Chapter 1

The role of FDI and multinational enterprises in Ukraine's economic development

Attracting foreign investors has been a top priority for Ukraine's authorities, particularly since 2014. Ukraine underwent a deep recession and a sharp macroeconomic adjustment in 2014-15, in large part due to unprecedented geopolitical tensions and military conflict in the East. As a result, FDI inflows reached their lowest level in a decade in 2014, before partially recovering in 2015. Companies from the European Union (EU), the United States and Russia are major foreign investors. The FDI Stock (49% of GDP at the end of 2014) is heavily concentrated in metallurgy, finance, retail trade and other non-tradable sectors. Over the long-term, attracting more export-oriented, efficiency seeking FDI projects in a broader range of manufacturing sub-sectors would benefit both export diversification and a better integration into EU value chains.

Introduction

Ukraine has faced considerable economic challenges in recent years and been living through enormous political turbulence since the end of 2013. Social unrest, which started in Kyiv at the end of 2013, led to an overturn of the Yanukovych government. New presidential elections took place at the end of May 2014. In 2014, relations between the Russian Federation and Ukraine became extremely tense, with a new gas supply dispute between Naftogaz and Gazprom, the events regarding the Autonomous Republic of Crimea, an escalation in fighting in Ukraine's Donbas region, severe damage to industrial capacity and infrastructure in the east, and significant disruptions in bilateral trade.

Ukraine suffers from three large economic problems. First, its foreign payments are unsustainable. In 2013, the current-account deficit reached 9.2% of GDP, with foreign-currency reserves covering just over two months of imports. High debt refinancing needs weigh on the balance of payments. Second, public finances are also unsustainable; with the consolidated budget deficit (i.e. including Naftogaz) exceeding 10% of GDP in 2014 and expected to remain well above 7% in 2015 amid weakness in revenue collection, skyrocketing government-bond yields, and increased security-related spending.[1] Third, macroeconomic adjustment has been sharp. Following the National Bank of Ukraine (NBU)'s forced abandonment of the currency peg in February 2014, the Hryvnia (UAH) depreciated by around 85%. Deficit monetisation by the NBU restricts its monetary policy aimed to cut inflation. Unprecedented security challenges and uncertainty have taken a severe toll on the economy, with activity shrinking by an estimated 8.2% in 2014 and the recession continuing in the first three quarters of 2015.

Since mid-2014, successive new governments committed themselves to restore macroeconomic stability, strengthen economic governance and transparency, and generate sound and sustainable economic growth, while protecting the most vulnerable. Ukraine signed an Association Agreement (AA), including a Deep and Comprehensive Free Trade Area (DCFTA), with the European Union (EU), secured a new International Monetary Fund (IMF) programme in August and initiated structural changes in the energy and banking sectors. Most remarkably, the second government appointed in December 2014 under Prime Minister Arseniy Yatsenyuk contains three foreign nationals, who were awarded Ukrainian citizenship the same day they became ministers.[2]

With a population of around 45 million inhabitants in 2013 and an area of 603 628 km^2, Ukraine is the largest country entirely within Europe and has the lowest geographical density. Within the Commonwealth of Independent States (CIS), which in 2011 signed the CIS Free Trade Area (CISFTA) Agreement, Ukraine is the second largest economy.[3] It is ranked as a lower middle-income country according to both the World Bank and the United Nations. With a Gross Domestic Product (GDP) per capita in purchasing power parity of USD 8 665 in 2013, it is the fourth-poorest country in both Central and Eastern Europe (after Moldova, Armenia and Georgia) and the CIS.[4] This reflects the fact that Ukraine has experienced one of the weakest post-1990 growth performances among post-communist Europe transition countries.

The country has suffered from recurrent political instability, particularly since 2012, and military spending, at 2.9% of GDP in 2010-14, is relatively high and growing. Successive governments have acknowledged that FDI can play a crucial role in national development. Nonetheless, with some exceptions, mostly in agribusiness, consumer products, retail trade and financial services, few large MNEs have invested in Ukraine. In some sectors, in particular consumer products and financial services, global corporations imported international business practices and set an example for domestic investors. Failure to attract FDI in high value-added and technology-intensive sectors means that the country's exports remain relatively undiversified (Table 1.2: the number of exported products has slightly decreased between 2008 and 2013, and is lower than Poland and Turkey), a contributing factor for slow economic growth.

The country faces enormous challenges to increase participation in global value chains (GVCs), to facilitate linkages between MNEs and domestic companies, and to accelerate productivity growth. Most promises of deep economic reforms have failed to materialise. As part of the 2014 Memorandum of Economic and Financial Policies with the IMF, authorities affirm that they will continue to pursue the objectives of restructuring Naftogaz and amending relevant laws to allow FDI in companies operating in the gas transport and storage business. The international community has confirmed its commitment to help authorities and is now eagerly waiting for action. It is against this backdrop that the OECD and Ukraine are collaborating.

Recent developments of the Ukrainian economy

As highlighted by Table 1.1, the structure of the economy has been evolving over the past decade or so. In fact, in Eastern Europe Ukraine has been one of the countries most seriously hit by the global financial and economic crisis. First of all, the manufacturing sector has always been central to Ukraine's economy. It was the most important contributor to GDP during the first part of the past decade, but its share of GDP declined steadily from 23% in 2007 to 13%

Table 1.1. **Percentage of real GDP per sector (System of National Accounts 2008)**

Sector	2000	2006	2012*
Agriculture, hunting, forestry and fishing	16.35	8.26	8.97
Mining and quarrying	4.91	4.39	6.54
Manufacturing	20.37	21.40	14.14
Utilities	7.74	4.43	4.17
Electricity	6.72	3.47	3.61
Water supply	1.02	0.96	0.56
Private services	37.10	45.49	49.09
Construction	4.06	4.64	3.21
Wholesale and retail commerce	9.86	13.77	16.66
Transport, storage	10.52	8.99	8.23
Restaurants and hotels	0.55	1.08	0.91
Information and telecommunications	3.31	3.32	3.50
Financial intermediation and insurance	2.18	5.21	4.94
Real estate	4.28	5.25	6.89
Professional activities	1.58	2.21	3.41
Other business services	0.76	1.02	1.34
Public services	12.12	14.21	15.27
Public administration and compulsory social security	4.50	5.36	5.10
Education	4.80	5.30	5.95
Human health and social service activities	2.82	3.55	4.22
Arts, entertainment	0.43	0.69	0.82
Other services	0.97	1.12	1.02
GDP at basic prices	100.0	100.0	100.0

* Preliminary data.

Source: State Statistical Service of Ukraine (SSSU), *Annual National Accounts*, *https://ukrstat.org/en* (accessed on 1 August 2015).

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in 2014. Manufacturing employed an estimated 12% of the labour force in 2009 (according to most recent data from the State Statistics Service of Ukraine). The crisis has had a particularly severe impact on the ferrous metal industry (i.e. cast iron, steel, and steel pipe), mineral fertilisers and sulphuric acid. Second, although Ukraine is also a major producer of grain, sunflower seeds, and beet sugar, the share of the agricultural sector in GDP has also been declining, from 17% of GDP in 2000, to 9.3% in 2012. On the other hand, this sector still employed 17.2% of the labour force in 2012. The contribution of private services, on the other hand, has risen fast, from 37.1% to 49.1% of GDP, with commerce and real estate showing remarkable dynamism (Table 1.1).

In fact, commerce has been the main driver of GDP growth during the 2000s and is now the single-largest contributor to GDP, at 16.7% in 2012.

Ukraine has opened its economy, including trade and investment liberalisation, and sought to expand and diversify its export base. Ukraine's average tariff is comparable to other transition economies that have acceded to the WTO, and lower than the average developing country (Hoekman et al., 2014). This indicates that the present tariff policy of Ukraine does not present substantial anti-export bias and, except for a few sectors with tariff peaks, the tariff regime is not an impediment to Ukrainian development. Nonetheless, several restrictions to private investment persist in certain key sectors (see below).

Merchandise exports have grown five-fold in the 18 years to 2013,[5] and per capita trade has grown 78% since 2008, and yet Ukraine has simply maintained its global market share. A comparison of its trade profile with those of two European emerging economies of comparable size, Poland and Turkey, is illustrative (Table 1.2).

Table 1.2. **Trade profiles – Ukraine compared to Poland and Turkey**

	Ukraine 2008	Ukraine 2013	Poland 2013	Turkey 2013
MERCHANDISE TRADE				
Share in world total exports	0.35	0.34	1.07	0.81
Number of exported products (at the HS6 digit level)	2 289	2 191	3 521	3 404
Number of export markets	131	102	112	115
Share in world total imports	0.43	0.41	1.09	1.33
Number of imported products (at the HS6 digit level)	3 500	3 420	4 110	3 828
Number of import markets	144	148	171	174
Trade per capita (USD, three-year average)	2 311	4 119	12 245	6 151
Breakdown in economy's total exports/by product				
Agricultural products	13.8	28.1	14.1	11.5
Fuels and mining products	11.4	13.5	9.0	8.7
Manufactures	73.6	57.4	76.7	76.1
Breakdown in economy's total exports/by partner				
Partner #1	31.5	26.5	74.3	42.3
Partner #2	22.5	23.8	5.4	7.9
Partner #3	6.2	6.0	2.9	4.6
Partner #4	3.2	4.3	2.2	3.7
Partner #5	3.1	4.3	2.0	3.3
COMMERCIAL SERVICES TRADE				
Share in world total exports	0.41	0.42	0.86	1.00
Share in world total imports	0.35	0.35	0.75	0.51
Breakdown in economy's total exports/by service item				
Transportation	44.8	41.8	30.5	28.2
Travel	33.7	26.2	28.4	60.5
Other commercial services	21.5	31.9	41.1	11.3
ECONOMIC COMPLEXITY INDEX	0.55	0.79	1.03	0.48

Source: Based on WTO, *World Integrated Trade Solution* (WITS) (database), *http://wits.worldbank.org/* (accessed on 1 December 2015); Observatory of Economic Complexity.

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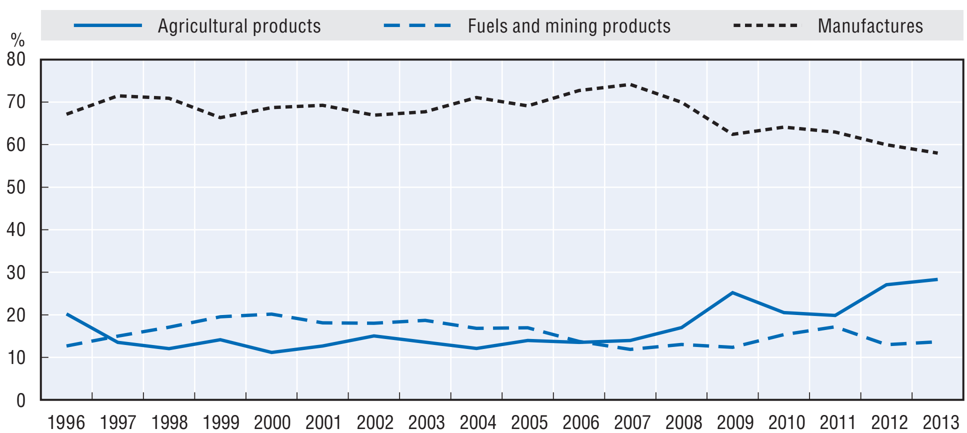
Primary products remain the backbone of commodity export trade. As a share of total merchandise trade, the traditional agricultural exports of wheat, barley, rapeseed and maize have more than doubled from almost 14% in 2008 to more than 28% in 2013. Fuels and mining products also saw their relative participation increase, although at a slower pace. While 73.6% of exports were industrial goods (Figure 1.1) in 2008 – more or less in line with the levels now prevailing in Poland and Turkey – their participation fell markedly to 57.4% in 2013. Most exports are destined for the European Union (EU) market, accounting for 26.5% of total exports in 2013, followed by Russia (23.8%), Turkey (6%) and the People's Republic of China (4.3%). The vast majority of imports also originate from the EU (35.1% of total imports in 2013) and Russia (30.2%) and mainly consist of manufacturing goods and energy, respectively. It is interesting to observe that the incidence of the EU as a trade destination has decreased over time (it accounted for 31.5% of exports in 2010) and is much lower than for Poland and Turkey.

Figure 1.1. **Structure of Ukrainian exports**



Source: WTO, *WTO Statistics* (database), *http://stat.wto.org/Home/WSDBHome.aspx?Language* (accessed on 1 December 2015).

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Unsuccessful integration into the world economy, despite the large benefits Ukraine could derive from trade, owes a lot to insufficient export diversification. In 2012 Ukraine exported fewer products to fewer partners than in 2008; the same is true when the comparison is made with Poland and Turkey (Hoekman et al., 2014). In practice the country's full "export basket" is fairly simple: farming products (corn and soybeans) and metals (iron and steel products). The case of trade with Italy, Ukraine's biggest export market in Western Europe, is exemplary – Ukraine sells a small number of simple goods, such as metals, food, minerals, and wood, and barely any machinery and more sophisticated manufactured goods. On the other hand, Russia buys not only metals, but also more complex manufactured goods, such as railway cars, aircraft parts, and car parts. For the country's medium-term growth prospects, improving trade links with Russia could thus help preserve and possibly upgrade these significant manufacturing sub-sectors.

Although economic integration has been central among the country's priorities in its short history as an independent nation, Ukraine has found it somewhat difficult to choose between two competing partners, the EU and the Customs Union of Russia, Belarus and Kazakhstan (RBK CU) established in the Eurasian Economic Community framework.[6] The talks on Association Agreement with the EU were launched in 1997, followed by technical negotiations of the Deep and Comprehensive FTA (DCFTA) that started in 2008 and were completed in October 2011. Parliament ratification of the agreement was delayed and in April 2014, in response to the seriousness of security, political and economic challenges, the EU unilaterally granted Ukraine preferential access to the EU market until 31 December 2015. DCFTA was finally ratified in September 2014, although the EU delayed implementing the trade accord until 31 December 2015 to guarantee Ukraine's access to the CIS market under the Ukraine-Russia bilateral preferential regime. The cooperation with the CIS countries has been also considered as a strategic priority of Ukraine. Ukraine currently has free trade status (with certain exceptions) with the members of the ECU, but significant non-tariff barriers exist.[7] The border clearance problems in August 2013 dramatically highlighted longstanding trade facilitation problems.

Research has shown that the greatest benefits from preferential trade agreements come from the deep aspects of the agreements, not from the preferential tariff liberalisation. In the case of Ukraine, the application of a supply chain-centred approach to lowering trade costs with, Belarus, Russia and Kazakhstan would be particularly useful. Indeed, lowering trade costs created by regulatory policies will generate much larger gains than changes in import tariffs (see, e.g. Movchan and Guicci, 2011).

Ukraine is not integrated in global value chains

As Ukraine has found it very difficult to attract FDI, especially in non-traditional export sectors, it is also failing to integrate its economy in GVCs where global MNEs play a crucial role. Foreign investors have so far mainly targeted the domestic market, especially non-tradable sectors such as finance, retail trade, and other services. Not only is the share of FDI in manufacturing smaller than in comparable countries like Poland and Turkey. FDI in manufacturing is also heavily concentrated in metallurgy, where the end product is sold as a commodity in global markets. Ukraine would benefit from attracting more export-oriented, efficiency seeking FDI projects in a broader range of manufacturing sub-sectors. Given the recent depreciation of the Hryvnia and competitive labour costs, Ukraine would be well placed to attract FDI into labour-intensive sectors. In this regard, deeper integration into EU value chains (which is consistent with the DCFTA with the EU) in sectors like automotive components or ICT equipment is a valuable option (Adarov et al., 2014).

While the political and security situation has deteriorated in recent years, the problems are long-term and have to do with poor business environment, weak institutions and widespread corruption. It is not surprising that linkages between foreign direct investors and domestic companies, including service SMEs, are underdeveloped and thus depress the competitiveness of Ukraine. The temptation is always strong to overcome these problems through specific measures to promote and facilitate targeted investments, but the emphasis should rather be on improving the business environment throughout the whole spectrum of policy areas. In that regard, Ukraine could benefit from the work of the OECD on GVCs, including in the area of investment policy (Box 1.1).

Box 1.1. **Global value chains and investment policy: key OECD messages**

- Given the important role of Multinational Enterprises (MNEs) in Global value chains (GVCs), lowering investment barriers is an efficient way for a country to become integrated in GVCs. By inhibiting the efficient functioning of GVCs, impediments to cross-border investment can have negative welfare impacts beyond the home and host country.
- The current international investment regime built on thousands of bilateral and regional investment agreements does not adequately reflect the interconnected nature of economies in GVCs. Multilateral co-operation and co-ordination, such as the OECD *Policy Framework for Investment* and the OECD *Codes of Liberalisation*, are needed to maintain the open and predictable international investment climate that has supported international investment in GVCs.
- To realise the full benefits of international investment, investment promotion and facilitation policies need to focus more closely on the activities undertaken in GVCs rather than on industries. These policies must recognise that success in GVCs depends on both inward and outward investment. Governments should avoid incentive wars to attract high-value stages of a GVC and should work together to ensure that the multilateral investment system continues to support growth.
- Large MNEs, including in some cases state-owned enterprises (SOEs) are prominent players in GVCs. This has raised policy concerns, for example about the effects on competition and markets further downstream.

Box 1.1. **Global value chains and investment policy: key OECD messages** *(cont.)*

- GVCs can support the spread of principles and best practices on responsible business conduct. The OECD Guidelines for Multinational Enterprises and implementation tools such as the OECD Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas are policy instruments for promoting responsible business in GVCs.

For further details on OECD work regarding global value chains, please refer to the 2013 OECD report "*Interconnected Economies: Benefiting from Global Value Chains*", *www.oecd.org/sti/ind/interconnected-economies-GVCs-synthesis.pdf*.

Because of these economic dynamics, Ukraine has a chequered history with regards to living standards and poverty reduction. While the poverty rate was reduced from 11.9% in 2000 to 1.9% in 2013 according to the absolute criterion (share of the population whose daily consumption is below USD 5.05 [PPP]), it hardly budged according to the relative criterion (the share of the population below the national poverty line), from 26.4% to 24.5% (UNDP, 2015).[8] In addition, almost every third family with children is poor (32.6%), as is every fifth working person (20.7%). As result of rapid economic growth, particularly prior to the global financial crisis, the poverty rate declined from 14.7% in 2006 to 3.9% in 2012. From 2007 to 2012, consumption for the bottom 40% grew by more than twice that of the rest of the population (3.9% vs. 1.5%). This reflected a higher growth in wage income than for the average of the population (24% vs. 19%), driven by improvements in the education profile of those in the bottom 40%, and a slight decrease in the share of unemployed over the period. Higher growth in social assistance receipts and child benefits also played a role. In 2014, the country was ranked 83rd out of 187 countries on the United Nations Development Programme (UNDP) Human Development Index.[9]

Public spending on education represented 6.7% of GDP in 2012, which is comparable to that of many OECD countries. The adult literacy rate was 99.7% in 2012, the youth one marginally higher at 99.8%, and the gender gap is nihil (UNESCO). According to the World Economic Forum 2015/2016 Global Competitiveness Index, Ukraine is ranked 45th out of 140 economies for the quality primary education and 46th for the quality of higher education. These figures makes Ukraine one the highest ranked countries for the quality of primary and higher education among European transition countries. The country performs much worse in terms of health, with a life expectancy of 71 years (and as low as 66 years for men) despite expenditure representing approximately 7.6% of GDP.

On the political front, Ukraine has found it difficult to establish a transparent and well-functioning democracy. Since 2004, successive democratically elected regimes have proven unable to complete their terms in power. It is hence one of the most politically unstable countries in Eastern Europe and the inefficiency and fragility of its institutions has hindered Ukraine's economic development. Corruption has also been a major problem for businesses in Ukraine.

On top of these factors, Ukraine is facing a number of new challenges that will negatively affect its long-run economic performance and competitiveness. First of all, although Ukraine has maintained a rather low level of income inequality (the Gini index shifted from 0.291 in 2002 to 0.248 in 2010) and 95% of the old-age population is covered by social security, fairness and unequal opportunities are considerable concerns. According to the IMF (2014), "the majority of social assistance is captured by higher-income households who consume the largest share of gas and heat. For instance, the top quintile in the income distribution gets subsidy benefits that are, as a rule, double those of the bottom quintile". High and increasing level of inter-regional inequality is another concern: the dispersion of regional GDP and household income is higher than in most OECD countries. Prior to the 2009 crisis, Kyiv saw its share of GDP grow, while GDP levels and living standards stagnated in the poorer (largely agricultural) regions (OECD, 2013).

Analysis of workplace conditions such as risk of on-the-job injury, various benefits/amenities, and insecurities with wage payments, shows that the inequalities in these conditions do exacerbate inequalities in hourly wages (Nizalova, 2014). The informal sector is relatively large in Ukraine (it was estimated to account for 23% of total employment in 2010) and its size is increasing due to the current economic downturn. Moreover, Ukraine experienced amplified criminality and violence in the 2000s and is faced with organised crime, mainly related to cigarettes, drug and human trafficking (the port of Odessa being notorious for these activities, also due to proximity with Transdniester, the pro-Russian enclave).[10]

The role of foreign direct investment in Ukraine's development

Over the past two decades, Ukraine has evolved as an investment destination. In the mid-1990s some pioneer enterprises in the light industrial sector (food processing and tobacco) established operations in the country, but the stock of foreign direct investment (FDI) in Ukraine was negligible compared to other transition economies in Central Europe (Meyer and Pind, 1999). It was not until the early 2000s – i.e. much later than in other former socialist countries – that the country began to sell off large state-owned enterprises and attract investment. Russian investors figured prominently in Ukrainian privatisation, in particular in energy and telecoms.

FDI stands out among the government's priorities and is well embedded in its current development strategy. The National Development Plan (NDP) 2011-14 has four main pillars of government actions: 1) social welfare; 2) public safety and social peace; 3) environment and land management; and 4) competitiveness and innovation. The last pillar is divided into two strategic objectives: i) increasing production through investments in human capital and infrastructure and increased efficiency; and ii) promoting sustainable growth by expanding and diversifying markets. According to the NDP, FDI has a key role to play in both strategic objectives. Recognised benefits of FDI by the government include bringing capital, creating direct jobs and contributing to increased efficiency and know-how. Particular attention is given by the government to linkages in order to strengthen small and medium-sized enterprises (SMEs).

The Ministry of Economic Development and Trade (MEDT) is in charge of defining the country's FDI policy, overseeing special incentives regimes, and co-ordinating FDI-related strategies and plans.[11] The State Agency for Investment and National Projects (SAINP), directed and coordinated by the Cabinet of Ministers, was responsible for implementing the FDI policy and managing strategic projects.[12] A department was designated for investment promotion (InvestUkraine). After the change of government in March 2014, the SAINP was liquidated and its functions have since then been passed to the MEDT.[13] The investment promotion and facilitation section of Chapter 2 provides further details.

Recent FDI trends

Statistics in Ukraine are compiled in accordance with the most recent international standards: the IMF's Balance of Payments and International Investment Positions Manual, 6th edition (BPM6) and the OECD's Benchmark Definition of Foreign Direct Investment, 4th edition (BMD4) (Box 1.2). Over the past two decades, gross annual FDI inflows to Ukraine have increased at an impressive pace, before decelerating abruptly in 2013 and in particular in 2014 when they reached their lowest level in more than a decade (Figure 1.2). Whereas in 2004 FDI inflows totalled USD 1 711 million, in 2008 it reached USD 10 700 million. Gross FDI inflows nonetheless more than halved in 2009, in the broader context of the global economic slowdown. In 2013, FDI flows to Ukraine declined again by 45%, reflecting mounting concerns about economic management and the business environment, and in 2014 plummeted by 81% in a context of political instability and escalating conflict in the Donetsk and Lughansk regions (Figure 1.2 below). FDI inflows (liabilities) recovered in 2015: they amounted to USD 3 050 million; while FDI inflows (liabilities) were only USD 847 million in 2014. This recovery of FDI inflows is largely due to the recapitalisation of foreign-owned banks, including through debt to equity conversion.

Box 1.2. **Ukraine's foreign direct investment statistics**

Statistics on Ukraine's foreign direct investment (FDI) are compiled and disseminated by both the National Bank of Ukraine (NBU) and the State Statistics Service of Ukraine (SSSU). The FDI statistics of the SSSU are compiled from data collected on quarterly and annual enterprise surveys. The SSSU currently disseminates statistics on inward and outward equity capital FDI positions by partner countries. The surveys used by SSSU have recently been revised to include information recommended in the latest international guidelines, including coverage of transactions and positions between fellow enterprises,* the identification of Special Purpose Entities (SPEs),** and identification information for the ultimate controlling investor. The first results from these revised surveys are expected to be released in 2016.

The NBU is responsible for publishing the quarterly and annual balance of payments and annual international investment position statistics. The NBU's FDI statistics are based on the FDI surveys conducted by the SSSU and on information from an International Transactions Reporting System. These data are supplemented by information on privatizations from the State Property Fund and, for debt instruments, by data from surveys that collect information on the external loans of banks and other enterprises. The NBU disseminates FDI statistics as part of Ukraine's balance of payments and international investment position statistics.

In common with other international organisations, such as the World Bank and UNCTAD, the OECD report refers to the NBU statistics for aggregate FDI flows and stocks and uses the SSSU statistics for the geographical breakdown given that such data are not systematically available in the NBU balance of payments reports.

While the NBU publishes data according to BPM6, there are some important details that are not published, including the amount of reinvested earnings and transactions and positions between fellow enterprises. The revised surveys that the SSSU has begun to use should enable the publication of this additional detail. In addition, these revised surveys should enable the SSSU to publish more detailed statistics on FDI that would be useful for globalization analysis, including supplemental presentations recommended in BMD4. First, the identification of FDI flows and positions associated with SPEs could enable SSSU to publish information on FDI flows and positions excluding SPEs, providing a much better measures of FDI into their country that is having a real impact on their economy. Second, the identification information on the ultimate controlling investor could enable the SSSU to publish statistics on inward investment in the Ukraine that identify the countries of the investors that ultimately control the investments in their country. This presentation shows the country of the direct investor who ultimately controls the investment

Box 1.2. **Ukraine's foreign direct investment statistics** *(cont.)*

and, thus, bears the risks and reaps the rewards of the investment. This presentation can result in substantial changes in the distribution of inward positions by country from the standard presentation by immediate investing country. In addition, this presentation can show inward investment controlled by investors in the reporting economy; this is inward FDI resulting from round-tripping. Round-tripping is when funds that have been channelled abroad by resident investors are returned to the domestic economy in the form of direct investment. It is of interest to know how important round-tripping is to the total inward FDI in a country because it can be argued that round-tripping is not genuine FDI into an economy.

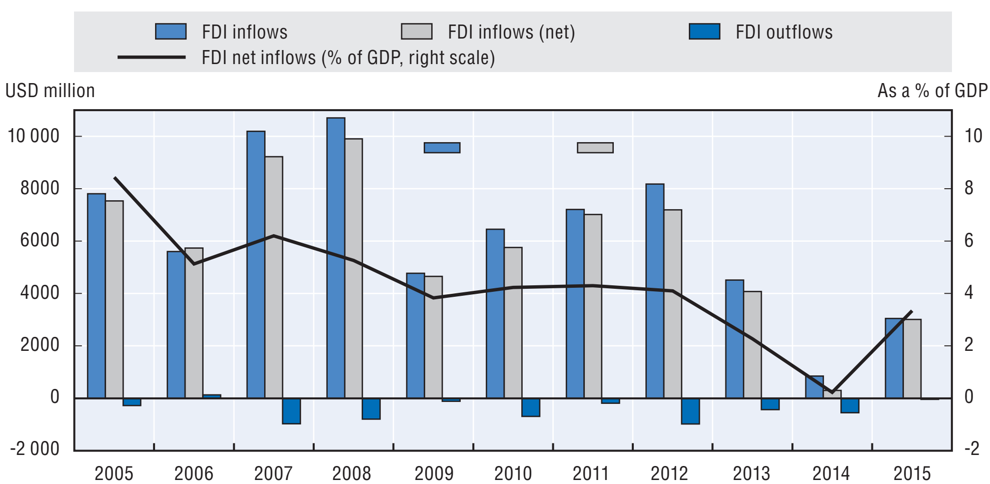
For more information on OECD statistical instruments: *www.oecd.org/investment/statistics.htm*.

* Fellow enterprises are entities that do not have a direct investment relationship themselves but that have a direct investor in common. Transactions and positions between fellow enterprises are included in FDI statistics because these transactions and positions likely resulted from the influence of the common direct investor.

** Special Purpose Entities are entities with little or no physical presence in the host economy but that provide services to the multinational enterprise, such as holding assets and liabilities and raising capital.

Figure 1.2. **FDI Inflows, outflows and net inflows (2004-15)**

USD millions (left axis) and % of GDP (right axis)



Source: Based on National Bank of Ukraine (NBU), *Balance of Payments Statistics* (database), *www.bank.gov.ua/control/en/publish/article?showHidden=1&art_id=19486397&cat_id=47388&ctime=1438695717136* (accessed on 1 March 2016); International Monetary Fund, *World Economic Outlook Database*, *www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx* (accessed on 1 March 2016).

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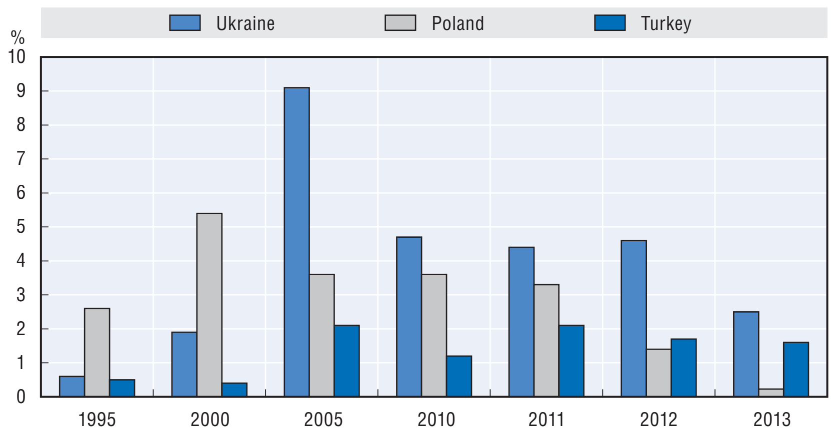
In relative terms, since 2005 FDI flows to Ukraine have performed well: in 2012 they were equal to more than 4% of GDP (Figure 1.2 above). In the 2000s, FDI inflows expressed in percentage of annual GDP have been significantly higher in Ukraine than in Poland and Turkey (see Figure 1.3 below). However, Ukraine's FDI stock *per capita* was well below the level of Poland and Turkey at the end of 2014 (Figure 1.4 below). These results, however, must be interpreted

Figure 1.3. **FDI inflows (gross) as a percentage of GDP in Ukraine, Poland, and Turkey for selected years**



Source: Based on National Bank of Ukraine (NBU), *Balance of Payments Statistics* (database), *www.bank.gov.ua/control/en/publish/article?showHidden=1&art_id=19486397&cat_id=47388&ctime=1438695717136* (accessed on 1 March 2016); International Monetary Fund, *World Economic Outlook Database*, *www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx* (accessed on 1 March 2016).

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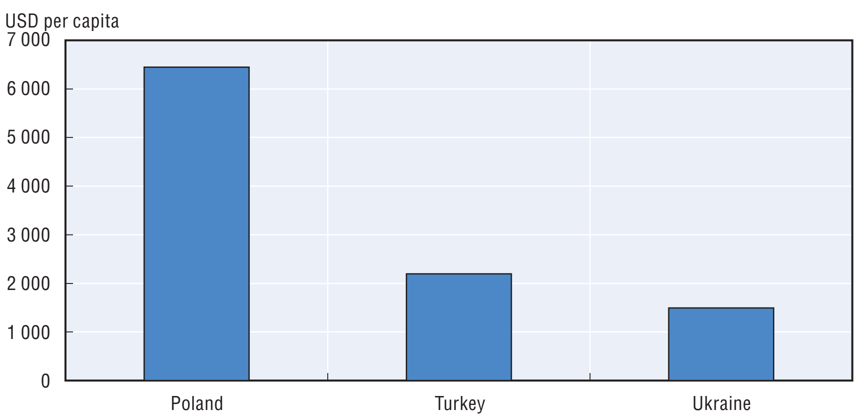
Figure 1.4. **FDI inward stock per capita, 2014**



Source: Based on UNCTAD, WIR Annex Tables, *http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx* (accessed on 1 March 2016).

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with caution, insofar as a sizeable portion of *prima facie* foreign capital may in fact correspond to round-tripping FDI: official statistics therefore overestimate the real level of inward FDI.

FDI inflows to Ukraine have been mostly composed of mergers and acquisitions (M&As, see Table 1.5 below), as Ukrainian companies were targets of significant deals from 2005 to 2011. However, Ukraine attracted remarkably little Greenfield FDI. The value of announced Greenfield projects to Ukraine has been consistently lower than in Poland and Turkey during the last 10 years (Table 1.3 below).

Table 1.3. **Value of announced Greenfield FDI projects 2004-14 (USD million)**

Year/Country	Ukraine	Poland	Turkey
2004	3 356	14 247	4 402
2005	5 814	13 882	4 922
2006	4 921	15 603	11 699
2007	7 050	18 336	15 426
2008	7 644	28 567	19 499
2009	4 463	13 804	19 619
2010	4 062	11 076	9 483
2011	2 869	10 820	11 185
2012	3 061	10 839	8 996
2013	4 669	8 848	9 714
2014	1 090	7 503	4 779

Source: UNCTAD, WIR Annex Tables, *http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx;* data from FDI markets (accessed on 1 March 2016).

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FDI by country of origin

The breakdown by nationality shows a predominance of foreign investors from OECD countries, with the exception of Cyprus[14] that is by far the single largest country of origin (Figure 1.5 below), accounting for 27.7% of the inward FDI stock at October 2015. One possible explanation for such a high share of Cyprus is that some Ukrainian investors channel investments through the Cypriot banking sector to finally re-invest in Ukraine, which gives rise to "round-tripping" FDIs. Beyond Cyprus, round tripping concern other "offshore" jurisdictions, for instance the British Virgin Islands (BVI), Luxembourg and the Netherlands. Indeed, the British Virgin Islands was the seventh largest foreign investor in Ukraine (4.2% of total FDI stock) as of October 2015. However, the exact share of round tripping in bilateral FDIs between Ukraine and these jurisdictions is unknown.[15]

The high share of Cyprus in the overall inward FDI stock probably also reflects trans-shipping investments from Russian multinational enterprises

Box 1.3. **The Cyprus* – Ukraine investment relationship**

Cyprus was the largest foreign investor in Ukraine at the end of 2010, with an inward FDI position of USD 9 billion (State statistical service of Ukraine). However, according to national data accessed through Eurostat, the outward FDI position of Cyprus in Ukraine was much smaller at USD 163 million at the end of 2010 (most recent data available).

How to reconcile these two observations? Cyprus outward FDI data exclude special purpose entities (SPEs), which on the other hand account for most of Ukraine's inward FDI transactions from Cyprus.

The existence of SPEs – holding companies with little or no physical presence in the host economy – is one important factor that can distort FDI statistics. First, transactions by SPEs inflate the FDI flows into and out of the country where they are located as investment passes through via SPEs to its ultimate destination. Second, SPEs can distort the geographic distribution of FDI statistics for countries that host a significant number of them because it can appear they are receiving investment from countries whose investors are just passing capital through SPEs. Likewise, it can appear that investors from this country are investing abroad when that investment really reflects the funds that have been passed through.

Round-tripping (Ukrainian investors) or trans-shipping FDI transactions (for instance, Russian investments channelled to Ukraine through Cyprus) can have different motives, such as tax advantage or ensuring confidentiality of the ultimate controlling investor. In addition, under some existing Ukrainian investment treaties as generally interpreted, a Ukrainian national can obtain treaty coverage for an investment as "foreign" by channelling its investment in Ukraine via a subsidiary in a foreign jurisdiction (see Chapter 2, Box 2.6).

In 2012, Ukraine and Cyprus signed a new double tax treaty to replace a 30 year-old USSR-Cyprus Treaty. It created a new framework which ensures that bilateral investment benefits from a stable and favourable tax environment. Another motive may be institutional arbitrage: Cyprus gives investors access to a stable and modern legal environment under English law, where the enforcement of property rights (particularly, shareholder rights) is less uncertain than in their domestic economy (Wilson, 2015).

Kokko and Kravtsova (2012) argue that most of the round-tripping FDI in Ukraine has been directed to Eastern Ukraine. Their empirical study suggest that "round tripping" inward FDI from Cyprus and other offshore jurisdictions do not have the positive spillover effects on local firms expected from "regular" inward FDI.

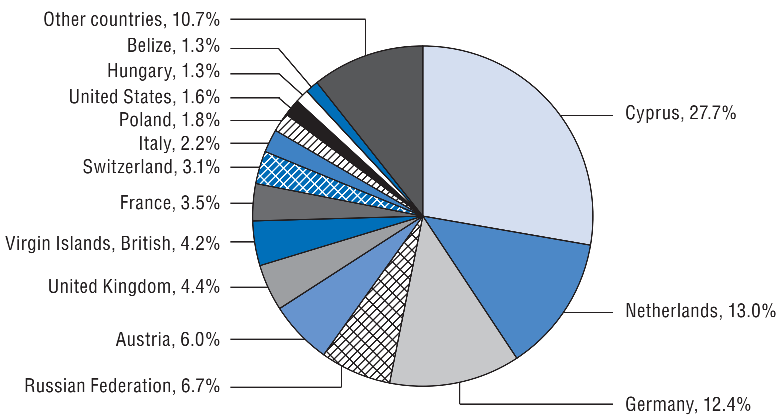
In 2012-13, Cyprus went through a dramatic sovereign and banking crisis. A haircut was imposed on deposits above EUR 100 000 in Cyprus's largest banks

Box 1.3. **The Cyprus* – Ukraine investment relationship** *(cont.)*

as part of the March 2013 bailout package. The impact on FDI flows to Ukraine is unclear. According to SSU data, the FDI stock from Cyprus grew throughout 2012 and 2013 to reach one third of the overall FDI stock at the end of 2013. The share of Cyprus in the overall FDI stock declined abruptly in 2014, which could reflect a withdrawal of capital from Ukraine by Russian and domestic investors (UNCTAD, 2015).

* Footnote by Turkey: The information in this document with reference to "Cyprus" relates to the Southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".
Footnote by all European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

Figure 1.5. **Inward FDI stock by country of origin (October 2015)**



Source: State Statistical Service of Ukraine (SSSU), *https://ukrstat.org/en* (accessed on 8 January 2016).

StatLink http://dx.doi.org/10.1787/888933355759

(MNEs) which use Cyprus as an offshore centre (Kononov, 2012; Kuznetsov, 2011). Round-tripping is also relevant for Ukraine's exposure to claims by foreign investors under international investment agreements (see Box 1.3 above).

Kvashnin and Kuznetsov (2014) use a database based on a systematic analysis of corporate reporting (CIS and Georgia Mutual Direct Investment Monitoring Database) and business news to measure mutual FDI in the CIS and Georgia. Their data confirms that the Russian FDI stock in Ukraine is underestimated by official statistics due to trans-shipping FDI through offshore jurisdictions (for instance, through Cyprus). According to their estimate (which only includes projects with value in excess of USD 3 3 million), at the end of 2014 the Russian FDI stock in Ukraine (USD 9.9 billion) was more than three times higher than reported by the State Statistics Service of Ukraine (USD 2.7 billion).

Although considerably lower than Cyprus, the Netherlands constitutes the second largest source of inward FDI with 13% of the overall FDI stock, and is closely followed by Germany[16] (12.4%, see Figure 1.5). All other significant investors (among which Austria, the United Kingdom, France, Italy, and Poland) are also from the European Union, with the exceptions of Switzerland (3.1%) and the United States (1.6%). While EU countries account for 77.2% of the total inward FDI stock, the EU share is likely overstated given the importance of Cyprus in the inward FDI Stock and its popularity as a flow through country with non-EU Investors. Indeed, Special Purpose Entities (SPEs) account for most of inward FDI transactions from Cyprus.

The outward FDI position of OECD countries in Ukraine, when available[17] (Table 1.4 below), is a useful complement to Ukrainian FDI statistics. As of March 2015, the OECD disseminates FDI statistics from member countries

Table 1.4. **Outward FDI stock positions of selected OECD countries excluding SPEs**

Investments excluding resident SPEs, except for Sweden, Denmark, the Netherlands and the United Kingdom (SPEs included for these countries)

Origin country	OECD BDM4 Data (Millions USD)	SSSU Data (Millions USD)
Netherlands*	12 358	5 544
Austria	2 499	3 179
Italy	1 189	1 210
France	1 011	1 741
United States	931	935
Sweden*	757	439
Hungary	542	686
Greece	530	333
United Kingdom*	489	2 768
Estonia	358	180
Poland	354	840
Denmark*	64	174
Slovenia	61	36
Czech Republic	58	83
Iceland	21	19
Norway	15	9
Korea	12	172

* Data includes FDI by Special Purpose Entities.

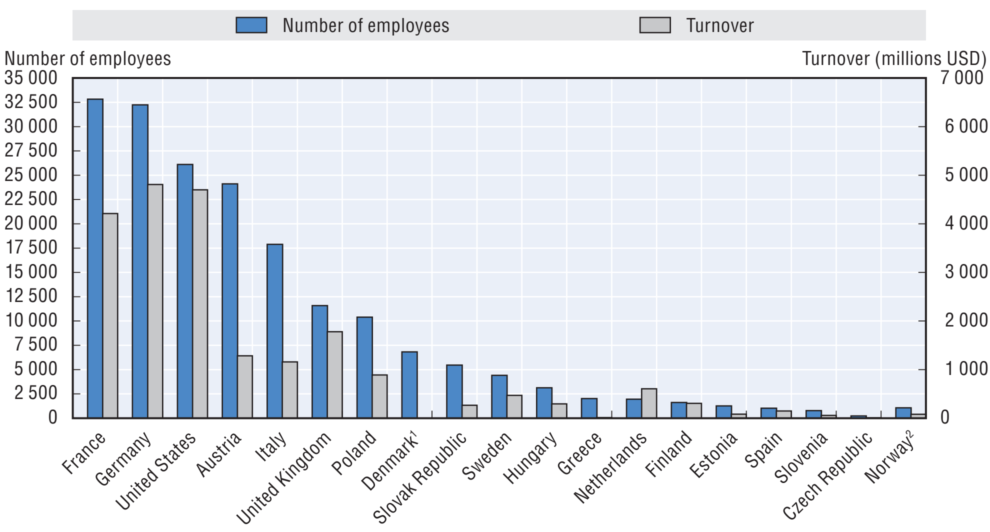
Source: OECD International Investment Statistics Database (BDM4), *http://stats.oecd.org/index.aspx* (accessed on 1 December 2015); State Statistical Service of Ukraine (2015), *https://ukrstat.org/en/operativ/operativ2015/zd/ivu/ivu_e/ivu0415_e.htm* (accessed on 1 December 2015).

StatLink http://dx.doi.org/10.1787/888933355885

according to the fourth edition of its Benchmark Definition of Foreign Direct investment (BMD4). For most countries, it excludes SPEs, whose role is to facilitate the internal financing of MNEs but that have little or no physical presence in an economy. Excluding such entities from FDI statistics give a much better measure of the FDI that have had a real impact on Ukraine's economy. Overall, this confirms that EU countries, along with the United States, are important foreign investors in Ukraine.

Data on the activities (employment, turnover) of foreign affiliates in partner countries (Foreign Affiliates Statistics, FATS) are available for some OECD countries (Figure 1.6 and Statistics in Annex C – Table C.1 and C.2). In 2012, MNEs from the European Union had roughly 200 000 employees in Ukraine, and MNEs from the United States had about 26 000 employees. For the purposes of comparison, Metinvest, the largest Ukrainian private conglomerate, had 104 000 employees at the end of 2012. Since 2010, the number of employees of EU affiliates has been stable, while the United States reported a 13% increase. Using cumulated turnover of affiliates rather than employment (Figure 1.6) introduces only small changes to the list of leading OECD foreign investors in Ukraine.

Figure 1.6. **Employment and turnover by foreign affiliates from OECD countries in Ukraine (2012)**



* Turnover non-available (confidential);** 2011.

Source: Eurostat, Outward FATS, main variables – NACE Rev. 2, *http://appsso.eurostat.ec.europa.eu/nui/show.do* (accessed on 1 December 2015); US Bureau of Economic Analysis; *www.bea.gov/iTable/iTable.cfm?ReqID=2&step=1#reqid=2&step=3&isuri=1&202=13&200=1&201=2* (accessed on 1 December 2015); OECD *AMNE Database*, *http://stats.oecd.org/* (accessed on 1 December 2015).

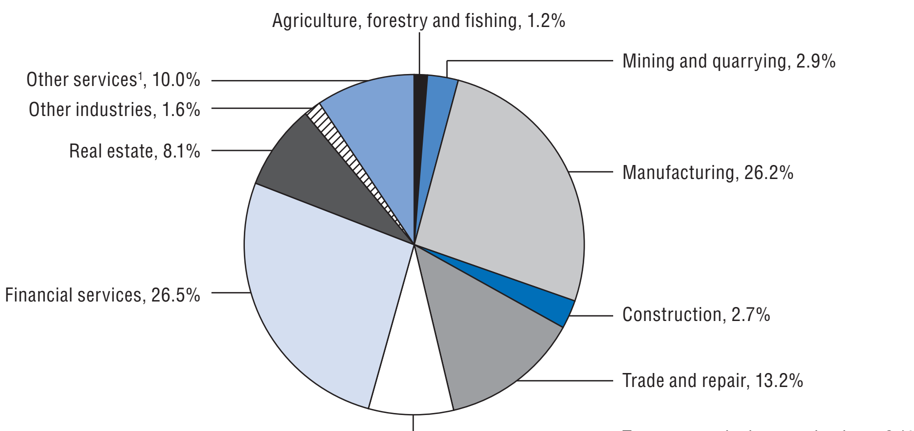
StatLink http://dx.doi.org/10.1787/888933355762

The regional distribution of the inward FDI stock is very uneven, with Kyiv accounting for 51.6% of the total, followed by Dnipropetrovsk (16.5%), and other urban centres (Donetsk, Kharkiv, Odessa and Lviv, respectively from 4.9% to 2.9%). This may reflect that many large foreign-owned corporations are incorporated in Kyiv, even though they often operate at the national level.

FDI in Ukraine by sector

As noted above, Ukraine has been rather unsuccessful in diversifying away from agri-industry and heavy industry and towards more technology-intensive activities since the 1990s. In mid-2015, the total inward stock was still dominated by financial services (26.5%) and manufacturing (26.2%, Figure 1.7), even though trade and repair now represents more than 13% of the total FDI stock. Metallurgy alone accounts for half of the total FDI stock in manufacturing and 12.2% of the overall FDI stock. The sector is central to Ukraine's economy: regardless of a decrease in steel production, Ukraine remained the 10th largest steel producer in the world in 2014.[18] Despite the country's comparative advantage in agriculture, the share of this sector in total FDI stock is very modest (1.2%), reflecting unpredictable regulatory changes in the sector and grain export restrictions (OECD, 2015b).

Figure 1.7. **Inward FDI stock by sector (October 2015)**



1. Other services are mainly business and professional services, accommodation, health and social services.
Source: Based on State Statistical Service of Ukraine (2015), *https://ukrstat.org/uk/druk/publicat/kat_u/publ10_u.htm* (accessed on 1 December 2015).

StatLink http://dx.doi.org/10.1787/888933355777

Since 2010, non-tradable services (wholesale and retail trade) and real estate have absorbed a growing share of total inward FDI flows. In contrast, the share of financial services decreased from 32% (end-2010) to 26.5% of total FDI stock (October 2015). This is primarily due to divestments by EU-based commercial banks between 2010 and 2013. As a consequence, the share of non-Russian foreign banks in total banking assets declined from 31% (end of 2010) to slightly above 20% at the end of 2014, while the share of Russian banks (16%) increased slightly (Barisitz and Fungáčová, 2015; see also sections on the banking sector in Chapter 3).

Most FDI inflows correspond to mergers & acquisitions (M&A) in the financial sector, mining and metallurgy, telecommunications, construction materials and food processing. In 2014, the largest inward M&A deal since Maidan saw Alfa Bank (part of Russia's Alfa Group) acquire the Ukrainian assets of the Bank of Cyprus (Table 1.5 below). M&A data indeed confirm that official FDI statistics tend to underestimate Russia's presence in the Ukrainian economy, insofar as Russian investment is often channelled through SPEs domiciled in Cyprus, Luxembourg and other jurisdictions. Moreover, investments from many other countries are also understated by official FDI Statistics in Ukraine given the high share of Cyprus, the Netherlands, British Virgin Islands and Austria in the inward FDI stock. Indeed, SPEs account for a significant share of FDI from these countries.

Table 1.5. **Major foreign M&A deals in Ukraine, 2005-15**

Year	Sector	Investor	Source country	Value (USD million)
2005	Steel	Arcelor/Mittal	Luxembourg	4 800
2005	Banking	Raiffeisen International	Austria	1 028
2005	Banking	BNP Paribas	France	465
2005	Telecom	Vimpelcom[1]	Russia/Netherlands	280
2006	Banking	Credit Agricole	France	262
2006	Banking	OTP Bank	Hungary	821
2007	Agrifood	Pepsico	United States	542
2007-08	Iron ores	Evraz	Russia	2 663
2008	Banking	UniCredit	Italy	2 076
2008	Banking	Private investor	Russia	350
2008	Banking	Intesa Sanpaolo	Italy	730
2010	Telecom	Vimpelcom[1]	Russia/Netherlands	5 515
2010	Energy	TNK-BP[2]	Russia/United Kingdom	313
2011	Steel	Mechel	Russia	537
2014	Banking	Alfa Bank	Russia	276

1. Vimpelcom is a joint venture between Alfa Group (Russia) and Telenor (Norway) with headquarters in the Netherlands.
2. Russian state-owned Rosneft acquired TNK-BP in March 2013.

Source: Dealogic, *www.dealogic.com/* (accessed on 1 October 2015).

StatLink http://dx.doi.org/10.1787/888933355895

Low FDI inflows are reflected in the limited weight of foreign capital among Ukrainian companies of the annual Deloitte Central Europe "Top 500" ranking.[19] In 2014, only 7 out of the 32 (22%) Ukrainian companies in the ranking are foreign-owned, accounting for 13% of their cumulated turnover (Table 1.6). The weight of foreign firms is much higher in almost all other Central European countries (both EU and non-EU members). For instance, among the 170 largest firms in Poland, 90 (53%) are foreign- owned, accounting for 43% of the cumulated turnover of the 170 largest firms.

Table 1.6. **Ownership of Ukraine's largest companies by turnover (USD million)**

Status	2012		2013		2014	
	Turnover *(share of total)*	Number	Turnover *(share of total)*	Number	Turnover *(share of total)*	Number
Local	59 679 *(53%)*	28	63 714 *(54%)*	28	42 612 *(55%)*	18
State-owned	37 059 *(33%)*	9	32 399 *(28%)*	7	25 504 (*33%)*	7
Foreign	15 356 *(14%)*	14	21 274 *(18%)*	18	9 870 (*13%)*	7
TOTAL	112 095	51	117 386	53	77 985	32

Source: Based on Deloitte CE Top 500 Ranking, *http://www2.deloitte.com/global/en/pages/about-deloitte/articles/central-europe-top500.html.*

StatLink http://dx.doi.org/10.1787/888933355907

One exception is mobile telephony, which is dominated by foreign operators: they include Kyivstar (a subsidiary of Norway's Telenor and Russia's Alfa Group) and MTS Ukraine (fully owned by Russia's Mobile TeleSystems). In June 2015, Turkcell (Turkey) announced a USD 100 billion investment into the third-largest mobile phone operator in Ukraine, giving him full control over the company. Foreign companies are also prominent players in Agribusiness (Cargill, Bunge, Louis Dreyfus), Food processing and Consumer products (JTI, Phillip Morris, Nestle, Procter & Gamble). Despite a recent reflux, foreign presence is also significant in the financial sector (see chapter 4 for more details). In retail, international players such as Metro Group, Auchan, Rewe Group (Billa) and Spar compete with local companies ATB Market and Fozzy Group that lead the market in terms of gross sales. Foreign presence is more modest in the manufacturing sector, even though steelmakers Evraz (a Russian Steel multinational) and Arcelor Mittal are among the largest companies in Ukraine.

Notes

1. See World Bank (2015), *Ukraine – Economic Update*, 29 April 2015, *www.worldbank.org/content/dam/Worldbank/document/eca/ukraine/ua-macro-april-2015-en.pdf*.
2. Natalia Jaresko, a U.S. citizen, became finance minister; Lithuanian Aivaras Abromavicius economy minister; and Aleksandre Kvitashvili of Georgia minister of health care.
3. The Commonwealth of Independent States is a regional organisation set up during the breakup of the Soviet Union by former Soviet Republics.

4. World Bank Development Indicators.
5. Whereas in 1996, Ukraine's total merchandise exports amounted to USD 14 232 million, in 2013, they reached USD 62 679 million.
6. The Eurasian Economic Community was terminated from 1 January 2015 in connection with the launch of the Eurasian Economic Union.
7. Russia has threatened to extend its food ban to Ukraine and to end the CIS preferential trade regime for Ukraine in case the country implements DCFTA with the EU.
8. The criterion of relative poverty, as determined by the Poverty Reduction Strategy, is equal to 75% of median level of expenditures, while for absolute poverty it is the minimum subsistence level defined by the national law.
9. The Human Development Index takes into account not only the standard of living but also social indicators, notably education and health.
10. Mikheil Saakashvili, a former President of Georgia, was appointed the new governor of Odessa in May 2015.
11. Jaanika Merilo, a member of the Estonian parliament of Ukrainian origin, was appointed the government advisor on foreign investment in January 2015.
12. Its main elements, as set out in 2011, included: implementation of the one-stop shop, creation of Project Marketplace as database of investment opportunities, and active promotion of the most significant projects, both of local and industries scope.
13. Resolution No. 442 of the Cabinet of Ministers "On Optimization of Central Executive Authorities" (10 September 2014) also liquidated the State Service for Personal Data Protection, the State Service for Combating HIV/AIDS and Other Socially Dangerous Diseases, the State Agency for Tourism and Resorts, the State Assay Service, the State Inspection for Price Control, the State Agricultural Inspectorate, and the State Environmental Investment Agency. The State Service for Food Safety and Consumer Protection, the State Service of Geodesy, Cartography and Cadastre, the State Service for Transportation Safety, the State Service for Medical Products and Drug Control, the State Service for Labour, the State Inspectorate for Energy Supervision were created as a result of reorganisation by merger. The State Agency for Restoration of Donbass was created separately.
14. Footnote by Turkey: The information in this document with reference to "Cyprus" relates to the Southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

    Footnote by all European Union member states of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.
15. Ukrainian investors also channel foreign direct investments to third countries ("genuine outward FDI") through the jurisdictions mentioned in this chapter. Conversely, some genuine foreign direct investors also channel their investments into Ukraine through these jurisdictions.
16. The high share of Germany mainly reflects the fact that the largest foreign investor in Ukraine, Arcelor Mittal, controls its Ukrainian affiliate (ArcelorMittal Kryvyi Rih) through a German entity.

17. BMD4 data is not yet available for several significant OECD investors in Ukraine, among which Germany.
18. *World steel in figures 2015*, Worldsteel Association.
19. Deloitte Central Europe Top 500 is a ranking of the 500 largest non-financial companies in Central Europe, excluding Russia and Belarus. The ranking is based on revenues reported by a particular legal entity operating in Central Europe. For more information: *http://www2.deloitte.com/global/en/pages/about-deloitte/articles/central-europe-top500-2014.html*.

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