAINE AND FDI

Foreign direct investment in Ukraine has exhibited dynamic growth in the past four years. From 2005 until the first quarter of 2007, foreign direct investment (FDI) into Ukraine constituted USD14.4 billion. As a result, major international corporations have entered the Ukrainian market. Most such players operate under the U.S. Foreign Corrupt Practices Act[33] or similar standards. Their entry into the Ukrainian market has increased levels of transparency and corporate best practices.

[33] The Foreign Corrupt Practices Act of 1977 (FCPA) is a United States federal law known primarily for two of its main provisions, one that addresses accounting transparency requirements under the Securities Exchange Act of 1934 and another concerning bribery of foreign officials. www.usdoj.gov/criminal/fraud/fcpa

In 2007 foreign investors put USD8 billion and 710,6 million of direct investments into the economy of Ukraine. From CIS countries – USD632,9 million or 7,3% to the general volume, from other world countries – USD8 billion and 77,7 million or 92,7%. In next 2008 foreign investors invested 10 billion and 991,1 million dollars of foreign direct investments in the economy of Ukraine, which is by 25,3% more than in 2007, according to the State Statistics Committee (Goskomstat).[34]

EU countries invested 8 billion and 766,4 million dollars or 80,3% of the whole volume, CIS countries – 932,9 million dollars or 8,6%, other countries – 1 billion and 211,8 million dollars or 11,1%. In 2008 non-residents took their capital to the sum of 847,8 million dollars. The total volume of foreign direct investments in Ukraine as of January 1, 2009 amounted 35 billion and 723,4 million dollars, which is by 20,9% more than the volume of investments as of the beginning of 2008. Calculating for one person the volume of foreign direct investments is 775,3 dollars. Investments came from 124 countries of the world. Among the ten main countries-investors, which have more than 81% of the whole volume of foreign direct investments, there are: Cyprus – 7 billion and 682,9 million dollars, Germany – 6 billion and 393,8 million dollars, the Netherlands – 3 billion and 180,8 million dollars, Austria – 2 billion and 445,6 million dollars, the United Kingdom – 2 billion and 273,5 million dollars, Russian Federation – 1 billion and 851,6 million dollars, the USA – 1 billion and 471,5 million dollars, the British Virgin Islands – 1 billion and 316,1 million dollars, Sweden – 1 billion and 263 million dollars, France – 1 billion and 226,1 million dollars. It is worth to mention that from 1997 the six main investors in Ukrainian market remain the same. The only obvious change that we can observe on the Table 1 is the volumes of FDI per each investor. In 1997 Cyprus was in the last position among the main investors by volume of FDI flows to Ukraine[35], where after eleven years have become the leader. On the other side, United States from the first place in 1997 fell to the last place in 2008. Germany has significantly increased its investing activity in Ukraine. Russian Federation, United Kingdom and Netherlands remained almost stable towards the amount of FDI directed to Ukraine.

Table 1. Foreign Direct Investments by Countries of Origin for 1997 and 2008

[34] www.ukrstat.gov.ua

[35] Dyker David A., "Foreign Direct Investment and Technology Transfer in the former Soviet Union", Published by Edward Elgar Publishing Limited, Northampton, 1999, pp. 164-165

Countries	1997		2008	
	Mln, USD	% of total	Mln, USD	% of total
USA	118.2	19.2	1471.5	5.2
Netherlands	94.4	15.3	3180.8	11.3
Germany	18.3	3.0	6393.8	22.7
Russian Federation	44.3	7.2	1851.6	6.6
United Kingdom	49.6	8.1	2273.5	8.1
Cyprus	39.5	6.4	7682.9	27.2

Source: Ministry of Statistics of Ukraine

The sum of credits and loans received by the Ukrainian enterprises from direct investors as of January 1, 2009 amounted 5 billion and 234 million dollars. At the same time, according to the UN Commission on Trade and Development[36], FDI in the world in 2008 decreased by 21% comparably with the same period of the previous year – to 1,45 trillion dollars. By estimations of the UNCTAD foreign direct investments obtained by the developed countries in 2008, fell by 33%, when in the developing countries FDI grew by 3,6%. It is worth to note that in September 2008 the volume of FDI in Ukrainian economy decreased by 32,91% comparably with the same period of 2007. Besides, in September 2008 there was a sharp flight of short-term capital – 1,719 billion dollars, comparably with 796 million dollars in August 2008 and 395 million dollars in July.

Sizeable volumes of direct investments from EU countries are concentrated in industrial enterprises making 23,8 percent. Among the sectors of processing industry the essential volumes of investments are put into metallurgical production and production of finished metal fabrics, production of food products, drinks and tobacco goods.

Enterprises of financial sphere account for 19,6% and organizations which carry out operations with real estate property, lease, engineering and services for entrepreneurs 9,3% respectively, are also attractive for investments.

[36] www.unctad.org

In the 1st quarter of 2009 foreign investors invested USD1 billion 175,5 million of direct investments in the economy of Ukraine, that makes 36,2 % of volumes in the 1st quarter of the previous year. According to the Goskomstat's data, from the EU countries – USD684,1 million or 58,2 % of total amount, from the CIS countries - USD297,4 million or 25,3 %, from other countries of the world - USD194,0 million or 16,5 %. In turn, non-residents withdrew the capital for the sum USD70,1 million. As a whole a gain of a total volume of the foreign capital in the national economy, taking into account its revaluation, losses and a course difference, has made USD819,5 million or 24,4 % of level of the corresponding period of the previous year.

In the 1st quarter of 2009 volumes of the capital from the Russian Federation have grown by USD285,9 million, the Netherlands by USD196,2 million, Cyprus by USD158,9 million and Switzerland by USD61,9 million. The mentioned countries have provided almost 86 % of a gain of the foreign capital in Ukraine. The gain of the foreign capital was observed at the enterprises which are carrying out financial activity, by USD284,4 million, operations with real estate, rent, engineering and granting of services to businessmen by USD236,0 million, trade, car repairs, household products, products of personal use by USD56,4 million and also at the industry enterprises by USD78,3 million. The total amount of direct foreign investments in Ukraine, for 1st April of 2009 has made USD36526,6 million that is by 2,3 % more than volumes of investments for the beginning of 2009 and counting on one person makes USD792,7. Investments have come from 125 countries of the world. Among ten basic countries-investors which make over 81 % of total amount of direct investments, there are: Cyprus - USD7890,2 million, Germany - USD6441,2 million, the Netherlands - USD3378,6 million, Austria - USD2448,6 million, the United Kingdom - USD2248,6 million, the Russian Federation - USD2135,5 million, the USA - USD1400,3 million, the Virgin Islands - USD1348,0 million, Sweden - USD1259,9 million and France - USD1221,8 million.

In the 1st quarter of 2009 from Ukraine in the economies of other countries of the world USD8,8 million of direct investments were directed. Investments were carried out mainly in the form of monetary payments. The volume of direct investments from Ukraine in the economies of the countries of the world, taking into account its revaluation, losses, a course difference, for the 1st April of 2009 has made USD6225,0 million, including in the EU countries - USD5940,8 million or 95,4 % of total amount, in the CIS countries - USD224,2 million or 3,6 %, in other countries of the world -

USD60,0 million or 1,0 %. Direct investments from Ukraine were carried out in 51 countries of the world. Their big part is directed to Cyprus. The sum of credits and the loans given by the Ukrainian residents to the enterprises of direct investment, for the 1st April of 2009 made USD123,3 million. The total amount of direct investments in the economies of other countries of the world, considering the extra capital, made USD6348,3 million.

2.3 OBSTACLES FOR FDI

According to the Ukraine Competitiveness Report[37] 2009, Ukraine is weak in institutional environment (115th place), infrastructure (79th place), macroeconomic stability (91st place) and goods market efficiency (103rd place). A survey carried out by the Ukrainian Center for Foreign Investment Promotion[38] has identified the following main difficulties impeding additional foreign investments:

- Instability and excessiveness of government regulations;
- Ambiguity of the legal system;
- Uncertainty in the economic environment;
- Corruption;
- High tax burden;
- Problems in establishing clear ownership conditions;
- Depressed disposable income level;
- Difficulty negotiating with government authorities;
- Lack of physical infrastructure;
- Volatility of the political environment.

These factors have led to government intervention and to conflicts with the private sector. The absence of a system for investment insurance, as well as the monopolization of the economy and restrictions for land transactions, also affects the level of foreign investment. A study conducted by the International Private Capital Task Force (IPCTF)[39] developed a range of recommendations for attracting foreign capital to

[37] The Ukraine Competitiveness Report 2009 is published by the Foundation for Effective Governance in partnership with the World Economic Forum. www.feg.org.ua

[38] Founded with the support of the Government of Ukraine in August 2005, InvestUkraine is an independent non-profit investment agency of Ukraine with an aim of promotion and development of investments in Ukraine. www.investukraine.org

[39] The International Private Capital Task Force (IPCTF) was created in early 2000 by an agreement between the Ukrainian Government and SigmaBleyzer (the Bleyzer Foundation is an international non-

Ukraine, including the creation of a favourable investment climate, improvement of Ukraine's image in world financial markets and development of a system that could attract foreign entrepreneurs and renew foreign investors' confidence in Ukraine. The Task Force specified the following key "policy actions" that affect the business climate in Ukraine and generate foreign investments:

- Liberalization and deregulation of business activities;
- Stability and predictability of the legal environment;
- Corporate and public governance;
- Liberalization of foreign trade and international capital movements;
- Financial sector development;
- Corruption level;
- Political risk;
- Country promotion and image;
- Targeted investment incentives.

Furthermore, the much-needed reduction of VAT from 20 per cent as well as its proper implementation regarding refunds to exporters is still a hot issue among parliamentarians and a primary issue preventing additional FDI into Ukraine. Corruption, petty[40] and grand[41], remains the single greatest barrier to expanding trade and investment in Ukraine. Foreign businesses complain most strongly about Ukrainian regulatory and legal barriers designed to elicit bribes. As in most countries afflicted by corruption, Ukrainian government employees, in hopes of eliciting bribes, deliberately design licensing and registration procedures to be so complex that they may credibly threaten to end or slow trade or a foreign investment. As a consequence, the time and expense of obtaining the required permits and licenses to trade or to set up and open a business add substantially to costs, reducing both trade and investment. Favoured privatizations also impede foreign investment. Ukraine's contradictory laws and corrupt

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government organization supporting the successful development of transition economies into healthy, democratic market economies. The Foundation provides informational and consultative assistance to developing countries in creating favourable market conditions, improving the investment climate, and ensuring sustainable economic growth. The Foundation helps these countries to complete the transition process and become successful, prosperous nations fully integrated into the global economic community, www.bleyzerfoubdation.org). The IPCTF Steering Committee included representatives from many international agencies and businesses operating in Ukraine.

[40] Petty corruption involves lower-level officials who make decisions about enforcing (or not enforcing) regulations.

[41] Grand corruption involves high-level officials with discretionary authority over government policy, the sale of government assets or large government contracts.

judges make it difficult for businesses to enforce contracts, which also discourage investment.[42]

As an example, the Swedish furniture giant has been trying to enter the Ukrainian market for several years. At the start of its Ukraine operations, the company clearly announced that it would not pay a single bribe. To date, IKEA has not been able to obtain the land it needs for constructing a retail store on the outskirts of Kyiv, nor has it built any retail stores elsewhere in Ukraine. While Kyiv government officials have cited environmental concerns in denying IKEA access to land, business analysts in Ukraine have noted that IKEA's difficulties may very well be linked to its stated non-corruption policy. While many foreign companies bring with them better practices, lawyers who advise foreign direct investors note that non-Ukrainian companies sometimes can be part of the problem. In an environment in which market access must be developed in a highly corrupt environment and alongside a shadow economy that in 2006 represented an estimated share of 27 percent of total GDP, foreign investors indirectly contribute to corrupt activities by hiring third-party consulting services to help open doors and facilitate market access. Experts interviewed by the Task Force believed that some of these intermediaries use part of their fees to provide "incentives" in the form of money or other material benefits to government officials.

On balance, however, domestic and international anti-corruption monitors agree that the arrival of foreign investors and international corporations, in particular companies from mature market economies, has had a positive impact on reducing corruption in Ukraine. Such large multinational corporations have a broad planning horizon, global opportunities for profit, high revenues and an imperative to preserve a reputation of corporate integrity. As a result, they and their personnel are less likely to engage in corrupt practices or to establish corrupt connections with Ukrainian authorities.

2.4 WHY TO INVEST IN UKRAINE

At present, Eastern Europe countries are one of the most attractive direct and portfolio investment destinations with exciting opportunities for business development and expansion. Among these countries Ukraine for sure is one of the leaders due to a number of reasons:

[42] Keith Crane, F. Stephen Larrabee, "Encouraging Trade and Foreign Direct Investment in Ukraine", National Security Research Division (RAND Corporation is a non-profit research organization providing objective analysis and effective solutions that address the challenges facing the public and private sectors around the world), 2007, www.rand.org

- Ukrainian soil is the richest in the world providing great opportunities for agricultural business;
- Ukraine has very fair and agro-friendly climate (no tornado, tsunami, deserts, dangerous insects, natural disasters);
- Ukrainian workers are skilled and lower-paid comparing to highly developed countries;
- Ukrainian market is huge – around 50 million consumers;
- Ukraine has extensive well-developed infrastructure (transportation, communication, hotels, etc);
- Ukraine is a net exporter of electricity, consequently entrepreneur may save a lot on electricity though;
- Ukraine enjoys great discount on gas from Russia (gas price in Ukraine is much lower than in the EU);
- Ukraine enjoys very favourable location (between Europe and Asia, North and South Europe) and geographical proximity to the EU market;
- Ukrainian income and corporate taxes are the lowest in Europe;
- Ukrainian environmental protection laws are very liberal comparing to highly developed countries;
- Ukrainian economy is steadily growing by high rates from year-to-year;
- From 2008 Ukraine is a member of World Trade Organization (WTO).

When President Yushchenko took office in January 2005, he made improving the investment climate one of his top economic policy goals. This led to a number of new government initiatives, such as creation of a State agency for investment and innovation and a number of investor councils chaired by the President. Over the past few years, Ukraine has liberalized its markets, reduced regulation, eliminated most licensing requirements, eliminated most restrictions on foreign exchange and begun the transformation of the agricultural sector from state-run farms to private agriculture. After years of hyperinflation and declining currency values, the national currency has been stable against the U.S. dollar for over four years.

As part of its mandate, the Ukrainian government has committed itself to increasing the level of foreign investment in Ukraine. The new administration has shown the political will and determination to implement radical policy changes to combat both corruption and poverty in Ukraine. However, the Government's recent decision to abruptly cancel

Special Economic Zones[43] has left investment in Ukraine in an unusual state of uncertainty.[44] There are 13 special economic zones (SEZs) as shown in the Table 2 and nine priority development territories (PDTs) in operation, offering tax and import duty exemptions and other benefits to encourage investment and production of goods for export, and covering around 10 per cent of Ukrainian territory. They differ by tax concessions granted to business entities that choose to operate in the zones. SEZs generally mandate privileges for 10 to 30 years, depending on the investment. On the one hand, the suddenness of this SEZs end decision is justified in terms of the government's desire to finance a deficit Budget, to combat the widespread corrupt schemes associated with earlier investments specifically in these zones and to establish a level playing field for all investors. On the other, the decision to cancel SEZs without providing for any compensatory mechanisms for those investors who were fairly doing their business has disregarded commitments made by the state and this can only weaken trust, confidence and loyalty among current investors. Moreover, some of these are hi-tech companies that have already invested or have plans to invest in Ukraine. Ukraine should not reject the option of special investment regimes. International experience shows that industrial parks, a widespread form of SEZ, can be very successful in attracting foreign investment to hi-tech, in particular, in the manufacture of electronics. Successful policy can lead to the creation of hi-tech clusters in Ukraine, the expansion of the country's export potential and an end to the brain-drain.

Table 2. Special Economic Zones (SEZs) in Ukraine

Name	**Location**	**Area**	**Established**	**Time limit**
NCEEZ Syvash	Autonomous Republic of Crimea		1996	5 years
Slavutych	Slavutych is a city in northern Ukraine.	2,000 ha	30.06.1998	till 01.01.2020
Azov	Mariupol	315 ha	21.07.1998	60 years

[43] A Special Economic Zone (SEZ) is a geographical region that has economic laws that are more liberal than a country's typical economic laws.
[44] Investment in Ukraine 2007, KPMG report, p. 29 (KPMG is one of the leading professional services organizations in Ukraine. It has had a representation in Ukraine since 1992 and a wholly owned Ukrainian legal entity since 1997). www.kpmg.ua

Donetsk	Donetsk	466 ha	21.07.1998	60 years
Zakarpattia	Uzhhorodskyi Region	737 ha	09.01.1999	30 years
Yavoriv	Yavorivskyi Raion, Lviv Region	116,000 ha	17.02.1999	till 01.01.2020
Interport Kovel	Kovel is a city located in the Volyn Reegion.	57 ha	01.01.2000	20 years
Truskavets	Truskavets is a city in western Ukraine's Lviv Region.	774 ha	01.01.2000	20 years
Mykolaiv	Mykolaiv	865 ha	01.01.2000	30 years
Port Krym	Kerch	27 ha	01.01.2000	30 years
Porto-Franco	Odessa	32 ha	01.01.2000	25 years
Reni	Reni is a small town in the Odessa Region.	94 ha	17.05.2000	30 years

Source: Ministry of Economy of Ukraine

A recent study compiled by the Kyiv-based think tank, the Institute of Reform, rated Ukraine's regions in terms of their investment appeal. It assigned scores in the areas of economic development, market and financial infrastructure, human resources development and the cooperation of business and local authorities. Kyiv topped the ranking in 2003 for the third consecutive year.

The city has drawn USD1.3 billion in foreign capital since independence, one-third of the USD3.9 billion in foreign capital that Ukraine has attracted in the past decade.[45] Kyiv is followed on the list by Ukraine's industrial regions. Dnipropetrovsk region took second place, despite the relatively poor development of its small businesses and the country's highest crime rate. Ukraine's most heavily industrialized and densely populated area, Donetsk region, was placed third in the overall ranking, followed by Kharkiv and Zaporizhya regions. Its high level of entrepreneurial activity and business-friendly authorities pulled Lviv region into the sixth spot on the list. Odessa region and

[45] Vladimir Piddubniy, "The Framework for Foreign Direct Investments in Ukraine", Investment Company ITT, Marat Terterov, "Doing Business with Ukraine: A Guide to Investment Opportunities and Business Practice", Third Edition, Published in Association with American Chamber of Commerce in Ukraine, 2005

Crimea were ranked seventh and eighth respectively. The survey suggested that reducing the number of bureaucrats may be key to improving regions' investment climate. Ukraine's two regions with the lowest investment appeal in the ranking, Kirovohrad and Zhytomyr regions had the highest ratio of government officials per 1,000 residents. Institute of Reform data shows that the city of Kyiv and six of Ukraine's 25 regions have accounted for 75 per cent of all the foreign investment brought to the country over the past 10 years.

2.5 CASE STUDY: MCDONALD'S

McDonald's is the world's largest global foodservice retailer with more than 24,800 restaurants, serving almost 40 million people each day in 115 countries. Worldwide, McDonald's Corporation reported record-high revenues of USD21.6 billion in 2006. McDonald's opening in Ukraine describes as the company's ongoing commitment to growth and infrastructure development in its Central European region.

"Our expansion in this region is an outstanding example of McDonald's continued growth potential in emerging markets around the world," stated Jim Skinner, president of the Europe Group, McDonald's International.

Since April of 1988, when McDonald's opened its first Central European restaurant, the company introduced its foodservices in 18 countries throughout the region and currently serves nearly one million customers per day in more than 500 restaurants.[46] In Ukraine the company has already opened 57 restaurants and planning to open more than ten in the next six to seven years. Company came into Ukraine as long term investor, thus it does not count on profits in the nearest seven to ten years, being committed to the development of a strong position in the Ukrainian fast-food market. Attracted by Ukrainian market potential, McDonald's intends to benefit from local creative assets exploitation as well. In the same time low cost inputs and skill quality of production labour are among insignificant factors for its investment decision.

McDonald's came into Ukrainian market seeking opportunities and was ready to difficulties, which did not make themselves waiting. The major was economic instability and ambiguity of legal system with high level of bureaucracy, difficulties in product certification and negotiation with privatization authorities. However, the similar kind of problem faces the 57 domestic companies as well, so company treats them as inevitable part of Ukrainian environment. Consequently, McDonald's is committed to enlarge its position in Ukrainian market despite the problems company currently

[46] Ukrainian Center for Foreign Investment Promotion, www.investukraine.org

suffers. McDonald's Ukraine Director Ihor Delov announced during a May 2007 press conference to mark the company's 10th anniversary that the fast-food giant would nearly double the number of its restaurants over the next several years, setting the goal of 100 restaurants. McDonald's currently boasts 57 restaurants in 16 Ukrainian cities. New restaurant opened in Kryvy Rih and the company plans to open new McDonald's in Odessa, Kyiv and Kharkiv in 2008, and about five new restaurants next year. Of McDonald's 57 current restaurants, 47 were opened in the first five years, with the rest entering the Ukrainian market thereafter. As a result, since launching operations in Ukraine, McDonald's has reported investment totaling 93 million dollars.

In 2002-2004, McDonald's corporation started a new strategy, the main tendency of which was not to open a big amount of new restaurants, but to increase the efficiency of existing restaurants. McDonald's Ukraine was a part of this global strategy. That is why McDonald's Ukraine did not open a lot of new restaurants in this period of time. However, now the fast-food giant is developing very rapidly. Its appetite for Ukraine's emerging economy and the country's high rate growth in disposable household incomes is growing. Furthermore, McDonald's Ukraine has good economic results.

According to the company, the opening of a single restaurant costs from 1 million to 1.5 million dollars. In most of the more than 100 countries in which McDonald's operates, around 70 percent, the restaurants are owned by a franchise. But McDonald's in Ukraine does not work with a franchise. The company explains that the Ukrainian legislation does not have enough means of control for the franchise's standards. But Ukraine is not the only country where McDonald's doesn't work with a franchise. The multinational, which boasts 31,000 outlets in more than 100 countries, unfortunately, refuses to release information on specific markets.

Ukraine, where 5,000 McDonald's workers are employed, was the 102nd country to host the fast-food giant. Since 1997, when McDonald's opened its first restaurant in Ukraine, other domestic fast-food chains have followed, such as Dva Husya, Mak Smak and foreign-owned Mister Snak. In Ukraine McDonald's enjoys 11 percent of visitors to fast-food eating establishments in Ukraine's biggest cities. The fast-food market in Ukraine is growing in double digits and the main reasons keeping out other international fast-food giants is Ukraine's high rental costs and franchising problems. One such likely international competitor for McDonald's in Ukraine is Yum! Yum is the world's largest restaurant company in terms of system units, with approximately 34,000 restaurants. Based in Louisville, Kentucky, Yum brands include Kentucky Fried Chicken, Pizza Hut

and Taco Bell. Today, the company is strongly developing in Central and Eastern Europe, specifically in Russia, Poland, the Czech Republic, Romania and Hungary. Of Yum's 34,000 restaurants, 2,500 are located in Europe. However, according to LeCureuil, Yum has no immediate plans to set up shop in Ukraine.[47]

"When opening in new countries, we seek to partner with franchisees that have the expertise, culture and financial means to develop scale. We have not yet found this partner in Ukraine," explained Chrisophe LeCureuil, the Yum's spokesman.

Working with franchises puts expenses like rental costs on the local operator. Yum has a presence in 120 countries with both wholly-owned and franchised restaurants and that 75 percent of its restaurants are franchised. Last year, Yum's international division generated over USD400 million in operating profits. Nevertheless, in a Ukrainian fast-food market franchises are still getting on their feet.

[47] Ukrainian Center for Foreign Investment Promotion, www.investukraine.org

CONCLUSIONS

Foreign Direct Investment in emerging economies has increased dramatically since the 1980s. Many countries, including developing and transition economies have changed their attitude towards foreign direct investment over the past decade. Countries have liberalized their policies to attract rather than repel investment from multinational enterprises (MNEs) and they actually compete against one another by offering generous incentive packages. Furthermore, many developing countries have offered special tax incentives and subsidies to attract foreign capital, as it is strongly believed that FDI and portfolio inflows encourage technology transfers that accelerate overall economic growth. While there has been a growing acknowledgement of the role that direct investment can play in stimulating economic growth and development, there remains a tremendous diversity in approaches of countries in their policies towards FDI, as well as a kind of scepticism in certain spheres as to the inevitability or universality of the benefits from FDI. As a result, many countries screen incoming investment and retain extensive controls on foreign participation in particular sectors. Performance requirements on investment are sometimes still considered necessary or desirable to ensure that the activities of foreign multinationals are coincident with host country development strategies. While, microeconomic studies generally have showed pessimistic evidence on the growth effects of foreign capital, many macroeconomic studies find a positive link between FDI and growth. Recent studies of developing countries have suggested that the effectiveness of foreign direct investment as incentive to economic growth depends on the availability of "human capital" or skilled labour in a host country. In other words, it is primarily the close connection between FDI and human capital, rather than FDI itself that acts as a strong stimulant to growth. Since many transition economies such as Ukraine have abundant human capital, this implies that policies that encourage FDI may be very beneficial in facilitating economic restructuring and stimulating growth. Some recent empirical surveys suggest a positive connection between FDI and growth. Moreover the impact of FDI on growth is larger in those countries that present higher rates of per capita income.

Nevertheless, as emerging economies integrate into the global economies, international trade and investment will continue to accelerate. TNCs will continue to act

as crucial interface between domestic and international markets and their relative importance may even increase further. Governments should conduct accurate policies so as to attract reasonable projects benefiting from foreign investments and minimizing the negative effects, which could be devastating to the economy during economic recession. Current crisis made its worst impact (ex. capital outflow) on the economy of Ukraine that is considerably dependent on foreign investments.

Ukraine has made a significant progress since the independence. It has established a functioning democracy with competitive elections, opened economy, a free media. It has implemented various liberalization programs and since 2004 Ukraine has made clear its aspiration towards European Union membership.

No doubt, with a great investment potential of a vast emerging market of around fifty million consumers making it the greatest market in Eastern Europe, highly competitive, well-educated, skilled workforce and strategic location at the crossroads of East-West and North-South trade routes, rapid economic growth and European integration makes Ukraine very attractive destination for potential investments.

However, despite the fact that Ukraine's economy has undergone various developments, there is still work to be done. Certain issues such as a poor banking system, uncertainty of the economic environment, ambiguity of the legal system, political instability, difficulty of negotiating with authorities, high restructuring costs and problems in finding a suitable partner, changing tax and regulations have caused barriers to investment. Another problem is a privatization that lacks transparency in Ukraine, consequently preventing foreign participation. Furthermore, procedures to obtain permits for business in Ukraine are complicated and confusing, taking up much time and money. Corruption is one of the major obstacles that negatively affect competition, economic efficiency, effective policymaking and foreign economic investment, as well as the democracy and sovereignty in whole.

In coming years, the successful transition to a market economy in Ukraine will depend to a great extent on the development of an adequate legal infrastructure to support an attractive and enabling investment environment. Combating corruption must be a priority action for Ukraine's long term economic and political prosperity. Efforts in improvement of investment climate should be supported by stable macroeconomic policies and fiscal stability. Government has to ensure security of property rights, continue liberalization of trade and financial markets. Changes in regulatory and tax policies should be predictable and constrained in terms of time. Ukrainian government

should reduce the level of state interference in the economy and strengthen anti-trust institutions. It is very important that international financial institutions and other multilateral aid organizations have focused on the adoption of macro-economic structural reform measures consisting of the elimination of exchange controls, price liberalization, restrictive fiscal and credit policies and privatization to facilitate the transition from command economies to market systems in the post-communist societies of Central and Eastern Europe. The new Government should take immediate advantage of the international business community's heightened interest in investing in Ukraine. Any serious delays in defining a new investment policy approach and making the necessary decisions could cause Ukraine to close the window of opportunity opened by the Orange Revolution.

Regardless of many obstacles and problems that are part of Ukrainian economy, if a potential investor has decided to reduce significantly its business costs and become more competitive towards competitors then, without a doubt, Ukraine is a good choice. However, when just starting up a business or planning to run any investment project in Ukraine, any company needs a homegrown partner, who possesses an excellent professional qualification as well as local knowledge and connections.

Despite the fact that Ukraine's investment climate is still maturing, foreign companies are successfully doing business in Ukraine. The more successful amongst them have adopted their business strategy to a changeable economic environment and have become familiar with having to forecast business and other risks which arise from time to time whilst engaged in the practice of business in the country.

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