

German Advisory Group
Institute for Economic Research and Policy Consulting

Policy Paper Series [PP/02/2015]

Foreign Direct Investment in Ukraine: Past, Present, and Future

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Berlin/Kyiv, June 2015

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Foreign Direct Investment in Ukraine: Past, Present, and Future

Executive Summary

Ukraine is currently in a very tense macroeconomic and financial situation. One problem area is the attraction of foreign direct investment (FDI). In 2014, only about USD 300 m (equivalent to 0.2% of GDP) have been attracted on a net basis, which is a multi-year low. The inward stock of FDI declined by about USD 15 bn to USD 63.8 bn (48.4% of GDP) over the year. These adverse developments give rise to a number of concerns, as FDI flows serve a dual purpose: They provide stable, long-term capital inflows that can support the external balance of the country, which is still rather shaky, and add to the country's overall investment levels, which are under severe pressure, despite significant reform efforts to improve and deregulate the business and investment climate.

In order to gain more insights into the past performance of FDI in Ukraine, we look at past trends between 2004 and 2014, also in comparison to neighbouring Poland and Romania, which can be considered natural benchmarks. This analysis reveals that Ukraine had a very mixed success of FDI inflows over this period. While Ukraine's inward FDI stock expressed in % of GDP is at first glance similar to Poland and Romania, serious doubts remain regarding the special role of Cyprus. Accounting for likely "round-tripping" of domestic capital, the genuine FDI level appears much lower in Ukraine than in Poland and Romania. Key differences can be also observed in the sectoral structure, as Ukraine attracted comparatively fewer inflows into export-oriented industries. In particular machine building and the chemical industry (which are the most important subsectors in both Poland and Romania) are not among the main targets of FDI in Ukraine, but metallurgy and food processing. Finally, a high share of FDI in the financial sector in Ukraine means that shareholder loans account for about 14% in the total reported FDI stock.

What can Ukraine and its international partners do to specifically improve the FDI outlook in the short-term? On a strategic level, the huge increase in political risk, which is a consequence of the conflict in the East, must be contained. Ukraine should target key (existing and potential) foreign investors in ad-hoc organised investment events abroad, where it should stress that the majority of the country is not directly affected by the situation in the East. Current wages that are less than a sixth of those in Poland and a third of Romania's, coupled with the country's closeness to EU markets should help to compensate for any risks (and remaining obstacles to doing business). Ukraine's international partners should consider offering affordable political risk insurance to FDI investors in Ukraine, which might support (existing and potential) investors, and contribute to an eventual economic and financial stabilisation.

On a tactical level, a number of measures can further support FDI attraction, without substantial costs. Eliminating obstacles for debt to equity swaps would create a Win-Win situation for foreign investors and the country, as the share of (external) debt in the FDI stock would decrease and a higher share of equity result. The reliability of the public real estate register, which is important for many transactions, should be enhanced by the establishment of the principle of legal force of the registered rights and their encumbrances. Finally, the problematic role of administrative restrictions that currently prohibit the transfer of dividends and of sales proceeds abroad must be highlighted, as these outflow restrictions serve also as a brake on inflows, and should thus be relaxed.

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Acknowledgements

The authors would like to thank Woldemar Walter for his excellent research assistance. The usual disclaimer applies.

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1. Introduction

Ukraine is still faced with a very tense macroeconomic and financial situation; even though some signs of stabilisation have emerged recently, like the (still fragile) stabilisation of the exchange rate after a massive depreciation in the beginning of the year. Reforms to achieve external stabilisation, which is crucial under current conditions, are well underway, even though they proceed with different speeds¹.

One particular area where Ukraine is currently confronted with adverse external headwinds relates to the attraction of foreign direct investment (FDI). In 2014, only about USD 300 m (equivalent to 0.2% of GDP) have been attracted on a net basis; the inward stock of FDI declined by about USD 15 bn to USD 63.8 bn (equivalent to 48.4% of GDP) over the year. These adverse developments give rise to a number of concerns, as FDI flows are of crucial importance for at least two reasons:

Balance of payments perspective: In the future, significant amounts of private capital, and here in particular stable and long-term oriented FDI inflows need to supplement and eventually replace capital inflows that are provided currently by official sources (IFIs, multilateral and bilateral donors).

Investment perspective: Due to their dual nature, inflows of FDI can supplement domestic investments, which are currently very low due to the challenging economic and security situation, as well as very high funding costs². Gross fixed capital formation shrunk by 23% in 2014 (versus 2013) to reach a level of only 14.0% of GDP – the lowest level since statistical records are available³. The fall in investments delivered a major negative contribution to the fall in real GDP of 6.8% in 2014. Thus, an eventual economic recovery would depend on reconstruction and modernisation of the Ukrainian economy needs to put a strong focus on FDI attraction.

The aim of this paper is to provide an empirical analysis of past and present FDI attraction in a comparative perspective. Based on this analysis, we put forward selected recommendations on how to keep the existing FDI stock and attract new inflows. To state it clearly from the beginning, the purpose of this paper is not to propose a mid-term comprehensive FDI policy, including issues like setting up, or reforming FDI attraction institutions/agencies, or offering specific instruments like industrial parks, but rather to provide concrete recommendations that are tailored to the current political-economic situation and which can be introduced in the short-term without major fiscal costs. At the same time, we do not focus on the significant efforts by the government to deregulate the economy and improve the business climate, which should eventually boost investment figures, both from local and foreign sources.

The paper is structured as follows: In the following chapter, we analyse empirical trends in FDI attraction in Ukraine, using neighboring Poland and Romania for comparative purposes. This chapter concludes with some major facts out of this analysis. In chapter 3, we derive a number of policy recommendations on how the stock and flow of FDI in Ukraine can be stabilised and improved. This relates to actions Ukraine can undertake, but also to areas where the international community can support Ukraine. Chapter 4 concludes.

¹ See German Advisory Group Policy Briefing PB/05/2015 „Economic reforms aimed at external stabilisation. A structural framework“ http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2014/06/PB_05_2015_en.pdf

² To give some examples, the NBU discount rate is currently at 30% p.a., the yield on 1-year sovereign local UAH bonds is about 25%, while new UAH loans are issued at about 22% not including commissions and charges.

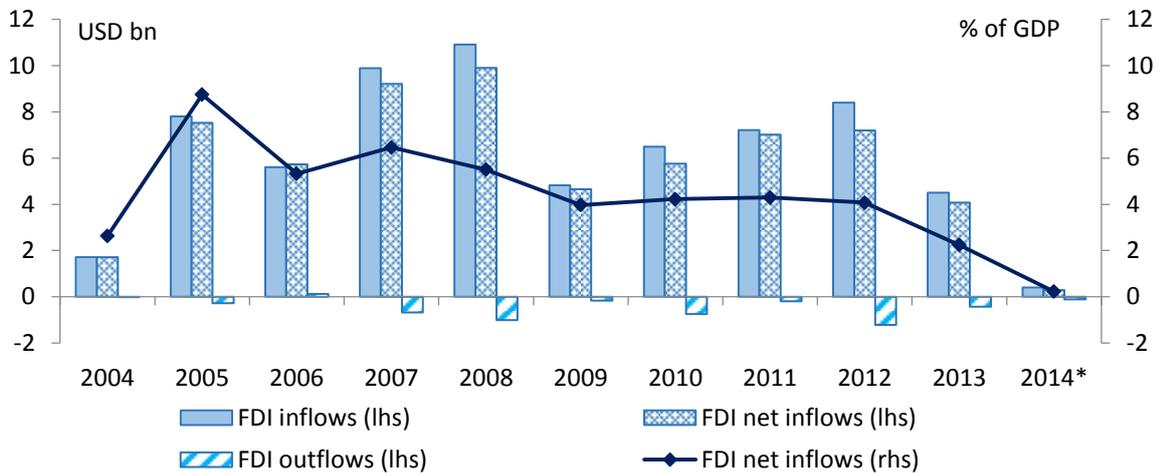
³ See IMF World Economic Outlook Database, April 2015 edition. The series (“total investment”) starts in 1992.

2. Empirical trends in FDI in Ukraine

In this chapter, we provide an analysis of empirical trends in FDI attraction during 2004-2014. The starting point is the development of inflows, outflows, and the resulting net FDI inflows during that period:

Figure 1

FDI inflows and outflows (USD bn and % of GDP)



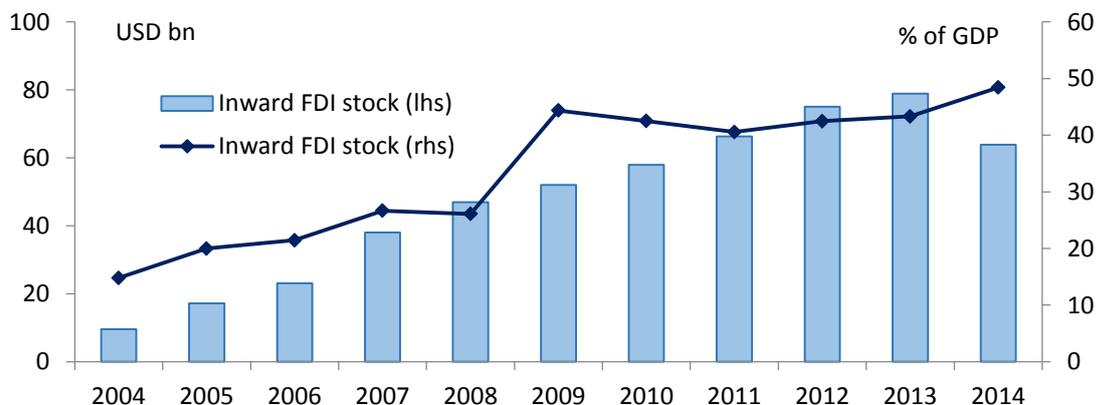
Source: NBU

Broadly, three different phases of FDI attraction can be distinguished⁴:

- “Boom” until the global financial crisis 2008: Inflows, in particular into the financial sector, topped the USD 10 bn mark, and were consistently above 5% of GDP.
- “Recovery” until 2012: The crisis led to a significant drop in FDI inflows by more than 50% in 2009. Once the economic recovery started, this amount started gradually to increase in absolute USD figures until 2012. As a share of GDP, FDI inflows were roughly stable at 4% of GDP p.a.
- “Decline” since 2013: The economic stagnation and rising macroeconomic instability lead to a significant drop in FDI already in 2013. This development continued in 2014, but for different reasons (economic and financial crisis and security situation with the military conflict in the East).

Figure 2

Inward FDI stock (USD bn and % of GDP)



Source: NBU

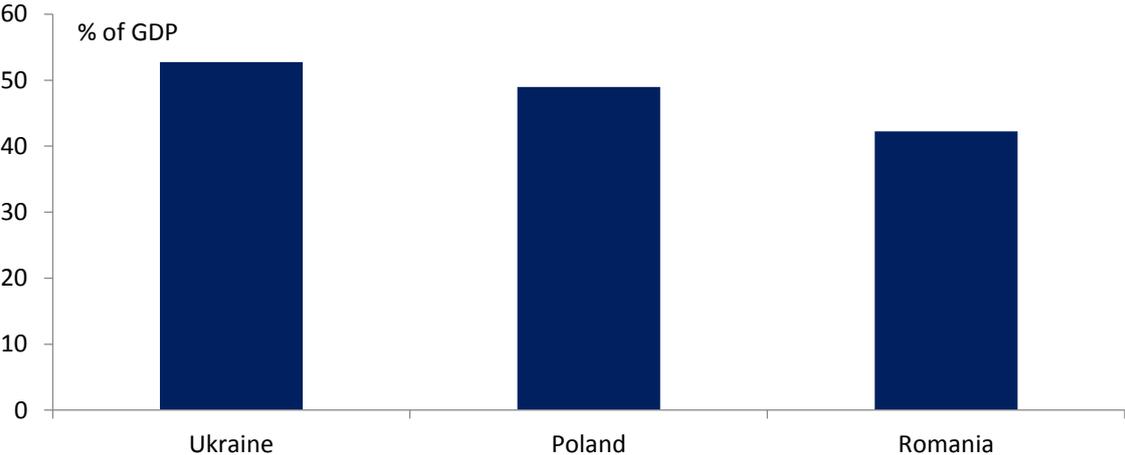
⁴ We do not focus on outward FDI, as it was generally insignificant as compared to inward FDI.

Generally in line with the flow dynamics shown in Figure 1, the inward stock of FDI in USD terms increased gradually over this period in USD terms until 2013. The developments in 2014 can be considered a break with this long-term trend, as for the first time the inward FDI stock actually shrank, by USD 15.1 bn, from USD 78.9 bn to USD 63.3 bn. However, this drop is primarily an accounting phenomenon, as the steep depreciation of the Hryvnia, and delays in revaluing (UAH-denominated) holdings reduced the USD equivalent of the FDI stock.

The dynamics of the inward stock are quite different relative to GDP, as the huge decline in nominal USD GDP in 2009 (which was a result of depreciation as well as a fall in real GDP) led to a respective jump in this ratio from 26.1% of GDP (2008) to 44.4% of GDP (2009). This also reflects the fact that FDI outflows were not observed in 2009 and inflows from bank recapitalization by foreign owners took place. However, once the economic recovery started, this ratio stabilised at about this level until 2013. In 2014, a similar effect like in 2009 took place, as the huge decrease in nominal GDP (from USD 179.6 bn to USD 130.7 bn) led to an increase in the ratio to 48.4% of GDP, despite an actual fall in the absolute FDI stock. The challenge for policymakers is thus not only to think about how to attract new inflows, but also how to keep existing investments, which have been decreasing in absolute terms.

The following Figure 3 compares the inward FDI stock to those of neighboring countries Poland and Romania:

Figure 3
Regional comparison of inward FDI stock (end-2014)

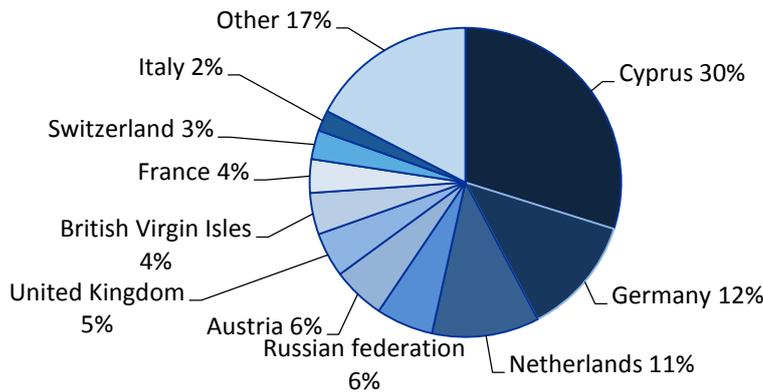


Source: NBU, NBP, NBR, Eurostat, own calculations
Note: FDI liabilities in EUR for comparability reasons⁵

Perhaps surprisingly, at around 50% of GDP, the inward FDI stock is a bit higher than that of Poland, and well ahead of Romania’s (42.2%). However, this issue deserves a deeper investigation, and one likely answer comes when looking at the composition of source countries that were responsible for those investments (Figure 4):

⁵ Domestically, FDI data differ between statistical institutions (Ukrstat and NBU) and in the case of Ukrstat the series contain a number of breaks.

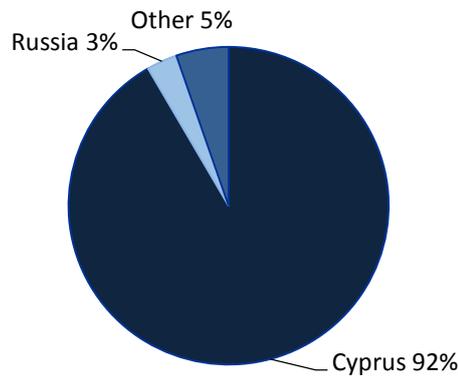
Figure 4
Ukraine's inward FDI stock by source country (2014)



Source: Ukrstat

Cyprus is by far the most important direct investor in Ukraine, which points to the presence of “round-tripping” funds previously withdrawn from Ukraine (or perhaps other CIS countries, e.g. Russia), and channeled to Ukraine via Cyprus. The presence of “round tripping” is further supported by looking at Ukraine’s FDI outward stock, where Cyprus commands an impressive share of 92%⁶.

Figure 5
Ukraine's outward FDI stock by country, (2014)



Source: Ukrstat

While this “round-tripping” procedure can have different reasons (tax advantages, advanced legal system with better protection, among others) it is clear that such funds don’t constitute genuine FDI flows with all their associated benefits (technical, management and human capital know-how transfers and spill-overs) but rather of domestic investment which is re-routed via an offshore zone⁷. This is quite different in the case of Poland and Romania, where Cyprus has a relatively low share of only 4% in each country’s FDI stock and thus does not play an important role (see Annex for more

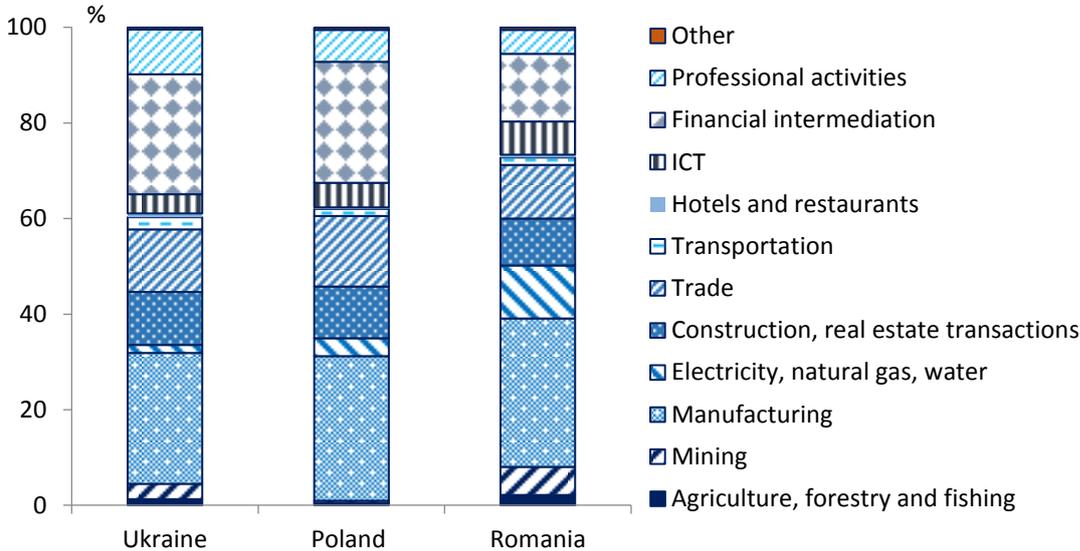
⁶ Of course, Ukraine’s inward and the outward stock related to Cyprus is not comparable in absolute terms, with the latter being much lower, as most outflows are probably not recorded officially.

⁷ If we take official FDI statistics from Cyprus (latest available for 2012), we note that the overall stock of FDI in European countries outside the EU (i.e. including Ukraine and Russia) by Cypriot residents was limited to EUR 2 bn, which does not match the Ukrainian figures at all.

detailed information). It is therefore safe to conclude that official statistics overestimate the “real” level of FDI in Ukraine’s economy, which is probably lower than in Poland and Romania⁸.

Turning to the sectoral distribution of the FDI stock in Ukraine (Figure 6), some interesting observations can be made⁹:

Figure 6
Inward FDI stock by economic activity



Source: Ukrstat, NBP, NBR
Note: Ukraine for 2014, Poland and Romania for 2013

Some interesting observations can be made from Figure 6: First, the FDI share in manufacturing, which is traditionally export-oriented, is lower in Ukraine than in both Poland and Romania. On the other hand, FDI in the banking sector is quite high¹⁰, at about the same level as in Poland, and significantly higher than in Romania. Also the (domestically-oriented) construction sector has a higher share in Ukraine than abroad. A further split of the FDI stock is available for the manufacturing sector, as Figure 7 shows:

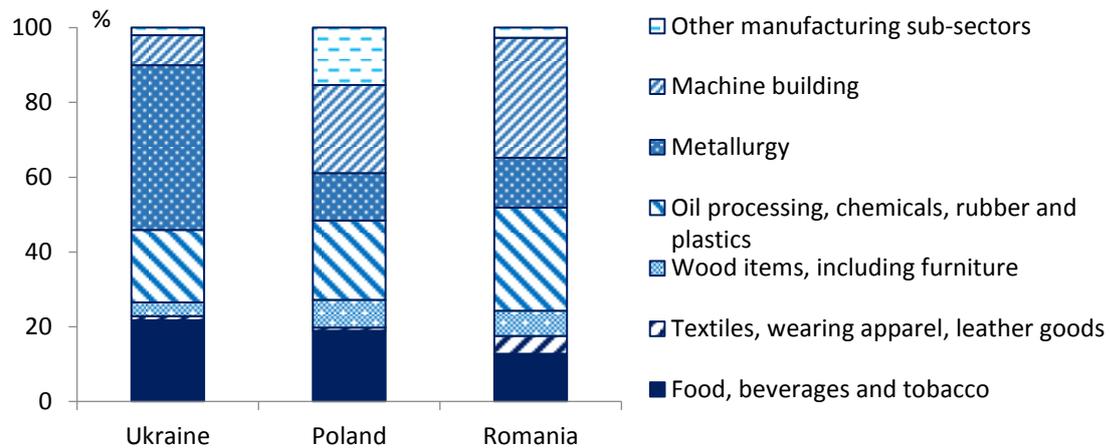
⁸ Excluding Cyprus, the FDI stock in % of GDP in Ukraine (2014) is similar to Romania, but smaller than in Poland. However, this also reflects the huge drop in nominal USD GDP in 2014 (by 28%), which affects the denominator. If we compare the per-capita inward FDI stock, Poland leads with 5,306 EUR before Romania (3802 EUR) and Ukraine (1223 EUR).

⁹ See „How to stabilise the economy of Ukraine“, wiiw Background Study, 15 April 2015 for more information.

¹⁰ One should also mention that the data are from 2014, after a number of foreign banks left Ukraine already.

Figure 7

Inward manufacturing FDI stock by economic activity



Note: Ukraine for 2014, Poland and Romania for 2013

Source: Ukrstat, NBP, NBR

By far the most important sub-sector in Ukraine is metallurgy, followed by food production. The respective shares are much higher than those for Poland and Romania, which show also a much more diversified structure. Furthermore, in both countries is the machine-building sector the main target sector for FDI, followed by the chemical/oil-processing sector.

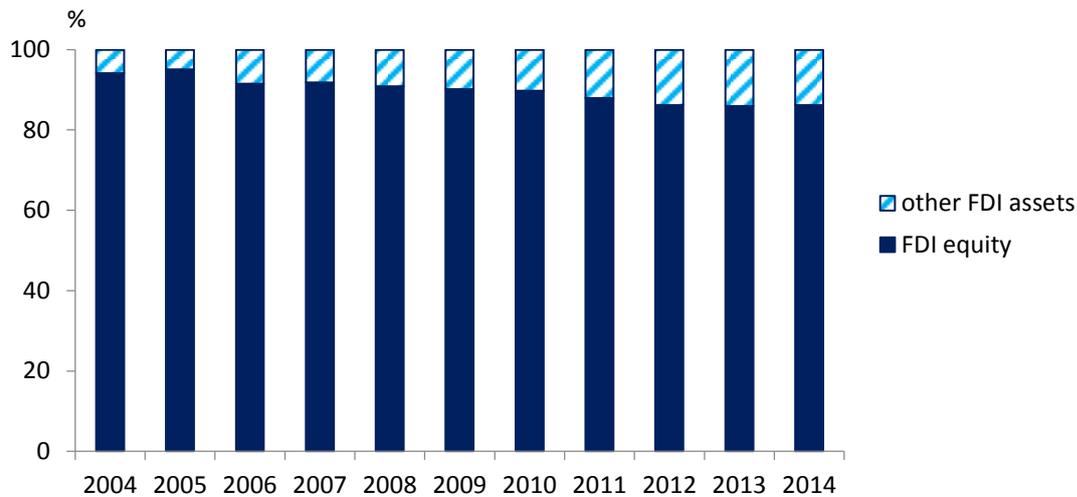
A further observation relates to the form of FDI inflows that Ukraine has received. While the majority of these flows entered the country in form of equity flows, other FDI assets like shareholder loans became increasingly common and constitute currently almost 14% of the total FDI inward stock¹¹. This in part reflects the high share of FDI in the financial sector over the last years (where this form of FDI is prevalent). It should be mentioned that such debt flows are also recorded in external debt statistics, and thus contribute to the external indebtedness of the country¹².

¹¹ Ukrstat initially recorded only equity flows and started later to report also debt flows. The geographical and industry distribution (Figures 4-7) is based only on the equity figures as reported by Ukrstat.

¹² One final issue in the empirical analysis of FDI flows relates to the question of Greenfield versus Brownfield (i.e. M&A) investments as modes of entry. Data from different private sources (as official statistics do not make this distinction) point to the fact that Ukraine has a particular poor performance of attracting Greenfield flows as compared to Poland and Romania. See „How to stabilise the economy of Ukraine“, wiiw Background Study, 15 April 2015 for more information.

Figure 8

Split of FDI stock by equity and other assets



Source: NBU

Main conclusions from the empirical analysis:

1. Ukraine had a very mixed success of **FDI inflows** over 2004-2014. Of particular note is that net FDI inflows to Ukraine **came almost to a halt in 2014**, whereas the **inward stock of FDI actually dropped by USD 15 bn**.
2. While Ukraine's inward FDI stock expressed in % of GDP is at first glance even higher than the levels observed in Poland and Romania, serious doubts remain regarding the special role of Cyprus. Accounting for likely "round-tripping" of domestic capital, the **genuine FDI level appears much lower** in Ukraine as compared to **Poland, and on par with Romania**. However, this also reflects the significant decrease in nominal USD GDP in Ukraine in 2014, which boosts the ratio. In terms of per-capita-figures, Ukraine is far behind both Poland and Romania.
3. In terms of the **sectoral structure**, domestically-oriented sectors like banks and construction showed high inflows, **less so export-oriented manufacturing**, which is different from Poland and Romania. Among the manufacturing sector, further differences to Poland and Romania are evident, as **machine building and the chemical industry** – which are the main beneficiaries in these countries- **are ranked in Ukraine only after metallurgy and food processing**.
4. While the inward FDI stock is mainly made up of equity, other instruments like **shareholder loans** have gradually gained weight. Currently, almost 14% of the total stock consist of such "other assets", which count also as external debt of Ukraine.

3. Towards a recovery in FDI flows: Selected policy recommendations

A main result from the previous chapter was that the new inflow of FDI has almost dried up, while the existing investment stock shrank. Against this background, it is of strategic importance to convince existing foreign investors to stay committed in the country; otherwise it would be close to impossible to attract new investors, as potential investors pay close attention to those currently engaged in the country, and their behaviour¹³. Thus, the target group is not just potential investors, but at the same time also existing investors.

How Ukraine and its Western Partners address this issue? We distinguish in the following chapter measures on the strategic level as well as on a more concrete, tactical level that would contribute to such a recovery in FDI flows.

3.1. Strategic considerations

Ukraine's security situation in the East has greatly increased the level of the political risk premium associated with the country, which is a major negative factor for any long-term real investment decision. At the same time, this conflict has in our view created also certain misperceptions of political risk, especially at corporate headquarters abroad, where the key decisions regarding FDI are taken. Due to extensive media coverage of the conflict in international media¹⁴, the whole country is to a large extent associated with the military conflict in the East, i.e. no clear distinction is made between different regions of Ukraine.

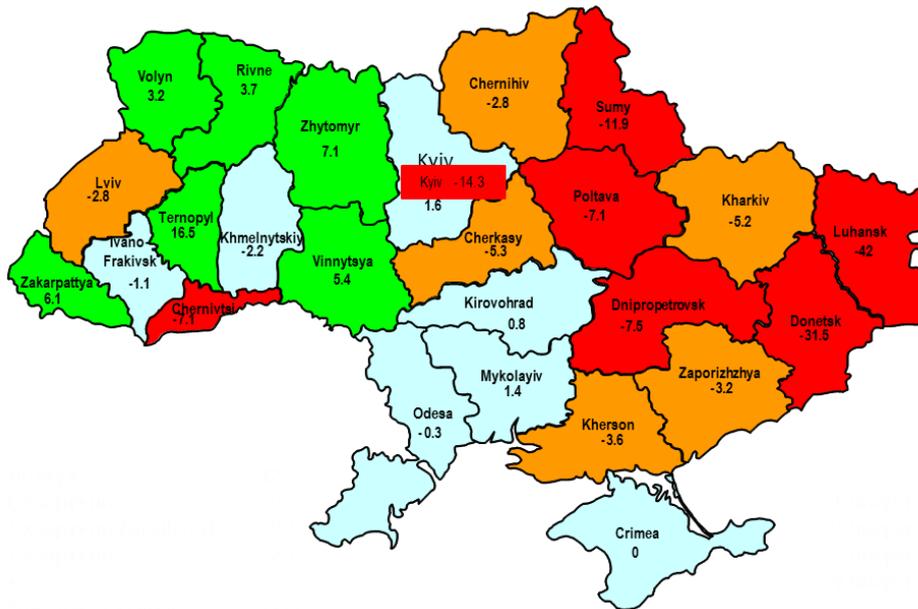
This view is problematic, as e.g. business conditions in Western or Central Ukraine materially differ from those in the conflict area, even though one cannot deny that there are not completely independent, as a certain impact is surely felt (e.g. the military draft, FX restrictions that were taken in response to confidence crisis originating in the East, etc.), and a future resolution of the conflict along the agreements of "Minsk II" is all but certain.

To give a concrete example for the need of differentiation, the following Figure 9 shows the performance of industrial production in different regions (oblasts) in Ukraine during 2014.

¹³ While the drop in the FDI stock was mainly related to the depreciation and the recession, and not many outright exits have been observed, many foreign companies engaged in Ukraine are currently in the process of examining their business plans. While capital account restrictions might prevent possible exits in the short term, their long-term effectiveness is in doubt.

¹⁴ A simple internet search among news on Ukraine (in English) shows that 49% of all results contain conflict-related keywords (35,699 out of 73,328 items).

Figure 9
Industrial output by regions in 2014, % yoy



Source: NBU, Ukrstat

What is evident is that the development was quite mixed, with a number of regions that actually showed robust growth in industrial output (mainly in the West of the country), and many more where output grew mildly, stagnated, or declined up to a certain degree. Not a single region showed the disastrous performance of the Donbas area, where output shrank by 31.5% (Donetsk) and 42% (Luhansk).

The question is now what Ukraine and its international partners can do about (a) this apparent misperception and (b) possible ways to deal with the overall increase in the level of political risk.

a. Targeted investment promotion abroad

While attracting new and engaging existing investors, Ukraine's government should try to deliver a consistent message directed at the right audience in an adequate format.

The message consists of targeted information about the real business situation on the ground, and the current available opportunities in different regions, for which Figure 9 is just a very crude sample. Apart from a progress update on the overall business deregulation agenda, which is a national topic, senior policymakers should stress that the conflict area is only a very small part of Ukraine, and is not crucial for economic survival of the country¹⁵.

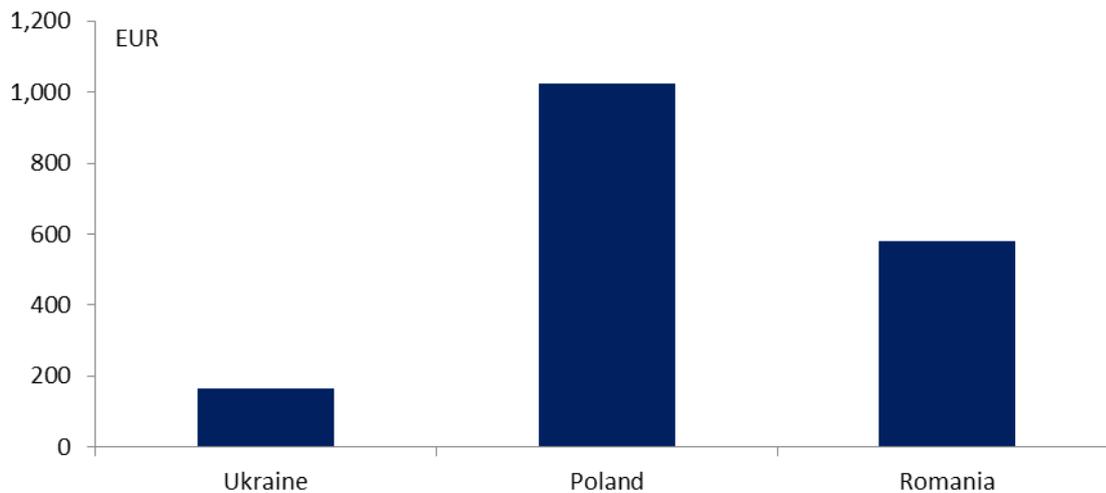
A further part of this message should be a reference to current wage costs in Ukraine, and especially in comparison to neighboring Poland and Romania¹⁶, as the following Figure 10 shows:

¹⁵ See German Advisory Group Policy Study PS/01/2015 „Implications of an economic detachment of the rebel-held area” (not published).

¹⁶ Bulgaria (not shown) has the lowest labor costs in the EU, which are about 20% lower than in Romania.

Figure 10

Average monthly gross wage



Source: Own calculations based on national statistics

Note: Latest available data, exchange rate as of 18.06.2015

This comparison demonstrates that Ukraine has significant potential to attract FDI especially into labor-intensive sectors¹⁷ that will help to create productivity gains and thus help to increase wages over time. The integration into EU value chains (which would be fully consistent with the objectives of the DCFTA) and a possible relocation of business from other CESEE countries to Ukraine would be a positive result of such endeavors.

As important as the message is the target audience. Here, we propose to address directly CEOs of major active/interested enterprises as they take the key strategic decisions on entry and exit. This has particular implications in terms of the format of these events, as it requires traveling to their international headquarters. Thus, the focus should be on conducting ad-hoc events in the national capitals of major FDI host-countries, where in cooperation with domestic business associations the key (potential) investors should be identified and invited.

As part of its investment promotion abroad, Ukraine should highlight the regional differentiation in economic performance, which is often not fully appreciated outside Ukraine. Given the comparatively low labor-costs, interesting investment opportunities have emerged, which should be communicated to key corporate decision makers during selected ad-hoc investment events conducted abroad.

b. Political risk insurance

What can Ukraine's international partners (e.g. the EU, G7) do to support private direct investments in the country? One idea that has recently gained some traction among observers¹⁸ refers to offering political risk insurance (PRI) for such investments via public institutions/funds, in order to decrease

¹⁷ More information can be found in the German Advisory Group Policy Paper PP/03/2015 „Industrial Sector in Ukraine: Trends, Challenges and Policy Options“.

¹⁸ See G. Soros “How the EU can save Ukraine” The Guardian, 29 May 2014; B. Toms “The urgent need for greatly increased political risk insurance for Ukraine”, Speech at the Ukraine Investment Issues Conference, 3 December 2014; A. Umland “Here’s One Practical Way to save Ukraine”, Atlantic Council Blog, 16 June 2015.

the risk premium and thus increase the flows of new and/or keep existing investments in the country¹⁹.

PRI usually provides insured investors protection against losses that result from political violence (war, terrorism, and civil war), various acts of expropriation, as well as currency transfer restrictions²⁰. Such insurance is offered by both public (multilateral and national) and private insurers against a premium to private equity and debt investors as well as lenders active in emerging markets. However, in reality only a small share of such investments is insured, a fact that is probably also true for Ukraine.

In the context of Ukraine, private insurance is hardly available at reasonable costs under current circumstances. This puts the spotlight on public insurers, which are in principle able to provide coverage for investors in Ukraine against a respective fee. Examples include the Multilateral Investment Guarantee Agency (MIGA), which is a part of the World Bank Group as well as bilateral institutions like the Investment Guarantees of the Federal Republic of Germany²¹, the Overseas Private Investment Corporation of the US, Canada's Export Development Canada (EDC) and other agencies. However, a number of experts argue that substantial premiums and strict project selection criteria as well as lengthy procedures prevent a significant increase in insured projects via traditional agencies.

In order to boost PRI as a major instrument to support FDI into government-controlled territory of Ukraine, the international community could provide stand-by guarantees in a new political risk insurance programme for Ukraine, which could be administered e.g. by MIGA. Such a programme would not involve huge upfront capital contributions from participating countries, but rather depend ultimately on the credibility of the insurance providers²². The more convincing this guarantee is, the less likely it will be invoked. Under such circumstances, even if the programme charges no, or only very low premiums, there is a good chance that no significant (fiscal) costs are associated with it, which should be of direct appeal to participating governments.

While the idea is of significant appeal, a number of issues must be addressed in order to develop this concept further:

- Degree of coverage: Provision of only partial insurance in order to reduce moral hazard?
- Scope of coverage: Only new foreign investments, or also existing (uninsured) foreign investments? One could also offer investors with new projects coverage that also includes their existing investments.
- Focus: Not all industries will be equally interested in coverage due to business-specific reasons. We assume that capital-intensive business will be more interested in obtaining PRI.
- Administration: MIGA is due to its vast experience and global reach an obvious starting point, but other institutions, e.g. of the EU might also work. In case the politically determined level of

¹⁹ While the positive impact of such investment flows on economic stability are obvious, this translates also into higher social stability, which rests ultimately on the creation of jobs and income.

²⁰ See K. Hamdani, E. Liebers and G. Zanjani "An Overview of Political Risk Insurance", Federal Reserve Bank of New York, May 2005.

²¹ The Federal Government appointed a consortium formed by PwC as lead partner, and Euler Hermes to manage this scheme.

²² Only a certain amount of fresh capital needs to be upfront; the rest could be in the form of callable capital that is only needed in case real losses need actually be paid out – see G. Soros for more details.

coverage is not compatible with the internal legal provisions of the agency in question, some special trust fund could be created.²³

- Premiums: Level of premiums?
- Currency transfer restrictions: Ukraine has temporarily introduced such restrictions in order to stabilize the exchange rate (see the next section for more details). This issue must be addressed, e.g. by excluding this risk from coverage, or dealing with it before such a programme is set up.

Offering affordable political risk insurance to FDI investors in Ukraine might support (existing and potential) investors, and contribute to an economic and financial stabilisation. This is a major political task for Ukraine's international partners, while many practical details still need to be worked out.

3.2. Tactical considerations

Apart from measures aimed at countering the implications of the increased political risk premium, Ukraine can even in the short term improve the investment climate in particular with respect to foreign investments. In the following section, we identify three areas where quick action might bring some positive results.

c. Increasing flexibility in capital structures: Debt to equity swaps

As was shown in Figure 8, not all FDI enters the country in form of equity flows. Often, cross-border shareholder loans (i.e. external debt) accompany these equity flows and finance a significant part of the overall investment. In certain situations, it can be useful for an enterprise to swap this cross-border debt into equity.

A debt to equity swap is a transaction in which debt is exchanged for a predetermined amount of equity in a company. In Ukraine, debt is swapped into equity, as a rule, by way of assignment of property rights in exchange for corporate rights, whereas setting off claims for a contribution by a participant is expressly prohibited by law. Since there are no clear rules governing debt to equity swaps, such transactions are seldom undertaken in practice.

Substantial contractual indebtedness of the company towards its participant (e.g. the non-resident shareholder) adversely affects its basic financial indicators and is an obstacle in the way of conducting business, in particular when it comes to making borrowings. In the current case of a devaluation of the local currency, the indebtedness of the company towards its participant is subject to revaluation which leads to losses and decrease of the company's equity.

By swapping debt to equity, the company decreases its accounts payable, and consequently its obligations towards the participant become subordinated to the claims of other creditors. Such a change positively reflects on the ability to meet payments and makes it easier for the company to get financing.

Swapping debt to equity may help the company comply with statutory requirements regarding its net assets. However, this issue is more relevant for financial institutions, as their financial reports are subject to a review by the financial regulator. Non-compliance with the financial requirements might cause disputes with the regulator.

²³ See B. Toms for more details in the case of Gaza and the West Bank, where a special trust fund was created separate from MIGA's own business, but under its administration.

One of the advantages of swapping debt into equity is the fact that no cash needs to be freed and no wire needs to be made (which eliminates any bank fees), what makes the transaction much easier in times of strict foreign exchange controls.

Swapping debt into equity is an effective instrument of economic policy in the country especially in crisis times, as it facilitates a reduction of external debt (which is also a major factor monitored by Rating Agencies) and keeps foreign currency in Ukraine. Also, since interest payments are tax-deductible, more equity implies *ceteris paribus* a higher tax-base and thus more tax revenue. Therefore, such a mechanism, which is widely used internationally, will facilitate increasing long-term foreign investments and decreasing the pressure upon the local currency, which is in line with the economic interests of the country.

Since beginning of the year, the Parliament received for review several draft laws which should eliminate legal obstacles for implementation of debt to equity swap in Ukraine. The bills *inter alia* suggest amending VAT tax rules which are quite ambiguous. The bills call for clear exemption of the transaction from VAT. According to the bills the investment laws should clearly admit investments by way of debt to equity, as divesting of such contributions is currently questionable in practice.

Eliminating obstacles for debt to equity swaps would create a Win-Win situation for direct investors as well as for the country. The share of (external) debt in the FDI stock would decrease and a higher share of stable equity result.

d. Gradual relaxation of relevant FDI-related administrative restrictions

The National Bank of Ukraine (NBU) was forced to react with a wide range of administrative restrictions to counter the significant exchange rate pressure that appeared in parallel to the worsening of the economic, financial and security crisis. As far as FDI-related transactions are concerned, these temporary restrictions²⁴ included the

- repatriation of proceeds received by non-resident investors as a result of an OTC sale of securities issued by Ukrainian issuers (except sovereign bonds),
- repatriation of proceeds received by non-resident investors as a result of the sale of equity stakes in Ukrainian enterprises other than securities (e.g. equity in a limited liability company),
- the repatriation of dividends by non-resident investors (except for dividends received from securities listed at one of the local stock exchanges).

Thus, no purchase of FX and its subsequent transfer abroad is possible for these purposes, even though domestic transactions (e.g. the sale of an equity stake to a new owner) are allowed.

It goes without saying that this measure targeted at capital outflows is at the same time a significant drag on new inflows, i.e. market exit barriers are at the same time also market entry barriers. As long as this legislation is in place, it will create significant headwinds for attracting new inflows.

Thus, in the process of gradually winding down the whole set of administrative restrictions once stabilisation is reached, which is agreed with the IMF under the programme, those negative implications should be kept clearly in mind.

A number of administrative restrictions currently prohibit the transfer of dividends and of the proceeds from sales of corporate rights abroad. These outflow restrictions serve also as a brake on inflows, and should thus be relaxed as the situation allows.

²⁴ They were originally introduced by NBU Resolution #591 from 22 September 2014 and were re-authorized in current form by NBU resolution #354 until 3 September 2015.

e. Legal force / Reliability of public real estate register

Foreign direct investment is often related to the purchase of real estate, both directly (i.e. as a target sector) and indirectly (i.e. when real estate is needed for e.g. setting up a plant). The current Law on "State Registration of Real Estate Rights and Their Encumbrances" provides for a declaration that "the State guarantees the authenticity of the registered rights on immovable and their encumbrances". This declaration survived from the previous provisions of the mentioned law, which however contained a requirement to establish a guarantee fund. Today the declaration on the guarantee of the state has not been specified in the law. On the opposite, according to Article 30 of the Law, state registrars, notaries, state cadastre register and state enforcement officers bear disciplinary, criminal and civil law liability for the breach of legislation on the real estate registration. Damage shall be recovered based on the respective court decision. Hence, declaring the guarantee of authenticity of registered rights by the state, the law does not provide for a possibility to hold the state liable for the damage arising out of non-authenticity of the registered information. Hence, the legal force of the real estate register has not been secured and has a rather declarative character.

In order to ensure the legal force of the real estate register the law should provide for special regulations on the public faith into the registered rights and encumbrances. The registered rights and encumbrances shall be considered as true and valid unless the owner or beneficiary knows about the incorrectness of the registered information or when an objection against the correctness has been registered. It must be noted that the current real estate register regulations do not foresee such a legal mechanism as registration of objections. It would be however necessary in order to give the chance to protest against wrong /incorrect registrations.

The establishment of a principle of legal force of the registered rights and their encumbrances would contribute to the legal security in the real estate market, reduce transaction costs and would thus enhance the market circulation of real estate and its use as a financing instrument²⁵.

The reliability of the public real estate register should be enhanced by the establishment of the principle of legal force of the registered rights and their encumbrances.

4. Concluding remarks

It is evident that Ukraine's economic, financial and security crisis has also negative implications for the inflows and the stock of foreign direct investment, which performed poorly in 2014. This is for several reasons problematic, as such stable capital flows usually support the external balance of the country, which is still rather shaky, and add to the country's overall investment levels, which are also under severe pressure.

The present paper analysed Ukraine's FDI performance over a longer time horizon, and concludes that there exists a significant gap to neighboring Poland and Romania in terms of quantity, structure and quality of FDI, which poses a long-term challenge to Ukraine's policy makers. While closing this gap was beyond of the scope of this paper, and should be part of a general FDI strategy to be developed by the government, some short-term actions could and should be taken to address the current challenges. These actions can be considered a common task by Ukraine and its international partners to stabilize the economic and social situation of the country.

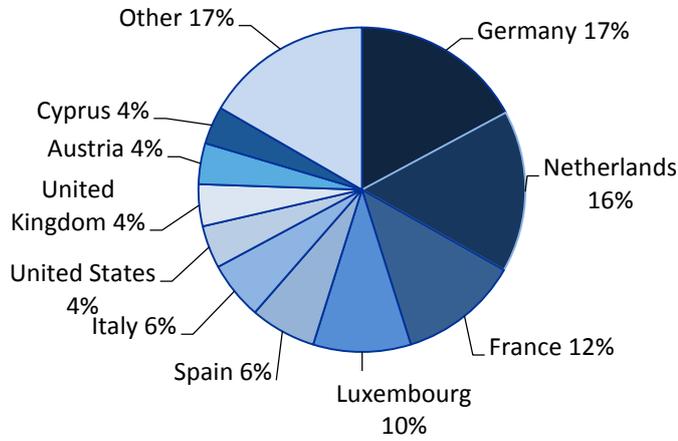
To put our recommendations into a broader perspective, the major factor impacting private investment decisions from resident and non-resident sources alike is a significantly improved and deregulated business climate. Thus, respective reforms, which are underway in Ukraine, will without doubt also positively impact FDI decisions, and additionally stimulate respective inflows in the future.

²⁵ As an example, the public faith into the real estate register has been established in Germany in Article 892 of the Civil Code already in 1900.

Annex

Figure A.1

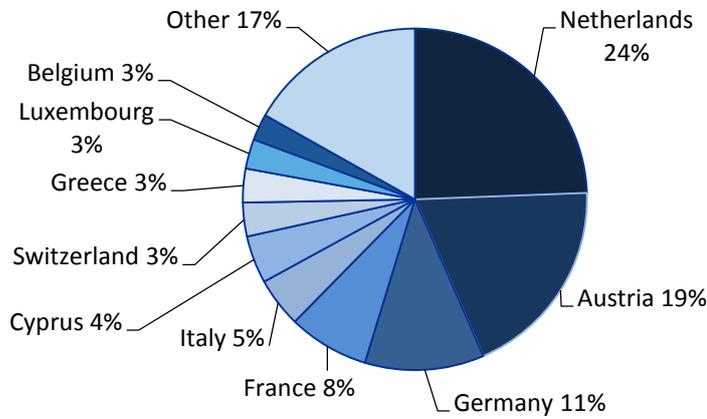
Poland's inward FDI stock by source country, 2013



Source: NBP

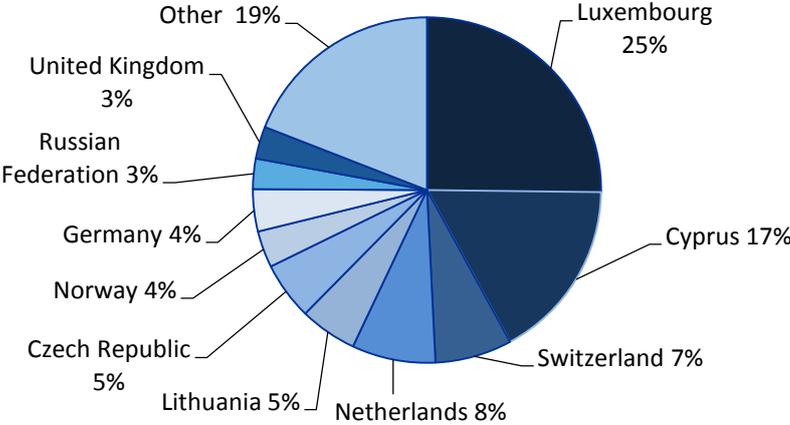
Figure A.2

Romania's inward FDI stock by source country, 2013



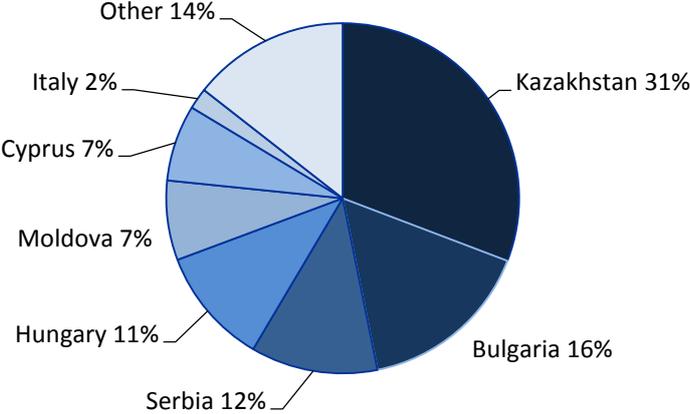
Source: NBR

Figure A.3
Poland's outward FDI stock by source country, 2013



Source: NBP

Figure A.4
Romania's inward FDI stock by source country, 2012



Source: UNCTAD FDI/TNC database, based on data from NBR

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