Foreign direct investment inflows and macroeconomic risks in Ukraine

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Abstract. The research focuses on the analysis of the foreign direct investment (hereinafter FDI) inflows to Ukraine and the macroeconomic risks connected with investing. According to the State Committee of Statistics, the largest FDI inflows to Ukraine as of January 1, 2011 were from Cyprus, with 22.2% of cumulative FDI, Germany with 15.8%, the Netherlands with 10.5%, Russia with 7.6%, Austria with 5.9%, France with 5.3% and the United Kingdom with 5.1%. The lion’s share of FDI to Ukraine was invested in the financial services and industry sector: USD 15 billion or 33.7% of total FDI and USD 14 billion or 31.4% of total FDI respectively.

There are several key macroeconomic risks for foreign investors to Ukrainian economy. The critical external factors for Ukraine’s economy include global commodities prices, primarily steel and oil and global appetite for emerging markets debt.

Regardless before mentioned risks, according to the United Nations trade and development body annual report on global FDI, Ukraine is the leader among the Commonwealth of Independent States (hereinafter CIS) countries in the FDI growth. FDI flow into Ukrainian economy increased by 35% up to USD 6.5 billion in 2010, making Ukraine one of the leading investment recipients in the CIS region. Recently, the global rating agency Fitch Ratings raised Ukraine’s long-term foreign credit rating from stable to positive. Notably, according to the World Investment Report 2011, the Ukrainian FDI flow constitutes 23% of gross fixed capital formation. At the same time, the average rate for the CIS is 15.1% and for the world – 9.1%.

Keywords: FDI inflows to Ukraine, macroeconomic risks, Ukrainian economy

JEL Codes: F02, F21, F36, F43, F47

Introduction

FDI is generally considered as a driving force in the integration of developing countries into the globalization process that characterizes the world economy. Although most FDI is concentrated in developed countries, developing countries have made the biggest gains in the 1990s in terms of flows of inward FDI.

OECD Benchmark Definition of the FDI [2] determine it as a category of investment that reflects the objective of establishing a lasting interest by a resident enterprise in one economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy other than that of the direct investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence (not necessarily control) on the management of the enterprise. The direct or indirect ownership of 10% or more of the voting power of an enterprise resident in one economy by an investor resident in another economy is the statistical evidence of such a relationship.

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Global investment trends

It is mentioned in the OECD “FDI IN FIGURES” [3] that according to preliminary estimates, in the first quarter 2011 worldwide FDI activity remained stable and did not confirm the upward trend observed in the last quarter of 2010. FDI outflows for the first quarter 2011 were USD 343 billion, representing a 9% increase from a year earlier but a 2% decline compared to the fourth quarter 2010 when they reached USD 350 billion (representing a 28% increase from the Q3 2010). The share of OECD investors, which accounted for around 80% of global FDI outflows in 2010, rose in the first quarter of 2011 to reach around 90% of world investments. This resulted from two consecutive increases of OECD’s FDI outflows in Q4 2010 and Q1 2011, each time by 22%, contrasting with a 24% drop to USD 215 billion in Q3 2010 (Fig.1).

Top three investing OECD countries in Q1 2011 were the United States (USD 86.5 billion), the United Kingdom (USD 45.2 billion) and Germany (USD 36 billion). The UK marked a spectacular recovery (ten times higher) from a year earlier On the other hand, France, among the top 10 OECD investors in 2010, was in the twenty-first position with its outflows dropping by -93% from a year earlier. As a whole, investors from the European Union accounted for 53% of global outflows in Q1 2011 (USD 181 billion).

FDI inflows to Ukraine

As for the Ukrainian official FDI statistics, the amount of the FDI to Ukraine trends to keep the stable year to year growth (Table 1).
Table 1. Foreign direct investment trends in Ukraine

<table>
<thead>
<tr>
<th>Year</th>
<th>Foreign direct investments in Ukraine</th>
<th>Foreign direct investments from Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount, USD million</td>
<td>Change to the previous year, %</td>
</tr>
<tr>
<td>2000</td>
<td>3281.8</td>
<td>-</td>
</tr>
<tr>
<td>2001</td>
<td>3875</td>
<td>+18.1</td>
</tr>
<tr>
<td>2002</td>
<td>4555.3</td>
<td>+17.6</td>
</tr>
<tr>
<td>2003</td>
<td>5471.8</td>
<td>+20.1</td>
</tr>
<tr>
<td>2004</td>
<td>6794.4</td>
<td>+24.2</td>
</tr>
<tr>
<td>2005</td>
<td>9047</td>
<td>+33.2</td>
</tr>
<tr>
<td>2006</td>
<td>16890</td>
<td>+86.7</td>
</tr>
<tr>
<td>2007</td>
<td>21607.3</td>
<td>+27.9</td>
</tr>
<tr>
<td>2008</td>
<td>29542.7</td>
<td>+36.7</td>
</tr>
<tr>
<td>2009</td>
<td>35616.4</td>
<td>+20.6</td>
</tr>
<tr>
<td>2010</td>
<td>40053</td>
<td>+12.5</td>
</tr>
<tr>
<td>2011 (forecast)</td>
<td>44708</td>
<td>+11.6</td>
</tr>
</tbody>
</table>

Data source: State Statistics Committee of Ukraine [5]

The largest FDI inflows to Ukraine as of January 1, 2011 were from Cyprus, with 22.2% of cumulative FDI, Germany with 15.8%, the Netherlands with 10.5%, Russia with 7.6%, Austria with 5.9%, France with 5.3% and the United Kingdom with 5.1%. Direct investment from Ukraine was USD 6.8 billion as of January 1, 2011. The largest portion of investments from Ukraine went to Cyprus. Both inflows and outflows of investment between Ukraine and Cyprus represent the capital transactions and movements done by the major Ukrainian industrialists aiming at optimizing taxation as well as allocating money for developing the international structures of their own businesses. Over more than a decade, Cyprus offshore economy has been playing an important role as a shelter for the evading Ukrainian money. The lion’s share of FDI to Ukraine was invested in the financial services and industry sector: USD 15 billion or 33.7% of total FDI and USD 14 billion or 31.4% of total FDI respectively. The real estate business and wholesale and retail trade absorbed 10.7% and 10.6% of total investment. [5]

Having suffered one of the sharpest economic downturns in the emerging markets (hereinafter EM) universe in 2009, Ukraine’s economy turned on a fast recovery path in 2010. Its real GDP rose an estimated 4.8% year-over-year in 11 month 2010 on improved foreign demand, as the export-oriented metallurgical, machinery and chemical sectors pushed full-year industrial output up 11.0% year-over-year. Domestically oriented industries were also growing, led by improving consumer confidence, increasing real wages and a gradual thaw in lending. This was in particular manifested by last year’s 7.8% year-over-year rise in retail turnover [6].

Macroeconomic environment in Ukraine

According to the Dragon Capital research [1] note presenting the outlook for the Ukrainian economy in 2011, export markets will remain a key driver for the Ukrainian economy going forward but domestic demand will play an increasingly important role, spurred by a steady recovery in bank lending. Ukrainian
banks enjoyed the strongest customer deposit inflows in the region last year, more than offsetting the 2008-09 deposit run and increasing the stock of deposits to an all time high of UAH 414bn by end-2010 (+26% y-o-y vs. average 10.3% for the peer group recorded in November). Corporate lending started to pick up in the second quarter 2010 and gained momentum in 2H10, offsetting the continued household deleveraging.

Ukraine’s external position in 2010 proved much stronger than many expected a year ago. Though the current account (C/A) deficit widened somewhat to an estimated 2.0% of GDP (from 1.5% in 2009), inflows of borrowed capital — spurred by the postelection political stabilization, reassessment of Ukrainian risks and renewal of cooperation with the IMF — pushed the financial account to a surplus estimated at 5.6% of GDP from a deficit of 10.2% in 2009. [5]

Dragon Capital experts expect capital inflows to moderate in 2011 but remain sufficient to cover the C/A gap. The government will continue borrowing actively abroad to cover the budget deficit, while deleveraging in the banking sector is set to end with lending gathering pace. Corporate sector external leverage is expected to keep increasing moderately in 2011 thanks to recovering private investment demand as well as widespread related party lending. With an end of the third quarter of 2010 gross external debt to GDP ratio of 84%, Ukraine’s external leverage remains moderate by both regional and European standards, being in line with the regional peer average of 89% and enabling the country’s public and private sector borrowers to tap global financial markets relatively easily (again, this depends on investors’ appetite for EM risk remaining strong and the IMF program for Ukraine continuing). Dragon Capital experts estimate this year’s net inflows of borrowed capital at 2.8% of GDP (in line with 2010) and expect FDI inflows at 3.4% of GDP (vs. 3.6% in 2010), fully covering the C/A gap. [1]

**Macroeconomic risks in Ukraine**

But, nevertheless, there are still a number of problems to be solved on the Ukrainian market in order to increase the amount of investments to Ukraine, as well as to simplify doing business in the country. Considering the MIGA-VCC Political Risk Survey in the BRICS 2009, political risks remain to be the most important factor for the foreign investors (Fig. 2) and will become even more important in middle-term period.

In this survey, representatives from business in different countries had to answer a question “In your opinion, which of the following factors will pose the greatest constraint on investment by your country in emerging markets this year and over the next three years?”. The results of it show that investors from emerging markets view political risk as a significant constraint on investment plans, together with macroeconomic instability and limited market opportunities.
Further I would like to stop on the key macroeconomic risks for foreign investors to Ukrainian economy. The critical external factors for Ukraine’s economy include global commodities prices, primarily steel and oil, and global appetite for EMs debt. Dragon Capital experts assume the annual average oil price (Urals) at $110/bbl in 2011 and 2012, implying an imported gas price of $400/bcm in the fourth quarter of 2011 and through 2012. They stick to rather conservative steel price assumptions, expecting annual average export prices to rise by a modest 3% year-over-year in 2012 (to $705/tonne for a blend of key steel products sold abroad), slowing from 25% this year, but think demand will remain rather favorable enabling domestic steel mills to moderately expand output.[1] It is also assumed that the appetite for EM risk among global debt investors will not worsen drastically compared with the H1 of 2011, with hikes in risk aversion in response to the escalating EU debt crisis being revealed as temporary.

Though the approval of the IMF-required pension reform in the first reading increases chances for the next disbursement, prospects for further lending under the current program look gloomy as domestic economic policies will inevitably grow more populist ahead of the elections.

Ukraine’s commodity-based economy naturally remains strongly exposed to the global commodity cycle. Ukrainian economists admit that international credit markets will play an even more important role in supporting the country’s fiscal and external positions. Therefore there are acknowledged growing risks to the economy and the currency. Among less severe risks, there are singled out slower than expected growth in bank lending, which would rein in domestic consumption and investment hindering economic recovery and representing a downside risk to the GDP growth forecast.

Also, the agricultural harvest is traditionally dependent upon weather conditions. With agriculture remaining an important sector for the economy and foods accounting for more than half of the consumption basket, an adverse weather shock poses a risk to the growth and inflation projections.
June’s inflation reading feels generally in line with the estimates (+0.3% month-over-month, +11.8% year-over-year) and Bloomberg consensus (+0.5% month-over-month, +11.9% year-over-year). Food price growth expectedly decelerated in month-over-month terms in June (to +0.3% from +0.8% in May) on seasonally higher supply of agricultural products. [6] But the pace of deceleration was slower than last year, reflecting higher fuel costs and buoyant domestic consumption demand. This pushed year-over-year inflation last month to a 17-month high. The slowdown in producer prices was largely a result of weaker global steel prices.

Watched by the IMF, Ukraine improved its fiscal position last year and entered 2011 with one of the most conservative budgets in the country’s history. As speedy economic recovery boosted revenue growth far above the initial target, full-year central budget revenues and spending targets were raised by UAH 14bn (to UAH 299bn, +16% year-over-year) and UAH 11bn (to UAH 334bn, +12% year-over-year) respectively, thus narrowing the central budget deficit target by 0.3pp to 2.7% of GDP (UAH 35bn). [5] The revised central budget deficit target (2.7% of GDP) seems consistent with the initial IMF requirement to keep the combined deficit of the general government (i.e. the central budget, local budgets and the Pension Fund) and oil and gas monopoly Naftogaz Ukrainy below 3.5% of GDP. The 2012 budget blueprint targets a central budget deficit of 2.5% of GDP, below this year’s limit and in line with IMF conditions.

Conclusion

As a conclusion, I would like to mention that there are several factors and risks, connected with the foreign investments in Ukraine. But according to the United Nations trade and development body annual report on global foreign direct investment, Ukraine is the leader among the Commonwealth of Independent States in the foreign direct investment growth. Foreign direct investment flow into Ukrainian economy increased by 35% up to USD 6.5 bln in 2010, making Ukraine one of the leading investment recipients in the CIS region. Recently, the global rating agency Fitch Ratings raised Ukraine's long-term foreign credit rating from stable to positive. The significantly smaller budget deficit this year has been stated as one of the reasons for the revision of Ukraine's rating. Also, the economic recovery and spending restraint along with parliamentary approval of an unpopular pension reform contributed to Fitch’s decision to mark Ukraine's economic advances. Notably, according to the World Investment Report 2011 [7], the Ukrainian FDI flow constitutes 23% of gross fixed capital formation. At the same time, the average rate for the CIS is 15.1% and for the world - 9.1%.

References