Foreign Direct Investment and the modernisation of Ukraine's economy

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The economic history of Ukraine since the break-up of the Soviet Union has been characterised by missed opportunities for reform and economic stagnation. It is only since the financial crisis of 1998 that economic management has improved and recovery began.

Table 1: Real Economic Growth in Ukraine 1990-1999: % year on year

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
UKR	-4.0	-8.7	-9.9	-14.2	-22.9	-12.2	-10.0	-3.0	-1.9	-0.2
PL		-7.0	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.1

Source: State Statistics Committee of Ukraine and EUROSTAT

According to official estimates the economy at the time of the crisis was only 40% of its size in 1990.[1]

This measure is undoubtedly an over-estimate of the real loss of output. The base level data produced in the lifetime of the Soviet Union overestimated the output of the economy compared to a calculation at market prices. And GDP is not the most sophisticated measure of welfare. Nevertheless it is clear that economic policy over this period did not produce the same recovery as was observed in neighbouring Poland, where output began to rise in the second half of 1992.

Ukraine suffered the additional problem of separation from the Soviet Union, of which, unlike Poland, it had been an integral part. It was saddled with a large armaments industry, with a stock of nuclear warheads and many other remnants of the Soviet empire.

However Ukrainian reforms in the 1990s were never thorough, producing a situation which favoured the establishment of financially integrated groups (FIGs) based on the old state industries and effectively eliminating competition. With little competition and with comfortable relations with the Government, these FIGs had no incentive to innovate or even to invest in new technologies. Their relations with Government also allowed them to ensure that the business environment in Ukraine remained opaque and geared to the elimination of competition. Hence, whereas in Poland, and even more so in Hungary, foreign investors entered the economy, in Ukraine foreign direct investment (FDI) remained extremely sparse throughout the decade.

The result of the lost 1990s for the average citizen was a standard of living which deteriorated considerably and which ended in the financial crisis of 1998. Real GDP per capita in 1999 had fallen to only 52% of that in 1992 (SSC).

[1] State Statistics Committee of Ukraine

The Ukrainian economy subsequently recovered strongly. Between 2000 and 2004 the average annual real growth rate of GDP was 9%; in 2004 it reached 12.1%. This was partly a result of the macro-economic stabilisation policy put in place after the crisis. The hyrvnya was strongly devalued and anchored to the dollar. The government deficit which had been almost 7% of GDP in 1997 was brought down to reach a small surplus in 2000. Financial constraints in the economy were made to bite. Pension and budgetary arrears were successfully tackled and inflation, which had been chronic up to the currency crisis, was brought down quickly into single figures.

Table 2: Real Economic Growth in Ukraine 2000-2005: % year on year

	2000	2001	2002	2003	2004	2005
Ukraine	5.9	9.2	5.2	9.6	12.1	2.6*
Poland	4.2	1.1	1.4	3.8	5.3	3.2*

Source: State Statistics Committee of Ukraine and EUROSTAT
* provisional

The recovery was also due to the strength of foreign demand for the products of Ukraine's metallurgy industries. Export prices rose and demand remained strong up to the end of 2004, notably from China. Energy exports also expanded.

However at the same time that macro-economic management was improved, measures were also taken to make the domestic business environment more attractive. Taxation was simplified for small businesses and the complexity of the regulatory framework was reduced by the elimination of a substantial number of laws which had had the effect of discouraging entrepreneurship. Competitive pressures inside Ukraine also increased considerably as a result of Government policy.

The extremely high growth rates registered in the period 2000-2004 could not be sustained, partly because they were due to positive factors which gradually faded as growth stimulants (strong demand and high export prices for metals and a strongly undervalued exchange rate for instance). Nevertheless the performance in 2005 was poor and growth is only now beginning to recover.

The sudden decline in growth coincided with the triumph of the Orange Revolution. The two events were linked but only very partially. The main determinants of lower growth in 2005 (apart from the statistical problem of a high base level in 2004) were the sharp declines in exports and investment (consumption remained buoyant thanks to government social expenditure). Exports were affected by falling demand and prices for metals on world markets (subsequently reversed), while investment was affected both by failing growth and by government policy.

The Orange forces, which were appointed by President Yushchenko to form a new government, pursued economic policies which were confusing. Disputes between the Prime Minister's Office and that of the President led to different policies being

announced on important issues affecting investment. The most widely reported of these issues was that of the number of firms to be re-privatised following the corrupt insider-privatisations which had characterised the Kuchma era. It was reported (though never substantiated) that the Prime Minister wanted to reopen 3000 such deals while the President intended to tackle only a few major deals. This created uncertainty of ownership across the economy and particularly in the privatisation process, one significant factor in the under-performance of investment. At the same time policy was made without sufficient consultation of interested parties. This was the case in the abolition of the privileges offered in special economic zones, a decision implemented with no transitional measures to ease in the change.[2]

These disputes culminated in the dismissal of the Government by the President in September 2005. The combination of the handover of substantial Presidential powers to the Parliament, the long and tough election campaign for the March 2006 legislative elections, followed by extremely complex coalition negotiations and the European Union's completely mixed messages on Ukraine's future integration with the Union have also not helped to create a propitious atmosphere for investment, both domestic and foreign.

Nevertheless the achievements of the Orange Revolution, even during the difficult year 2005, hold much promise for economic development in Ukraine in the coming years.

The Presidential election in December 2004 ushered in a more open society and economy. This may sound optimistic in the light of the extremely obscure and bizarre negotiations on energy prices with Russia. However a good indication is that Ukraine held its first election free of major corruption and vote-rigging in March 2006. Another is that the media is now free, although media ownership is still a rather opaque matter. Ukraine also now has a far more critical public, prepared to get involved in important matters of state policy. These are all signs that democracy has become entrenched in Ukraine in a way which is favourable for the country's integration into international economic institutions. This creates confidence amongst investors too.

Concrete achievements were also made in 2005 in policy directly affecting the economy.

One of the most crucial achievements was to make a start in rolling back the insider economy. The modernisation of Ukraine's economy has been held back by isolation from external competition and by the power of the 'insider economy'. The insider economy is especially well developed in Ukraine, where large financial industrial groups (FIGs) dominate industrial output. These groups maintain strong connections with Government and other state institutions, allowing them to circumvent the normal operating rules of the market economy.

The existence of these negative factors has led foreign investors to shy away from investing in Ukraine. The new government began to tackle the problems of the

[2] World Bank, The debate on elimination of free enterprise zones in Ukraine, December 2005

insider economy and corruption in 2005 immediately after the Presidential elections. It has done its best to reduce the scale of the insider economy over recent months, with some success. The World Bank reports that there has been a marked decrease in insider deals concerned with privatisation of state-owned firms and state contracts. The greatest success in this field was the privatisation at the end of 2005 of Kryvorizhstal, the largest steel plant in Ukraine for $4.8bn to Mittal Steel. This had previously been sold by the Government for only $800 million.

Another hopeful sign is that some of the FIGs are now beginning the transition to open, law abiding companies, with an international status. As these companies begin to invest abroad, they will be compelled to abide by international standards of corporate governance.

Steps were also taken in 2005 to clear up smuggling and corruption in customs clearance. This campaign showed some success and led to a rise in customs receipts for the Government. The budget agreed in March 2005 also eliminated many tax privileges and exemptions. Together with improvements in tax collection, this led to a rise in tax revenues and helped to keep the Government deficit in reasonable limits. Government debt is at an extremely low level.

Investment should benefit too from the measures taken in the direction of the liberalisation of currency movements, particularly the abolition of the compulsory 50% sale of export revenues to the National Bank.

Finally on the international level, although WTO accession was not achieved, progress towards it was made, so that accession in 2007 is likely. Strenuous attempts were also made to realise the aims of the President's 'European Choice' but here the Government came up against the unwillingness of the Union to consider, under any circumstances, the accession of Ukraine to the Union.

Accelerating Ukraine's integration into the international economic community must be one of the new Governing Coalition's tasks if it is to succeed in raising the standard of living of Ukraine's population. Together with the improvement of the business environment, including further reductions in the level of corruption, this will improve Ukraine's chances of attracting much-needed FDI.

FDI and the modernisation of Ukraine's economy

The literature on the relationship between economic growth and FDI in transitional economies is vast and controversial. The majority of studies suggest that FDI was an important factor in GDP growth in central Europe in the 1990s, working through its impact on capital formation, the introduction of superior technology and the improvement of management skills and techniques. While FDI is affected by the quality of the business environment, once established it has a beneficial impact on that environment helping to make it more open and transparent.

The relationship between FDI and capital formation is not simple.[3] In the case of certain privatisations, it may lead to no increase at all or even a reduction.

This could be the case for instance where a firm was sold to a foreign investor, who rationalised the production process before selling the firm on, the original purchase price being absorbed into the Government account. Green-field investments on the other hand usually imply a significant increase in capital formation though the relationship may not be 1:1. Across the whole economy in the transition countries of central and eastern Europe however FDI has been an important source of additions to the capital stock.

The relationship of FDI to productivity has also been questioned. Generally the productivity of foreign investments (privatisation or green-field) is higher than that of the general economy in transition economies. This is the result of both better technology and improvements in management. Old state enterprises have frequently employed large numbers of workers at low levels of productivity, the rational result of a centrally planned system. This overcapacity is usually reduced rapidly at privatisation without a corresponding loss of output, especially when foreign buyers are involved. FDI contributed to the doubling of the level of productivity in Poland between 1990 and 1999.

However theory tells us that productivity also rises in local firms through knowledge spillovers from foreign-owned companies. This frequently occurs when foreign-owned companies require minimum quality standards from local suppliers at the same time as putting pressure on input prices through encouraging competition. Research suggests that such spillover effects from backward linkages do exist, though more strongly in FDI aimed at supplying the domestic market than for export-oriented FDI.[4]

Finally through competition FDI tends to raise productivity horizontally in domestic companies competing with the foreign company. This effect is somewhat difficult to disentangle from the other factors bearing on productivity growth.

Economic and institutional reforms encourage FDI. However it is also true that FDI tends to support reforms once it is established. Foreign owners and their local management staff will support initiatives to create transparent business conditions and to push forward other reforms, which underpin democracy and the market economy. In the early years of the transition, this is not always the case, when foreign investors have the power to demand that governments create protected markets for them (by raising tariffs for their products for instance). However once FDI reaches a substantial volume, quasi-monopolistic practices give way to competitive markets and foreign investors will tend to support economic and institutional reforms.

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[3] Libor Krkoska, Foreign direct investment financing of capital formation in central and eastern Europe, EBRD 2001.

[4] Beata Smarzynska, 2002, 'Does Foreign Direct Investment Increase the Productivity of Domestic Firms', World Bank Policy Research Working Paper 2923.

Finally a substantial level of foreign direct investment offsets the trade deficit as high investment draws in imports of capital goods. In transitional economies foreign direct investment may account for a large proportion of total foreign trade as foreign firms import inputs and export a part of their production. As local supplies of inputs rise, imports may begin to decline.

Factors determining FDI

Much has also been written about the factors which attract foreign companies to invest and circumstances which militate against FDI.[5]

Four main factors appear to explain a large part of the FDI which has taken place in the EU's new Member States:

- The size of the market
- The costs of production
- The business environment
- EU integration

The size of the market has been of considerable importance in these countries. Early investors after 1989 predicted a rise in the consumption propensity and invested to ensure that they could supply this growing demand. The majority of foreign investments were made to serve domestic markets rather than for export. The heavy investments of companies such as Metro, Tesco and Carrefour in retailing were obviously responses to potential local markets. This of course would suggest that large economies, such as Poland, benefited over-proportionally, simply because of the large domestic market. However with the liberalisation of trade, not simply bilaterally with the EU but between the countries of central Europe themselves (CEFTA), companies could serve the whole region from any country in the region. Nevertheless it is probably true that Poland, Hungary and the Czech Republic benefited in attracting foreign consumer goods and services companies because of the size of their domestic market.

Some research points to production costs being a relatively unimportant factor in FDI to the transitional economies in central Europe. However though not necessarily being the predominant explanatory variable, production costs are likely to have been an important component of most investment decisions. The establishment of the car industry in the Slovak Republic and in Poland certainly resulted partly from the cost savings which European car-makers could achieve by relocating production there. High profile 'delocalisation' cases in western Europe were also mainly explained by relative labour costs, even though the overall impact in the west has been at best marginal. Indeed the long-standing trading arrangement for EU producers to export textile materials for processing into finished goods and to re-import these goods in to the Union free of duty (outward processing) was established to allow EU producers to reduce overall wage costs.

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[5] Bevan, AA and Estrin, S. (2004) 'The determinants of foreign direct investment into European transition economies', Journal of Comparative Economics 32(4):

Wage costs can however change rapidly as a combination of wage cost increases (wages and non-wage costs) and exchange rate changes. The new member states have seen their costs rise as a combination of these factors. Wages will rise because of the rapid increases in productivity in the new member states and because of skill shortages. More traditional sectors, where productivity is rising less rapidly will be affected by the general upward wage trend and investors will begin to look elsewhere for production sites. Ukraine has already benefited in a small way from a further relocation of output from the new member states as costs here have risen.

Theory suggests that a real revaluation of exchange rates in the new member states should occur. This has already partially taken place and in the longer term will continue to do so. The competitive position of these countries has therefore been affected. Undervaluation of the hyrvnja in Ukraine is also beginning to be corrected and this will affect its position as a host to FDI.

The quality of the business environment is often quoted as a reason why Ukraine has not attracted FDI. There are obviously more or less favourable tax regimes, flexible and less flexible labour codes and more complex and less complex administrative procedures. All of these technical issues affect the choice of locational decisions by multi-national companies. However what is important above all is the predictability of the business environment. While in transition there is an operational necessity for decisions to be taken rapidly, they must be undertaken in the context of an economic policy strategy which has been well-thought-out and is understood by the international business community.

A business environment polluted by corruption is lethal for both economic development and FDI. For foreign-owned business corruption severely reduces the stability and reliability of the business environment. There is no guarantee that the investment will not ultimately be stolen by government or other government-near business. Far less radical problems such as abusive inspections, discriminatory use of regulation, payments which amount to protection or worse, bribes to ensure that the business is not excluded from the market all consume resources, which make many investments simply not worth doing.

Essentially most foreign investors want to be given a sort of 'national' treatment, where they are treated in the same way as national companies in an environment which is as free as possible from corruption.

That a European country is engaged in a process of serious EU integration is important for foreign investors because it gives a certain guarantee that the business environment will become progressively more transparent and open. It also suggests that reforms which are carried out will be embedded and irreversible. But beyond this, deeper integration with the Union promises reductions in costs as the adoption of EU regulation leads to significant cost savings and progressively protection from the EU's trade defence mechanisms (although this is only achieved at a high level of integration of the EEA type).

The performance of Ukraine in attracting FDI

While the new member states of the Union have attracted large amounts of foreign direct investment, Ukraine has been unable to do so even though it has serious advantages even over its western neighbours (table 3).

Table 3: FDI in central and eastern Europe, 1989-2004
(EBRD 2005)

Country	Cumulative FDI inflows 1989-2004 US$mln	FDI inflows per capita 1989-2004 US$
Hungary	37,294	3,693
Poland	57,352	1,502
Russia	7,843	54
Ukraine	**7,924**	**168**

It is true that 2005 saw a massive jump in FDI in Ukraine, so that according to the Ukrainian Statistical Service investment in 2005 alone equalled the cumulative FDI from 1995 to 2004. This was however the result of two very large deals. The re-privatisation of the Kryvorizhstal steel works raised $4.8 billion when sold to the Mittal steel group. Raiffeisen also bought into the Ukrainian banking sector (Aval Bank) for over $1 billion. Without these two deals 2005 FDI was around 10% higher than in 2004.

However there has been a considerable acceleration of FDI in the first three quarters of 2006 (estimated at $4.5bn for the year) but it is too early to say that there has been a fundamental reassessment of Ukraine as a destination for FDI in the future. Much of this foreign interest appears to be in the banking sector.

Several factors seem to be involved in this development, some of which will continue to influence the situation in the coming years.

- The Orange Revolution and the fundamental changes which this brought to the political and economic culture of Ukraine certainly played a role, in spite of some of the less than optimal policy decisions taken afterwards. These changes were considered to reduce the risk of investing in Ukraine, increase predictability in political decisions and also to improve the longer-term economic outlook for the country.
- The first key foreign investments, such as Mittal or Raiffeisen, encourage competitors to consider investments in the country more seriously. In the early stages of FDI competition between foreign investors plays an important role.
- As costs rise in the new member states, some investors look for lower costs in Ukraine. This tends to be a sector specific effect and concerns businesses with relatively high labour input.

The source of the foreign investment which has been made in Ukraine is also telling. The largest investor at the end of 2005 was Germany but this was essentially because it was legally Mittal Deutschland which bought the Kryvorizhstal steel works. If we look at cumulative FDI at the end of 2004, the picture changes as shown in table 4.

Table 4: Sources of FDI in Ukraine at 1.1.2005

Country	FDI as of 1.1.2005 ($mln)	Percentage of total FDI
Total	8353.9	100
USA	1153.7	13.8
Cyprus	1035.6	12.4
UK	895.9	10.7
Germany	631.6	7.6
Netherlands	548.3	6.6
British Virgin Islands	543.8	6.5
Russia	457.5	5.5
Switzerland	411.3	4.9
Austria	345.6	4.1
Poland	192.3	2.3
Hungary	179.1	2.1
South Korea	172.4	2.1

Source: State Statistics Committee

The striking fact of this table is the weight of normally insignificant investors like Cyprus and the Virgin Islands. It is of course probable that it is Ukrainian and perhaps also Russian capital which is being invested. If both these states' shares of FDI are added to that of Russia, the latter accounted for just under 25% of Ukraine's FDI. Almost 40% came from the EU-25 and 14% from the USA. FDI coming from the 'West' is in general of more value to Ukraine than that from Ukrainian foreign capital or Russia as it is globally associated with more advanced technology and management techniques.

If the factors affecting FDI considered in the previous section are analysed, Ukraine has clear advantages in both the size of the market and relative labour costs.

Ukraine is a large and populous country.[6] The GDP per capita however is only around EUR 1400, less than 15% of its neighbour Hungary. Nevertheless there is clearly a domestic market which is likely to grow rapidly if Ukraine follows the pattern of development of the new member states. Already in the richer regions, the disposable income is well above the national average. This applies especially of course to the Kyiv region and that around the industrial centres in the east of the country.

In terms of labour costs too Ukraine has clear advantages. The average wage is around EUR 150/ month compared to EUR 700 /month in Poland, its western neighbour. In terms of unit labour costs the situation is less favourable owing to lower productivity. However productivity could be expected to rise rapidly in future years. Foreign investors can also expect far higher productivity either in new greenfield sites or as new management methods turn around privatised enterprises.

[6] Ukraine has an area two and a half times that of the UK with a population of 46 million (UK 60 million)

Against these advantages however there are major disadvantages in the business environment and it is here that the main barriers to FDI in Ukraine arise.

The business environment

The recently published SIGMA Governance Assessment Report analysed a wide spectrum of legal and administrative structures and procedures in Ukraine.[7] While praising the reforms undertaken in 2005-6, it nevertheless comes to fairly damning criticism of the political system and by inference of the political class:

'The understanding of the rule of law does not appear to reflect the fundamental notion that law is how society constrains authority – not the other way round'.

'An inadequate system of law opens the door to corruption and arbitrariness; it reduces the economic development potential of the country'.

Such a situation of course does not attract serious investors. It is especially negative for small and medium-sized companies which do not have the legal capacity to fight injustice.[8]

Corruption

Ukraine ranks poorly in world comparisons on corruption. This is demonstrated by the indices of the EBRD, in which Ukraine scores badly even in comparison to the average for the CIS countries.[9] This average itself is well above scores for the new EU member states. However the EBRD notes significant progress having been made between 2002 and 2005 in bribe taxes and the frequency of bribes.

High level corruption is of course part of the 'insider' economy in Ukraine. The World Bank described the impact of this phenomenon succinctly in its 2004 Country Economic Memorandum:

'the insider economy hinders fair competition, encourages low transparency and corruption, discourages foreign investment, restricts the adaptability of the economy to changing market conditions, limits the realisation of genuine comparative advantage, and complicates processes associated with access to foreign markets and world economic integration' (WB; SEM August 2004).

The insider economy

The prevalence of the insider economy is therefore one of the major hindrances to the modernisation of the Ukrainian economy. Its impact in limiting competition, both domestically and through foreign direct investment, means that there is little incentive for the Financially Integrated Groups to invest in the modernisation of plant or to

[7] OECD-SIGMA: Governance Assessment, Ukraine. Paris July 2006
[8] Foreign SMEs, especially from Germany, have been more important in the development of neighbouring Hungary and Poland than is reflected in the statistics on the volume of investment.
[9] EBRD, Transition Report, 2005.

improve management methods. Lack of competition slows innovation. The result is that Ukraine has one of the technologically most backward capital stocks in Europe. This is particularly noticeable in the all-important metals sector.[10]

Many operators in Ukraine are thriving from the economic rents they derive from the lack of a transparent and competitive environment. They make super-normal profits and have little incentive to change the system. Their resistance to change often persuades their employees that their jobs will be protected for life. This, together with investments in local facilities, often leads to public appreciation even though in the medium-term the public is being condemned to work in low quality jobs at a very poor standard of living. The status quo seems less risky than change.

The Government of Ukraine has been fighting corruption, especially high-level corruption, with some success since the Presidential election of 2004. The World Bank acknowledges the progress made here, especially in the weakening of business links with the Government. However the challenge is very great and requires the continued attention of the Government in the medium-term. The situation is not made easier by the fact that many businesses have bought their way into the Parliament to protect their interests.

Apart from Government efforts to fight the 'insider' economy, a natural process of development in the FIGs themselves is leading to the establishment of a more open and transparent system. The largest groups are now beginning to invest abroad. Industrial Union of Donbass has taken over the Częstochowa steel works in Poland while SCM has invested in Italy (Ferriera Valsider). As these groups look for opportunities abroad, so they are forced to become more open and transparent to conform to regulation in the EU and elsewhere. There are also good financial reasons. As these groups need to borrow money for investment they find that by transforming themselves into honest and transparent companies their borrowing costs are sharply reduced. Today these arguments are being discussed in the boardrooms of many Ukrainian companies. These developments promise a future for Ukrainian business in which the insider economy is progressively transformed into a competitive and open environment.

Nevertheless the perception that corruption is widespread in Ukraine pervades the thinking of foreign companies considering investments abroad. The new Government will have to reinforce measures to fight against corruption and to make sure that its successes are publicised abroad.

Business regulatory environment

The need to improve the business regulatory environment is evident from business surveys carried out with domestic and foreign companies.[11] The complexity of dealing with the public authorities nationally and regionally, difficult and sometimes corrupt customs procedures, the low security of property rights, the enforcement of contracts and the lack of security for minority shareholders all persuade foreign

[10] World Bank, 2004, Country Economic Memorandum Ukraine
[11] World Bank, Doing Business in Ukraine, 2005.

investors not to move into Ukraine in spite of all its advantages in terms of costs and proximity to markets.

The EBRD describes Ukraine as one of the most difficult locations in which to deal with the Administration in the central and eastern European region.[12] In terms of time spent dealing with public officials, managers rated Ukraine only marginally better than Albania, Serbia and Macedonia and well behind the new member states. Overall Ukraine is classed by EBRD in the lowest category in terms of compliance with international standards of corporate governance.

The outlook for the business environment is not however as black as this might suggest. The Government has been active over recent years in trying to tackle some of the worst problems for business in Ukraine. These problems have been analysed by SigmaBleyzer staff in a recent publication.[13] They group them into nine different categories:

1. public governance
2. macroeconomic stability
3. a stable and predictable legal environment
4. business liberalisation and deregulation
5. corporate governance
6. liberalisation of foreign trade and international capital movements
7. a healthy financial sector
8. minimising corruption
9. minimising political uncertainty

Macro-economic stability has not been a major problem recently partly because of the highly responsible and professional behaviour of the National Bank of Ukraine. Fiscal policy has shown signs of strain under political pressure, especially just prior to the Presidential election in 2004. Nevertheless this is not likely to be a major factor acting against FDI.

The problems of public governance are raised in the recent SIGMA report mentioned above. These are serious problems because they affect the efficiency of policy-making as well as the implementation of policy. Inefficiencies of the bureaucracy, overlapping responsibilities, inadequate pay in the public sector all contribute to make reform complex. OECD-SIGMA suggests that progress can only be made step-by-step, because the situation is too difficult to make a wholesale reform feasible.

Minimising political uncertainty was a hope associated with the recent legislative elections, which promised four years of stable government. The unclear outcome unfortunately looks like maintaining uncertainty over the coming months and years.

In many of the other areas mentioned in the study however progress has been made even though serious problems still remain.

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[12] EBRD, 2005, Transition Report

[13] Segura, Ustenko,Pogarsak and Bilan, Ukrainian Odyssey: Economy 2006 and Investment Climate, SigmaBleyzer, Kyiv 2006

The legal environment for business was an area where the government was determined to make progress. It has made great efforts to achieve improvements. New civil and commercial codes were adopted in 2004 as part of this policy. Unfortunately there is considerable overlap in these codes, which are in part contradictory. This underlines one of the major problems in Ukraine – the inability of the Government to control the passage of its draft legislation through Parliament. A combination of lack of party discipline in the Rada and members who have very specific business of other interests means that there is no guarantee that a draft law which enters the Rada will be recognisable when it finally becomes law.

The judiciary poses another set of problems which affects foreign investors. Legal inefficiency costs investors financial losses and takes up large chunks of valuable management time. This results from the massive under-financing of the judiciary and the great need for the training of judges especially in areas like company law, tax law, and intellectual property law.

Corporate governance is another area where although the Government has attempted to speed up reform, many problems still remain. Above all transparency has still not been achieved in matters of ownership structure, as was obvious in the question of the ownership of RosUkrEnergo, the company at the heart of the 2005 gas dispute with Russia.

Finally in 2005 the Government made a major effort to simplify regulation and to deregulate, introducing a ’regulatory guillotine’. It also attempted to make the opening of a business somewhat less cumbersome.[14]

Foreign Direct Investment and European Integration

European integration can help Ukraine increase its attractiveness to foreign investors, depending on the depth of integration that is achieved. It acts in two ways:

- European integration raises the credibility of the country and suggests greater stability to foreign investors
- the EU-Ukraine Action Plan includes many measures which are essential to improving the business environment in Ukraine

The evidence from the new member states in central Europe suggests that foreign investors’ perception of country risk changed many years before actual accession. It is true that these countries set their eyes on full accession early in the 1990s but the explosion of FDI in Hungary came in the first half of the decade, long before it was clear that accession was a realistic option.

The situation with Ukraine is different in various respects from that of Hungary or Poland. Notably Ukraine has not received any sort of commitment from the Union to its accession to the Union. The European Commission proposed to the Council in

[14] see SigmaBleyzer, op.cit page 40

September 2006 that it should be allowed to negotiate 'an enhanced agreement' with Ukraine but even that is uncertain.

Nevertheless the implementation of parts of the Action Plan does give Ukraine the chance to integrate with the EU in a quite meaningful way. It is important to show at every step that Ukraine and the Union are working constructively together and that integration is progressing. This will already have an impact on the perception of Ukraine by foreign investors, as it did fifteen years ago in Hungary. The aim of the President of Ukraine is full accession to the Union. However even in the relatively short-term, confidence of investors can be increased by constructive engagement with the Union.

However visible EU integration must go hand in hand with perceived stabilisation of democracy, the functioning of the Constitutional Court, civilised behaviour in the Verkhovna Rada and many other elementary characteristics of a functioning state.

Full implementation of the Action Plan would make Ukraine a much more attractive location for foreign investors. It includes a wide range of measures which would lead to a massive improvement in the business environment:

- regulatory reform
- strengthening banking regulation and supervision
- adoption of a new Joint Stock Company law
- adoption of international standards in customs application
- approximation to EU standards in technical regulations and conformity assessment including the negotiation of an Agreement on Conformity Assessment and Acceptance of Industrial Products
- improved sanitary and phyto-sanitary standards with the aim of reaching new agreements with the EU
- reforms in the company law area
- fully implementation of PCA commitments on the movement of capital and current payments
- transparency in the granting of state aid
- ensuring that public procurement is open and transparent

Progress in some or all of these areas would allow Ukraine to capitalise on its existing advantages for FDI.

Realistically it is most doubtful that Ukraine can fulfil all the expectations of the EU – it is also probably not desirable from a Ukrainian perspective. What is needed is a National Strategy for European Integration to replace that which was produced several years ago. Such a Strategy would prioritise actions on the Ukrainian side to implement the Action Plan so that reforms in the business environment which the Ukrainian Government considers necessary can be underpinned by the objective of European integration.

To some extent the Ukrainian administration has given the impression that the Action Plan contains 'instructions' which have to be carried out. This is wrong for two reasons:

- it makes people suspicious that actions by government will not be followed up with implementation
- it may mean that measures are taken which are unhelpful for Ukraine's economic development

There is little doubt however that progressive integration with the EU will help to accelerate the growth of FDI on which Ukraine's economic and political future partly depends.

Conclusion

Foreign direct investment was crucial to economic expansion in the new Member States of the EU and it is likely to be so for Ukraine as well. So far Ukraine's performance in attracting FDI has been poor, although two large investments in 2005 resulted in an almost doubling of cumulative FDI since independence, and the 2006 performance appears quite promising.

The key problems which must be tackled to remedy this situation are those linked to the quality of the business regulatory environment, corruption and stability of policies and institutions.

European integration, even short of accession, promises to improve the attractiveness of Ukraine to foreign investors, as it leads both to a reduction in perceived country risk and to the underpinning of Government efforts to improve the business environment.