Attracting foreign investment to Ukraine: Quantitative and qualitative aspects

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1. The importance of foreign investment

Foreign investment (FI): Crucial topic for Ukraine

- FI can increase the amount of capital in the economy and thus tackle the problem of capital scarcity
- Contribution to higher private and public investment
- Higher economic growth and welfare possible
- On top: FI often contributes to the adoption of modern production & management technologies as well as better standards of bookkeeping and reporting (more transparency)

<u>Conclusion</u>: Very important topic; long-term perspective

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2. FI policy: Quantity and quality matter

Obvious goal for government regarding FI:

- Attraction of significant amounts of FI
- Quantity matters

However:

- Effect of FI on the economy and its financial stability depends strongly on the form of FI
- Thus: Need to distinguish between different forms of FI
- On top: Need to create a healthy structure of FI/capital inflows
- Conclusions: Not only quantity, but also quality of FI matters

Illustration:

- 2007/2008: Ukraine attracted high quantities of FI
- But: Unhealthy structure; too much (short-term) bank loans and too little FDI led to increasing external vulnerabilities
- Result: International financial crisis hit Ukraine very strongly
- Thus: Need to learn the lessons from recent crisis

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2. FI policy (cont'd)

Goal of this policy briefing

- Recommendations on how to attract more FI (quantitative view)

- Separate analysis for different positions in the capital account:
  - Direct investment (FDI)
  - Portfolio investment (equity and bonds)
  - Other investment (loans)

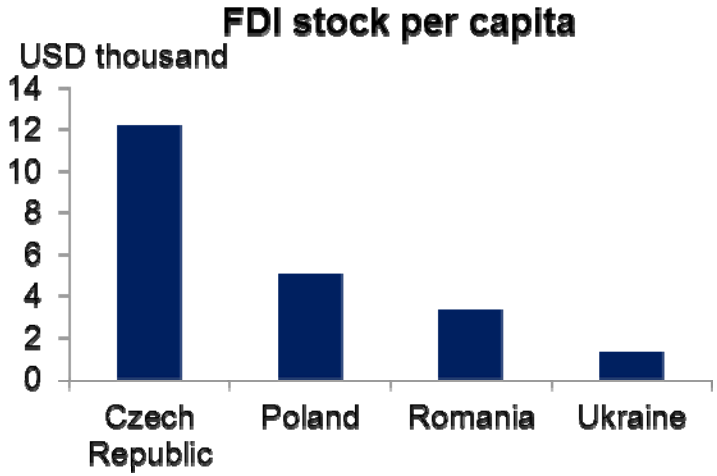
- Recommendations on a healthy &sustainable structure of FI (qualitative view)

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3.1. Direct investment (FDI)

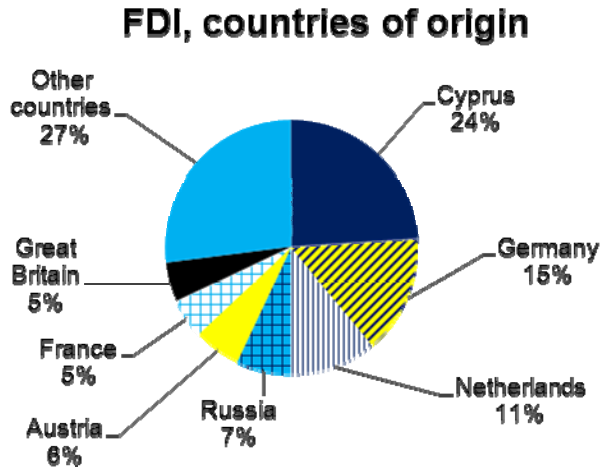
FDI stock in Ukraine

- Very low in international comparison



Source: National Statistical Offices

- Cyprus No. 1 country of origin: “Foreign”?



Source: National Statistical Offices, Stock 2010

Conclusion:

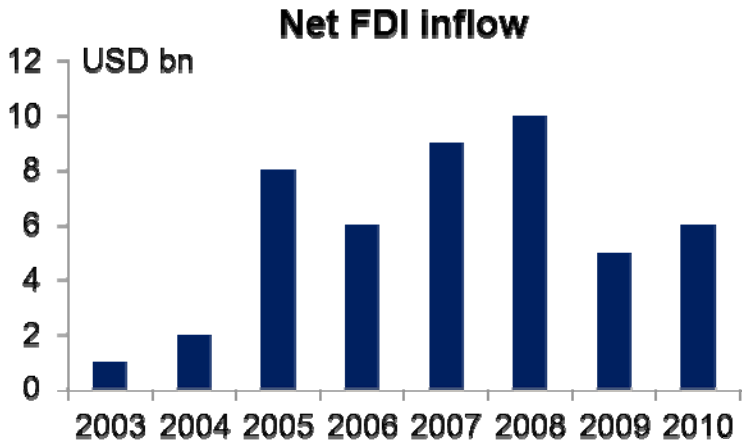
- Very low FDI stock
- “Real” FDI stock probably even lower than official data

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3.1. FDI (cont'd)

FDI flows into Ukraine:

- Relatively low flows in recent years
- Flows did not recover after the crisis



Source: National Bank of Ukraine

Conclusion: Neither FDI stock nor FDI flows are satisfactory

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3.1. FDI (cont'd)

What to do?

i. Improvement of business/investment climate

- In last two years: Important measures to improve legislation (Tax Code, deregulation,…)
- But at the same time: Business people report about higher corruption and a lack of rule of law
- Improving legislation is important, but business people care about real conditions for doing business, not just legislation

Recommendation 1: Government should focus on better legislation AND on the adequate implementation of legislation

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3.1. FDI (cont'd)

What to do?

ii. The role of the investment promotion agency ("SAINP")

- Current focus of promotion agency: National projects
- Approach: State defines the investment areas and projects
- Consequently: Agency looks for "investors" to finance the project
- View of Western private investors: Dislike of this approach
- Common comment: "I am an investor, not a bank"

Recommendation 2:

- Agency should change its focus
- Instead of national projects, agency should focus on greenfield investment for big, medium and small investors
- In short: Agency should follow best international practice, see PB/14/2011

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3.1. FDI (cont'd)

What to do?

iii. Political governance

- Ukraine is again making headlines in international news
- But: Very negative reporting about the political situation
- For investors: Political governance and the perspective for a peaceful handover of power between democratic parties crucial for investment decisions
- Otherwise: Change in power in the future might put the investment project at risk
- Thus: Improvement of international image of Ukraine regarding politics is crucial for attracting Western FDI

Recommendation 3:

- Resolving current political and image problems should be an immediate goal of the authorities, also for FDI attraction

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3.2. Portfolio investment (equity and bonds)

- Existing portfolio flows are mainly directed into instruments issued and traded off-shore and in FX
  - Eurobonds and shares traded abroad
- Local markets remain underdeveloped

- Stock market:
  - Low liquidity/free float
  - No real IPO activity

  (only abroad)

- Bond market:
  - Small and illiquid sovereign

  and corporate bond market



Source: World Bank (2009)



Source: World Bank, own calculations (2009)

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3.2. Portfolio investment (equity and bonds)

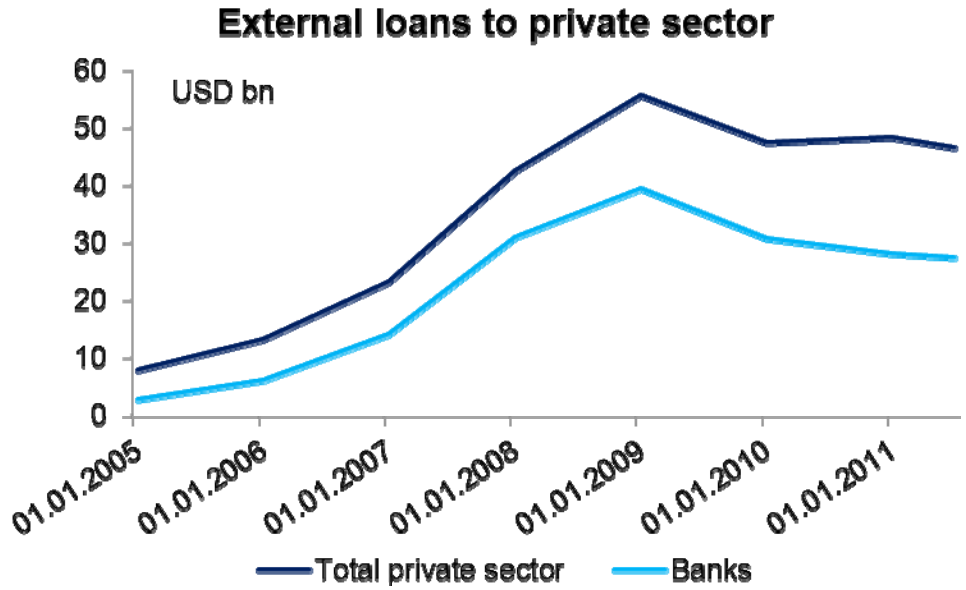
What to do?

- Accelerate development of local equity market (i.e. stock exchange)
- Develop a liquid local market for sovereign bonds
  - Build a medium- to long term sovereign yield curve that facilities also the corporate bond market
- Facilitate access of foreign investors to local markets

Recommendation 4: Developing local bond and equity markets with the increased participation of foreign investors might facilitate portfolio flows and help to reduce risks associated with such flows

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3.3. Other investment (loans)



Source: NBU (External Debt Statistics)
Note: Only external loans to private sector (banks and other sectors) are show; trade credits and intercompany lending are excluded

- Rapid growth in cross-border loans before the crisis made Ukraine susceptible to roll-over risk
- Deleveraging process that started in the crisis continues; especially banking sector is concerned

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3.3. Other investment (cont'd)

Interpretation:

- Reduction in cross-border lending to banking sector ("de-leveraging") is a necessary adjustment process
- Authorities should not try to interfere with this process

Key problem:

- Domestic bank borrow in foreign currency, but can only lend (with exemptions) in local currency; no effective hedging instruments in place

What to do?

- Bank and financial sector reform: Acceleration of structural reforms could slow down the reduction in cross-border lending

Recommendation 5:

- Adoption/implementation of legislative reforms for better protecting creditors and for facilitating mergers & acquisitions in banking sector
- Establishment of hedging instruments to deal with FX risks
- See list of recommendations in PP/02/2011

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Focus: Privatisation

When discussing the quantity of FI that can be attracted, privatisation of state assets should be considered carefully, as this can be bring FI in different forms into the country:

- FDI (sale to a strategic investor)
  - As a rule, each dollar in privatisation revenues generates an additional 35 cents in new FDI inflows (World Bank)
- Portfolio capital (when conducted via local/foreign stock exchange)
  - In case local stock exchange: This could facilitate market development (see e.g. experience of Poland)

Direct positive impact of higher foreign participation on privatisation revenue (i.e. higher prices)

Recommendation 6: Privatisation is an crucial instrument to attract foreign investment. Necessary: Open and transparent privatisation framework and process

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4. Qualitative aspects of FI

FI: High opportunities for a country

But: At the same time significant risks for financial stability, as shown in 2008/2009 (international financial crisis)

Key question:

- How to secure the opportunities without creating unnecessary risks for financial stability?
- Answer: Structure/quality of FI crucial

Widely accepted rules (following international experience):

- Long-term FI more stable than short-term
- FI involving production activities more stable than purely financial transactions
- Official lending (IFI's, bilateral) more stable (and usually cheaper) than private lending

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4. Qualitative aspects of FI (cont'd)

Recommendation 7:

- FDI should be treated with highest priority, since it entails many positive aspects without endangering financial stability
- Stronger cooperation with IFI's, since typically longer terms and/or better conditions than private lending
- In particular: Swift agreement with IMF on program continuation extremely important, given the multiplying nature of such agreements on official lending by other institutions as well as the attitude of private investors towards Ukraine

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5. FI policy and the exchange rate

- Currently in Ukraine: Significant pressure on the exchange rate and on official reserves
- Key question: Is this a legitimate motive to become more active in the attraction of foreign investment?
- Our view: Not a legitimate motive!

Reasons:

- Attraction of foreign investment is a long-term topic
- If reducing pressure on currency becomes the dominant motive, then little emphasis will be put on the structure/quality of FI
- Risk: Short-term deals with unfavourable conditions; higher vulnerabilities in the medium- and long-term
- Furthermore: FI policy is not an instrument to deal with short-term balance of payments problems
- Appropriate macroeconomic instruments:
  - Exchange rate policy
  - Monetary and fiscal policy

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6. Final remarks

- FI of crucial importance for the Ukrainian economy
- The times of easy FI attraction as before the crisis are over
- As of today: Much more difficult to attract FI, since investors became more cautious
- Thus: Ukraine needs to make important steps to become more attractive as a destination of FI
  - Need to attract more FI (quantitative aspect)
  - However: Also quality/structure of FI very important
- Important prerequisite: Macroeconomic stability
  - Low and stable inflation
  - No significant external and internal imbalances
- Current Priorities:
  - Quick resumption of IMF program
  - Increased efforts with respect to FDI attraction; new approach of promotion agency is needed

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