

**THE MOTIVES FOR FOREIGN DIRECT
INVESTMENT IN UKRAINE**

by

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Abstract

This thesis reports data on foreign direct investment in Ukraine obtained from surveys of major foreign investors. Dunning's internalization theory was used to relate this empirical work to the mainstream literature in international business. The surveys found that the major motive for foreign direct investment in Ukraine is market-seeking with other motives insignificant. The surveys also identify key problems foreign investors face in Ukraine.

Introduction

When talking about investment in Ukraine, word "foreign" is added to the word investment automatically. While there are no prospects for effective domestic investment, everyone in governmental circles relies on the magic foreign investor, who will come and rescue the country. This has predetermined official policy toward foreign direct investment (FDI), which is intended to promote it. However, foreigners still view Ukraine as effectively an unattractive place to invest.

Despite a common pessimism about investment in Ukraine, some courageous companies have already risked establish their production here. Empirical investigation of what their motives were, what their hopes are and what problems they are currently facing is the main objective of this paper. An understanding of FDI pioneers will reveal major incentives and disincentives for foreign investors coming to Ukraine, which in its turn could be helpful in FDI policy making.

The study was conducted by means of personal interviews with senior executives of 13 foreign companies operating in Ukraine, coming from 9 industries and 6 countries. All of them made significant capital expenditure, in other words they have set up their production facilities in Ukraine. When this research was being conducted, i.e. March 1999, they had invested a total of USD 610 mln: that represents 24% of the total FDI stock in Ukraine. The companies in the sample represent top investors in Ukraine according to their contribution to the Ukrainian economy.

To relate this empirical work to the mainstream literature in international business, Dunning's internalization theory is employed to provide analytical insights into both the corporate FDI decision and the public policy/government implications of the regulation of foreign investment in Ukraine.

The paper will proceed in the following way. First it will briefly discuss the importance of FDI for a country in transition and describe the legal framework and current situation with respect to foreign investment in Ukraine. Second, it will review Dunning's internalization theory as the most commonly accepted theory of explaining FDI flows. Third, it will examine how this theory fits Ukrainian reality. The paper concludes with investigation of the problems which foreign investors face in Ukraine and considers possible ways of promoting investment.

Section I. Importance of FDI and Ukraine's Environment.

1.1 Importance of foreign investments for transition economies.

The importance of direct investment for countries in transition is widely accepted, and is a key feature of policy for western financial assistance. (Hardt, J. Kaiser, F.,1995, 2). Official financial aid, (e.g. IMF, World Bank, EBRD) is of crucial importance for urgent patching of financial holes, but in the longer term countries should rely on private capital flows, which could provide non-debt sources of funding for monetary stabilization and restructuring of transitional economies. This claim is supported by the experience of certain developing countries namely Malaysia, Singapore, Taiwan and Thailand which have been highly successful in building a development strategy based on foreign investment in their economies. (OECD, 1998, 17).

The benefits of foreign direct investment (FDI) usually manifest themselves in the host country **trade performance**. Initially, investment influences the pattern of goods and services that are exported. In the longer term it promotes growth through transfers of new capital and technology. (OECD, 1998, 17). What is more, there is an indirect FDI contribution to economic development through **growing competitiveness of local firms** in the world markets. Multinational enterprises (MNEs), by transferring **technology** and skills training and establishing linkages with the local economy, help to create domestic industrial capabilities, that would not otherwise exist. (OECD, 1998, 17).

Another attractive feature of FDI is its impact on host country **productivity**. A study of foreign affiliates found that productivity growth in foreign affiliates was largely due to increased production capacity, while in domestic firms it was accounted for mostly by labor shedding (OECD, 1998, 23). Furthermore, it was found that the labor productivity of foreign affiliates rose more rapidly than that of national firms, by this signaling about more efficient production. It is supported by the fact that foreign affiliates rely for most of their technology on the parent company, although the share of foreign affiliates in overall research and development has tended to rise steadily over time (OECD, 1998, 21).

The OECD experience shows that foreign investment can enhance the level of **competition in domestic markets** and hence economic efficiency to the benefit of host country (OECD, 1998, 25). New players challenge positions of already established companies, by this forcing them to adjust in order to remain competitive. What is more, participation of foreign investors on a national treatment basis in bids for concessions provides a guarantee that such concessions are granted to the most efficient bidder. Also, the possibility for domestic enterprises to borrow directly from the foreign banks abroad exerts helpful pressure on domestic banks to reduce the cost of their services and extend the range of services they offer. Even if it is not relevant for Ukraine currently, but the opportunity given to domestic enterprises to raise funds on international capital markets incites stock market institutions to improve the functioning and the attractiveness of local capital markets (OECD, 1998, 25).

However, there may be the cases when foreign investments reduce competition in the domestic market through increased concentration of firms in the industry or by pursuing cartel strategy. The presence of foreign firms in a domestic market may also complicate the task of the national competition authority, particularly if cartel activity is suspected, as information necessary to the investigation of a cartel is spread across the jurisdictions of several countries (OECD, 1998, 25). But this is not a reason to hamper foreign investment, because anti-competitive practice is neither inherent nor exclusive behavior of foreign investors. What is more, removal of remaining discriminatory restrictions on entry of foreign firms can greatly help the task of national competition agencies, as the entry of additional firms is the best long-term strategy to prevent the acquisition of excessive market power. (OECD, 1998, 25).

1.2 Legal Framework for FDI in Ukraine

One of the most important issues that will be scrutinized by a serious potential investor in any new market is the stability of the domestic legal system from the point of view of the protection and enforcement of rights and the legal framework for foreign investment, in particular. Although there are notable recent examples of improvement in quality, Ukrainian legislation still remains quite inconsistent, frequently changing and weakly enforceable. The result is uncertainty, which makes it difficult for the players to understand the "rules of game" and magnifies the risks associated with doing business in Ukraine.

A major piece of legislation governing the regime of foreign investment in Ukraine - the *Law on the Regime of Foreign Investment* (April 25, 1996). This document contains following major statements:

?? Protection against changes in legislation (foreign investor is guaranteed protection for 10 years in the event Ukraine's foreign investment legislation is changed).

?? Protection against nationalization.

?? Guarantee for compensation and reimbursement of losses, suffered as a result of improper or negligent actions of state authorities or their representatives.

?? Guarantee in the event of termination of investment activity (right to remit revenues and withdraw investment from Ukraine).

?? Guarantee for repatriation of profit.

A point of extreme concern of foreign investors, namely taxation is subject of constant changes in Ukraine. Initially, enterprises with foreign investment (that is enterprises having from 10 to 100 per cent foreign participation) were exempted from the income (later profit) tax during 5 years beginning from the date of registration. (Decree, 1993). This tax holiday has been significantly limited in 1994 by applying only to enterprises registered before January 1,1995 and under conditions that (i) the foreign investment amounted to the qualified minimum of USD 100 000 and (ii) it would not be alienated during the entire period of tax holiday. (Law, 1994).

The above mentioned Law "On the regime of foreign investment" (1996) did not make any changes to the income taxation, while freed from custom duties the import of goods designed to constitute the foreign part of the statutory capital of the enterprise.

In April, 1997, based on Ukrainian Minister of Finance' claim that the amount "lost by the budget" from the beginning of the tax holiday was 1,650 mln. hryvna (approx. 890 mln. USD), the Parliament passed a new Law (1997), which states that the profit of enterprises with foreign investment should be taxed according to the general rules. The custom exemptions brought by 1996 Law are also repealed.

Thereupon, many foreign investors went to the courts and won cases about restitution of their facilities. Despite numerous winning cases and Supreme Court clarifications, 1997 Law is still in force. The number of court winners grew significantly, so the attempts to rise budget revenues by means of foreign investor's income tax has failed. The official blow to these dissenting investors was Presidential Decree of 26 February 1999, which suspends the international activity of 37 enterprises with FDI and temporarily blocks their exchange payments. Recently this decree was repealed, but the Cabinet of Ministers passed new one, which puts off tax exemptions even for court winners up to the final decision of Supreme Court on this matter. This state of affairs clearly illustrates the situation with FDI in Ukraine. From one side officials understand the importance of investment and make the attempts to attract them, from another side the same officials pursue practices, which completely deter any potential investor from coming into this country. "They love investment but hate investors" (said investor in Ukraine, who for

four years fought for an investment of USD 50 mln that would save several hundred jobs but has still made no headway). (Mollers, 1998, 141).

1.3 Ukraine and Foreign Direct Investment

Ukraine enjoys the distinction of perhaps the least attractive host country for foreign investors after Belarus in all of Eastern Europe and the former Soviet Union. (Dean, Manea, 1998, 6). Being potentially attractive place to invest, the country possesses a great amount of unused or underused physical and human capital, billions of dollars of idle savings, altogether with strong domestic market in 51 mln people (one of the largest in Europe) and easy access to even greater markets of Russia and other former Soviet republics. (Szyrmer, 1998, 2). Given its strategic position between Eastern Europe and Russia, and its access to nuclear weapons and the Black Sea fleet, the US moved quickly to entice Ukraine firmly into the Western camp. (Dean, Manea, 1998, 6). Ukraine is now the third largest country recipient of US foreign aid, after Israel and Egypt. The World Bank, IMF and EBRD have also been generous. Much of this aid has taken the form of technical assistance for building the market and legal institutions that underpin a capitalist economy. Hence it is even more remarkable that the country has remained so unattractive to foreign investors. (Dean, Manea, 1998, 6).

From the other side, despite quite an optimistic situation in the beginning/first half 1997, the end of 1997 financial crisis has heavily hurt the seemingly recovering economy.

Thus, today it is hard to find some attraction in macroeconomic situation. There was no economic growth since USSR collapse, and what is more, there is no hope for serious improvement in the nearest future. Ukrainian enterprises and population are becoming more and more indebted. The significant part of economy works without money at all, resorting to the ancient form of trade relations, such as barter or given-taken raw materials. The number of administrative restrictions restrains foreign trade. The institutional environment is extremely unhospital as well: the legal system is too ambiguous and unenforceable, economic policy is highly inconsistent, bureaucracy and corruption are flourishing, deterring any serious potential entrant.

Thus, it is not surprising, that given an estimated need over the coming years of USD 40 billion in foreign investment for industrial restructuring, the level and per capita indicators for foreign investment are still very far from adequate. (CCET, 1997, 8). According to Ministry of Statistics of Ukraine data, as of the end of 1998, cumulative foreign direct investment into Ukraine since 1991 reached approximately USD 2.7 billion, the majority of which was invested in joint ventures. In 1998, Ukraine received just USD 807 mln in FDI. While this represented a 31.2 per cent rise on the level in 1997, it still represented less than USD 16.7 per head in FDI inflows. Cumulative FDI per capita at the end of 1998 remained under USD 54, while this level for most advanced transitional countries Hungary and Poland is USD 2,673 and USD 724 correspondingly. The following data are based on the official statistics for total direct investment from 1991 through the end of 1998 (in USD millions).

Table 1. **FDI in Ukraine 1992-1998.**

	1992	1993	1994	1995	1996	1997	1998
FDI Stock, mln. USD	170,0	370,0	521,0	778,0	1278,0	1893,0	2700,0
FDI per capita	3,3	7,1	10,0	15,0	24,9	37,2	53,9
FDI % of GDP	2,1	1,2	1,6	2,3	3,0	4,1	6,6

Source: Ministry of Statistics of Ukraine

In the beginning of 1998, the main interests of foreign investors were in food sector (20.6%). Other domestic trade operations constituted 19.5%, finance 8.5%, engineering and metallurgy 8.2%, chemical and oil refining 6.9%, health protection services 5.6% and construction and building materials 4.4%.

Table 2. **Ukraine: FDI by Sectors.**

Sectors	1996		1997	
	mln USD	% of total	mln USD	% of total
Food Industry	166.63	11.6%	422.07	20.6%
Trade and Commerce	487.79	33.9%	400.65	19.5%
Credit, Finance, Insurance	70.71	4.9%	174.08	8.5%
Engineering and Metallurgy	138.86	9.7%	168.7	8.2%
Chemical and Oil Refining	41.4	2.9%	141.22	6.9%
Medical Care	74.65	5.2%	114.87	5.6%

Construction and Building Materials	69.08	4.8%	90.55	4.4%
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Source: Ministry of Statistics of Ukraine

By origin of the investment, as of 1 January 1998, the United States, which had made investment valued at USD 363.53 mln, led with 19.2% of all investment followed by the Netherlands with 11.3%, Germany (10.6%), the Russian Federation (8.4%), the United Kingdom (7.6%) and Cyprus (5.9%).

Table 3. Foreign Direct Investment by Countries of Origin.

Countries	1995		1996		1997	
	mln	% of	mln	% of	mln	% of
	USD	total	USD	total	USD	total
USA	86.7	21.0	79.1	14.6	118.2	19.2
Netherlands	34.6	8.4	73.1	13.5	94.4	15.3
Germany	55.6	13.4	9.6	1.8	18.3	3.0
Russian Federation	30.9	7.5	56.2	10.4	44.3	7.2
United Kingdom	20.1	4.9	46.4	8.6	49.6	8.1
Cyprus	23	5.6	34.7	6.4	39.5	6.4

Source: Ministry of Statistics of Ukraine

Section 2. The motives for Foreign Production

(Conceptual Background).

Today, it is widely agreed that FDI takes place when three sets of determining factors exist simultaneously (Dunning, 1993, 79): the presence of ownership-specific advantages of property rights and intangible assets in the multinational enterprise (MNE); the presence of internalization incentive advantages, and the presence of locational advantages in a host country.

?? *Ownership specific advantages* (of property rights and intangible assets) arise from the firm's size and access to markets and resources, the firm's ability to co-ordinate complementary activities, such as manufacturing and distribution, and the ability to exploit differences between countries (Rugman, 1998, 6).

?? *Internalization incentive advantages* arise from exploiting imperfections in external markets. These include the reduction of uncertainty and transactions costs in order to generate knowledge more efficiently; and the reduction of state-generated imperfections such as tariffs, foreign exchange controls, and subsidies. They may reflect either the greater organizational efficiency of hierarchies or their ability to exercise monopoly power over the assets under their governance (Rugman, 1998, 6).

?? *Location specific advantages*, which include differences in country natural endowments, transport costs, cultural factors and government regulations. They determine which countries are host to MNE foreign production (Rugman, 1998, 6).

While the first and second are firm-specific determinants of FDI, the third is location-specific and has a crucial influence on a host country's inflows of FDI. If only the first condition is met, firms will rely on exports, licensing or the sale of patents to service a foreign market. In the presence of internalization incentives, e.g. protection from supply disruptions and price hikes, lack of suitable licensee, and economies of common governance FDI becomes the preferred mode of servicing foreign markets, but only if location-specific advantages are present. Within the trinity of conditions for FDI to occur, locational determinants are the only ones that host governments can influence directly. (UNCTAD, 1998, 89).

Whereas it has not been possible to arrange MNEs locational-specific decisions into a uniform theoretical pattern so far, the literature cites a large number of very different factors that impact on business potential and the risks associated with individual locations. They can be grouped into three broad categories, such as national policy framework for FDI, economic motives and business facilitation.

The **core FDI** policy is of crucial importance. Without foreign investment legislation no foreign investment will take place in a particular country. What is more, it was found that while the investment policy restrictions are very important in discouraging foreign

investment, investment policy incentives are only one variable attracting such investment (OECD, 1998, 17).

Equally important as FDI policy frameworks in encouraging investment inflows are measures that **facilitate business transactions**. These include business promotion, investment incentives, after-investment services, improvements in amenities, and measures that reduce the "hassle" cost (related to corruption and administrative efficiency) of doing business. Financial or fiscal incentives are also used to attract investors, even though they typically figure into investor' location decisions only when the economic determinants are in place (Mallampally, Sauvant, 1999, 37).

However, the most important determinants for the location of FDI are **economic considerations**, which will be carefully examined in this paper. They come into full play once an enabling FDI policy framework is in place. Following from the principal motivations of MNEs for investing in foreign countries, economic determinants can be grouped into three clusters, such as resource-seeking, market-seeking and efficiency-seeking, as showed in the table below. The objective of this paper is to examine the location-specific (host-country) determinants of FDI and to analyze which of them are substantial for Ukraine nowadays. Furthermore, the relative significance of different motives in a locational decision is to be scrutinized together with various problems of foreign investors in Ukraine.

Table 4. Host Country Determinants of Foreign Direct Investment

Host country determinants	Type of FDI classified By motives of firms	Principal economic determinants in host countries
<p>Policy framework for FDI</p> <p>Economic, political, and social stability</p> <p>Rules regarding entry and operations</p> <p>Standards of treatment of foreign affiliates</p> <p>Policies on functioning and structure of markets (especially competition and policies governing mergers and acquisitions)</p> <p>International agreements on FDI</p> <p>Privatization policy</p> <p>Trade policy (tariffs and nontariff barriers) and coherence of FDI and trade policies</p> <p>Tax policy</p>	Market-seeking	<p>Market size and per capita income</p> <p>Market growth</p> <p>Access to regional and global markets</p> <p>Country-specific consumer preferences</p> <p>Structure of markets</p>
	Resource/asset seeking	<p>Raw materials</p> <p>Low-cost unskilled labor</p> <p>Skilled labor</p> <p>Technological, innovative, and other created assets (for example, brand names), including as embodied in individuals, firms, and clusters</p> <p>Physical infrastructure (ports, roads, power, telecommunications)</p>

Economic determinants		
Business facilitation		
Investment promotion (including image-building and investment-generating activities and investment-facilitation services)		
Investment incentives		
Hassle costs (related to corruption and administrative efficiency)		
Social amenities (for example, bilingual schools, quality of life)		
After-investment services		
	Efficiency seeking	Cost of resources and assets listed above, adjusted for labor productivity Other input costs, such as transport and communication costs to/from and within host economy and other intermediate products Membership of a regional integration agreement conducive to the establishment of regional corporate networks

UNCTAD, World Investment Report 1998: Trends and Determinants. Table IV.1. p.91

Availability of **natural resources**, cheap unskilled or semi-skilled labor, creative assets and physical infrastructure promotes **resource-seeking activities**. Historically, the most important host country determinant of FDI has been the availability of natural resources, e.g. minerals, raw materials and agricultural products. In the nineteenth century

"much of the FDI by European and United States firms was prompted by the need to secure an economic and reliable source of minerals, primary products for the investing industrializing nations of Europe and North America" (Dunning, 1993, 57).

Up to the eve of the Second World War, about 60% of the world stock of FDI was in natural resources (Dunning, 1993).

Even when it was prominent as an FDI determinant, the presence of natural resources by itself was not sufficient for FDI to take place. Comparative advantage in natural resources usually gave rise to trade rather than to FDI. Investment took place when resource-

abundant countries either lacked the large amounts of capital typically required for resource-extraction or did not have the technical skills needed to extract or sell raw materials to the rest of the world. In addition, infrastructure facilities for getting the raw materials out of the host country and to its final destination had to be in place or needed to be created (UNCTAD, 1998, 106).

Labor-seeking investment is usually undertaken by manufacturing and service MNEs from countries with high real labor costs, which set up or acquire subsidiaries in countries with lower real labor costs to supply labor intensive intermediate or final products. Frequently, to attract such production, host countries have set up free trade or export processing zones (Dunning, 1993, 57).

Another highly important group of economic determinants of FDI is **market factors**, which are market size, in absolute terms as well as in relation to the size and income of its population, and market growth. For firms, new markets provide a chance to stay competitive and grow within the industry as well as achieve scale and scope economies.

Traditionally, market size and growth as FDI determinants related to national markets for manufacturing products sheltered from international competition by high tariffs or quotas that triggered "tariff-jumping" FDI (UNCTAD, 1998, 107).

Market access was paramount in the wave of United States investment in Europe, especially in the United Kingdom, during the early post-war period, and in Japanese investments in United States after the mid-1980s, following voluntary export restrictions and the possibility of further protectionist measures in the automobile industry (Dunning, 1998, 258).

National markets were also important for many service MNEs, although the principal reason was not the existence of tariffs, but the fact that most services were not tradable and therefore the only way to deliver them to foreign markets was through establishments abroad (UNCTAD, 1998, 107).

Apart from market size and trade restrictions, MNEs might be prompted to engage in market-seeking investment, when their main suppliers or customers have set up foreign producing facilities and in order to retain their business they need to follow them overseas (Dunning, 1993, 58).

However, undoubtedly the single most important reason for market-seeking investment remains the action of host governments encouraging such investment. The traditional instrument chosen by governments has been to impose tariffs or other import controls. History suggests that the majority of first time manufacturing and service investment were undertaken to circumvent such trade barriers (Dunning, 1993, 59).

The motivation of **efficiency seeking** FDI is to rationalize the structure of established resource based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities. The intention of the efficiency seeking MNE is to take advantage of different factor endowments, cultures, institutional arrangements, economic systems and policies, and

market structures by concentrating production in a limited number of locations to supply multiple markets (Dunning, 1993, 59).

In order for efficiency seeking foreign production to take place, cross-border markets must be both well developed and open. This is why it flourishes usually in regionally integrated markets (Dunning, 1993, 59).

However it is worth noting that in the early 1990s many of the larger MNEs are pursuing pluralistic objectives and most engage in FDI that combines the characteristics of each of the above categories. The motives for foreign production may also change as, for example, when a firm becomes an established and experienced foreign investor (Dunning, 1993, 56).

Considering **Ukraine as a host country**, one could expect a large amount of **labor and market seeking FDI**: the former due to availability of cheap labor and rather abundant agricultural products, while high trade barriers and a large internal market promote the latter. However, conditions for efficiency-seeking investment are unclear: from one side, cross-border trade is restricted, whilst from another Ukraine is a member of different regional integration agreements conducive to trade facilitation.

Thus, if one considers only economic determinants of FDI one would wonder why Ukraine's experience with FDI is so poor so far. However, if one incorporates policy and

business facilitation aspects as well, he will find the exact kind of behavior which rational investors will pursue in similar situation.

Section 3. The Motives for FDI in Ukraine.

3.1 Motivation Profile of Foreign Investors in Ukraine.

A starting point for the analysis of foreign investment in Ukraine has been to distinguish three types of investment projects by their main strategic motivation for locating in the country. The first of these are *market-seeking investment*, whose main objective is to supply the Ukrainian and other CEE markets. The second category represents *resource-seeking investment*, which involves relocation of production in order to benefit from more cost-efficient production in the host country. They are, therefore, mainly export focused. The third type of operations covered by this classification is *efficiency-seeking investment* made with the purpose of taking advantage of labor productivity, or local specific creative assets (market knowledge or original local technology) in order to extend the MNE group's product range and/or technological scope.

The information given by the firms participating in the survey has found one dominant objective, market-seeking (the major motive for 92% of respondents), with efficiency- and resource-seeking never more than secondary preoccupations.

The motives were assessed in order of their importance for the investment decision. The interviewees chose among 3 grades ranging from "main objective "(=1), "secondary objective"(=2) to "not a part of our role"(=3) (for the questionnaire see Appendix 1). The

average response (AR) calculated as arithmetic mean of respondents' replies clearly demonstrates the results:

Table 5. Foreign Subsidiaries' Evaluation of Motives for Investment in Ukraine

Rank	Motive	Average Response
1	<i>Market-seeking</i>	1.08
2	<i>Resource-seeking</i>	2.33
3	<i>Efficiency-seeking</i>	2.42

Source: *Surveys' results*

Thus, market-seeking is a common strategy (only in 1 case the extension of sales to Ukrainian market was seen as a secondary objective). The values of AR of 2.33 and 2.44 testifies that on average resource- and efficiency-seeking activities were no more than secondary objective (frequently regarded as "not a part of our role" at all).

Among host country determinants (reasons for investment) market factors are at the top as well. Average response, which demonstrates a degree of importance of a particular reason, was calculated for each of the 8 motives under consideration ("major reason"=1; "minor reason"=2; "not have a reason"=3). Therefore, the closer the degree of importance is to unity, the more important is the corresponding motive.

Table 6. Motives for Companies Investing in Ukraine

Rank	Why did you choose to invest in Ukraine?	Average Response
1	<i>to establish a strong position in the Ukrainian market.</i>	1.25
2	<i>the skill quality of production labor.</i>	2.08
3	<i>to achieve access to a new regional (Central and</i>	2.5

	<i>Eastern European) market</i>	
3	<i>to improve our competitiveness in supplying our established markets (e.g. Western Europe)</i>	2.5
4	<i>availability of low-cost input factors (e.g. cheap labor; raw materials).</i>	2.58
5	<i>availability of scientific inputs.</i>	2.7
6	<i>a chance to access particular national research and technological expertise available in Ukraine.</i>	2.9
7	<i>to establish access to EU market.</i>	3.0

Source: *Surveys' results*

The desire to supply the local Ukrainian market strictly dominates other reasons (AR=1.25), it was a major motive for 77% respondents, while the next important reason, e.g. skill quality of production labor has AR of 2.08 only. This means that at average availability of skilled labor was treated as a minor reason (even skewed toward no reason); in particular only for 16.6% respondents this target was of primary importance, while for 42% it was of no importance at all.

The other two market-related factors, i.e. expansion into Central and Eastern European markets and improvement of MNE competitiveness in supplying its established markets in Western Europe share third place with average response equal to 2.5. Thus, all three market factors are among top three motives, by this indicating its prevalence over others.

The next relevant influence on foreign investment decisions is the availability of low-cost input factors (e.g. cheap labor, raw materials). However, the AR for this motive is 2.58

with only 7% of respondents considering this as a major reason. It is remarkable that 66% of interviewees rated cheap inputs of no importance at all.

The remaining three motives (availability of scientific inputs, a chance to access particular national research and technological expertise available in Ukraine, and to establish access to EU market) are ranked as comparatively unimportant.

The least relevant reason given to invest in Ukraine is "to establish access to EU market"; in fact it was stated to be of no importance in 100% of cases. The survey found that all respondents had their subsidiaries in Europe prior to their expansion in Ukraine. This motive was included in the questionnaire because of recent findings by Manea and Pearce (1997), which surmises that non-European companies might set up the production in the host country (e.g. Ukraine) as a strategic move towards entering the European Union market. The underlying assumption is that these firms do not have any operations in the EU but would like to expand into this important part of the global market, and decide that a more cost-efficient way to do it is by producing in Ukraine. Their products then will be exported to other parts of Europe. Nevertheless, the survey shows that this kind of behavior has not been observed in Ukraine so far.

Thus, investors' behavior in Ukraine is found to be strongly market-seeking. This can be explained by high import tariffs and the opportunity to supply a large and unsatisfied market. However, labor-seeking was found not to be a motive for investing in Ukraine.

Why not? Because one should consider not nominal wages by itself, but total labor costs which also depend on labor productivity, regulatory interventions and other factors.

The impact of low labor productivity is clear: "Cheap labor? It is not cheap. You should hire fifty Ukrainian workers for the job that five would Canadians do," said the manager of Northland Power - Canadian power generating company. Due to a lack of capital, necessary training and inferior management, labor productivity is so low that total labor costs end up higher than in other Eastern European countries (despite low Ukrainian nominal wages).

However, one should be careful when inferring low labor productivity in Ukraine. It is worthwhile to distinguish two types of investment:

- 1) A foreign investor acquires an existing factory, that is burdened with a huge stock of unused capital and untrained labor;
- 2) A foreign investor builds a new factory, supplies modern equipment and trains workers.

Though in the first case labor productivity is still low (because the new owner can't fire or train several thousand people simultaneously), in the second case Ukrainian workers perform no worse than their western counterparts. The first case is evidenced in Northland Power and OTIS experience, whereas the second is evidenced in McDonald's and Procter&Gamble (see appendix).

With respect to 1) above, a feature that raises labor costs significantly is the impossibility of firing significant number of workers. Local authorities, being extremely concerned with employment, usually put a constraint on headcount cuts in the contract when a foreigner acquires a local company. This policy prohibits a new owner from firing a large number of unproductive people, thus drastically raising total labor costs.

Frequently, foreign investors are obliged to inherit all the social infrastructure of large industrial complexes: e.g. hospitals, kindergartens, summer camps, farms, greenhouses etc. "There were 30,000 workers before, today there are still 17,000, whereas three viable departments of this enterprise need only 300-500 employees" (GAG, 1999, 10).

These obstacles erode the cost advantage of cheaper labor by making production more difficult and expensive. In this situation foreign entry can be "promoted" only by tariff barriers that make imports costlier than local production despite high unit costs. Thus, while Ukraine is perceived as a market of the future, it is not taking advantage of its greatest location-specific advantage: its qualified and hard-working labor force (Mollers, 1998, 148).

The evidence of market-seeking activities' prevalence in Ukraine is also supported by the research done by the German Advisory Group (GAG) in 1998. A sample of 20 foreign investors was chosen and their motives for committing capital to Ukraine were examined. The respondents assessed the importance of each particular motive among 4 grades

ranging from "very important"(=4), "great"(=3) and "slight"(=1) to "unimportant"(=0) (Mollers, 1998,144).

Estimation of the replies completely confirms the findings of the investigation above by ranking three sales oriented motives as issues of primary concern. The remaining motives turned out to be relatively unimportant.

Table 7. Motives for Companies Investing in Transition Countries

Rank	Motive	Ukraine	CEE	Russia	Czech Republic
1	Secure potential sales markets	3.65	3.08	2.96	2.63
2	Develop new sales markets	3.50	3.22	2.95	2.75
3	Overcome import barriers	2.50	1.36	1.72	0.85
4	Secure and cultivate existing sales markets	1.70	2.70	3.00	2.57
5	Enhance competitiveness through primary production in the host country	1.58	2.12	1.94	2.72
6	Lower labor costs	1.40	2.76	2.16	3.34
7	Lower tax burden	1.20	1.46	1.58	1.48
8	Better purchasing and procurement possibilities	1.10	1.34	1.58	1.11
9	Longer working hours	0.68	1.38	0.95	1.73
10	Fewer administrative impediments	0.55	1.18	1.83	0.96
11	Longer machine running times	0.54	1.21	0.79	2.00
12	Less stringent environmental constraints	0.33	0.73	0.58	0.81

Source: Mollers, (1998) "Foreign Direct Investment in Ukraine - Experiences Taken from Reality" p.145

The next part of the paper analyses how the importance of different motives for the investment decision varies across countries. The significance of different factors responsible for investment decisions is estimated by introducing an "overall indicator of significance" (IS), calculated as the mean of the average scores of all respondents to each of the twelve motives investigated in the study. Thus, IS for Ukraine equals:

$$IS_{\text{Ukraine}} = (3.65+3.50+2.50+1.70+1.58+1.40+1.10+1.20+0.68+0.55+0.54+0.33)/12 = 1.56$$

Similarly, $IS_{\text{CEE}} = 1.88$; $IS_{\text{Russia}} = 1.84$ and $IS_{\text{Czech Republic}} = 1.70$

These indicators constitute the criterion value to determine which factors act as major stimulants for attracting foreign investment in particular country. A higher score than IS for a factor means that it is a significant determinant of investment in that country (high influence) and a lower score indicates a factor that does not play an important role in the decision process (low influence).

The difference in the significance of twelve decision-factors among countries can be visually demonstrated using the following matrix, which on the vertical axis captures the twelve prospective influences according to the scores obtained in the survey and on the horizontal dimension the four countries under consideration. The vertical axis is divided into strong (high)-influence and low-influence on the decision process with the break point between these two at country-specific IS.

The matrix can now be used to discuss how the set of locational advantages differs across countries.

From the investor's point of view Ukraine exhibits a similar profile to Russia, where market-seeking activities dominate. However, across all CEE countries, lower labor costs turns out to be ranked third, because the sample now includes countries which are more successful in market reforms than Ukraine. What is more, in the case of Czech Republic, where reforms are already at a very advanced stage, low labor costs become the key motive, even though they are considerably higher than in Ukraine. Thus, if investors perceive the Czech Republic as exhibiting a labor cost advantage, then it is even more transparent that impediments to raising productivity in Ukraine outweigh the cheap nominal cost of labor.

This claim is also supported by the study's ranking of "enhancing competitiveness through primary production" as almost as important a motive for relocation to the Czech Republic as market-related motives. However for Ukraine and Russia this aspect is of no more than secondary importance, though again labor costs are lower than in the Czech Republic.

The next interesting point applies to import barriers, which influenced on the investment decision only in the Ukrainian case. This means that import restrictions become irrelevant when other host country advantages come into play, e.g. vast market (as in Russia), or cheap labor (as in CEE and Czech Republic).

It is rather surprising that two factors that are usually used by policy makers as an incentive to investment do not appear among the motives that are influential for respondents for all countries in the sample. In the bottom of the matrix one can find "lower tax burden" and "less stringent environmental constraints".

3.2 Deterrents to Investment in Ukraine.

As it was mentioned in the previous section, there is clear evidence that Ukraine can not enjoy the attractiveness of its cheap labor because of low labor productivity. This justifies the importance of investigation of the main obstacles, which foreign investors face in Ukraine, obstacles that, in effect, lower labor productivity. Therefore a question in the survey asked foreign subsidiaries that are already operating in the Ukrainian economy to identify and evaluate the main current problems encountered by foreign investors in the investment process in Ukraine.

Twelve out of thirteen interviewees view the major obstacles to foreign production in high economic uncertainty, and eleven out of thirteen consider the ambiguity of the legal system as a major problem. Political instability ranks next on the list of Ukrainian

disadvantages. The problems of negotiating with government, establishing clear ownership conditions, finding a suitable partner and high restructuring costs turned out to be slightly important. Finally, another factors, namely lack of physical infrastructure and business skills, backward technology and problems in establishing clear conditions of corporate governance were not considered to be obstacles to production in Ukraine.

Table 8. Impediments to Investment in Ukraine

Rank	Obstacles to Investment	Average Response
1	the economic environment is too uncertain	1.08
2	the legal system is too ambiguous	1.17
3	the political environment is too volatile	1.5
4	Difficulty of negotiating with government and/or privatization authorities	1.7
5	Restructuring costs too high	1.9
5	Finding a suitable partner	1.9
5	Problems establishing clear ownership conditions.	1.9
6	lack of physical infrastructure	2.25
7	Problems establishing clear conditions of corporate governance	2.3
8	lack of business skills	2.4
9	Backward technology	2.55
10	Problems in exporting to our MNE's established markets (e.g. Western Europe)	2.6
11	Problems in exporting to potential new markets (e.g. Eastern Europe)	2.75

Source: *Surveys' results*

It is interesting to note that whereas investors ranked the problems of exporting their products to potential new markets at the very bottom of the table, this was not because of

scarcity of impediments to exports in Ukraine (although some companies outlined the problems of negotiating with customs as a serious obstacle), but because of a lack of export-oriented activities, which are typical for resource-seeking and efficiency-seeking investment. This indirectly confirms again the prevalence of market-seeking activities in Ukraine.

However, impediments to investment in Ukraine are not depleted by this short list. There is a number of another "attractions", which helps Ukraine in losing considerable amount of unrealized investments. While these problems are more substantial for one group of investors and less for others, it is worth to consider them as it could give more complete picture of Ukraine as a potential investment location.

Taxation

At first, we should mention punitive and unpredictable taxation, which was often deemed as a substantial impediment to doing business in Ukraine (see Kyiv Atlantic's case).

The need to raise taxes, compounded by the reliance of much of the working population on collecting rents from the old, Soviet-style system, is the root poison that deters foreign investment from Ukraine. Taxes take the usual forms of corporate, personal and VAT, but the levels are excessive: for example the business payroll stands at over 50 percent. Taxes are not only excessive, exemptions abound and they are arbitrary and unpredictably applied. Tax avoidance is rampant, as is the bribery and corruption associated with tax avoidance. The informal, "underground" economy has mushroomed

from about 12 percent of economic activity prior to independence to more than 60% now.

By definition, none of this informal activity is taxed.

A costly side-effect of the shrinking tax base is that private enterprises (not to mention individuals) eschew banks like the plague, since bank deposits would expose them to tax collection. The broadly defined money supply, M2, is only 12% of GDP, a fraction of the levels of any but the world's least developed economies, or those that (unlike Ukraine) suffer from hyper-inflation. Hence Ukraine is effectively a cash economy, with all the usual costly consequences for doing business. Another consequence of tax avoidance is that firms are biased toward inefficiently high capital expenditures in an effort to minimize reported profits (famous Averch-Johnson effect). This does not bode well for shareholders.

Unhappily, the implication of this for foreign investors is not that they can expect to evade taxes alongside the underground indigenous enterprises; quite the reverse, they can expect to be treated as highly visible and vulnerable cash cows. They can expect to pay not only legitimate, pre-announced taxes, but also ad hoc assessments and bribes that depend on the power of particular government officials to block their activities. This is a part of a wider pattern of government interference.

Government interference

Survey shows that the next "popular" drawback of Ukrainian environment is high government interference. Ukrainian managers spent huge amount of time dealing with

government officials over taxation, licensing and related matters. Private firms spend more time on this than do state owned enterprises. Nor are projects sponsored by the international financial institutions immune. For example, an EBRD-financed agricultural services project has been subject to 28 external tax audits in 18 months. Real estate development is a particular headache: in Kiev, it can take two years from the first application to the receipt of formal approval. Applications by both Hilton and Marriott hotels remain on hold while hotel facilities are so inadequate that the major EBRD meetings scheduled for Kiev in 1998 was under the threat of breaking up. Obstacles arise from a plethora of agencies, including tax authorities, the customs service, the Ministries of Finance, Economy, and Foreign Economic Relations and Trade, branch industries and local authorities.

What is more, municipal and oblast administrations do not seem to appreciate what effect investors can actually produce or what their role and position should be in concert with foreign companies. They still perceive themselves as planners and controllers, but not as partners with an onus to offer companies something as well.

Restrictions on trade

The Ukrainian government has built up an unenviable record of restricting trade, often by arbitrary decrees. For example in November 1996 restrictions were imposed on both export and import of a number of commodities, in direct contravention of loan agreements with the World Bank. As another example, in mid-1996, local officials in several oblasts (counties) illegally banned wheat exports. This was followed by the

impounding of privately owned grain in state-owned elevators. These actions, in turn, severely disrupted trading on the wheat futures markets. Remarkably, attempts by President Kuchma to stop local interference with the grain trade were unsuccessful. Local authorities also have a history of claiming priority access to rail cars, port facilities and other transportation infrastructure.

Constantly changing laws

In the absence of a Civil Code, existing legal ambiguity is compounded by the uncertain precedence of one enactment over another. A common problem is that licensing and regulatory requirements are not only not clear at the outset of a project, they change and invariably multiply as project development proceeds. Even worse, new regulations are often applied retroactively by this rising crucially risks of operating in the country.

Customs

It is again the legal uncertainty to which most complaints on customs clearance refer (see DHL case). New regulations not yet published or published only the previous day are immediately put into practice by the customs authorities. In many cases this leads to delays lasting several days, making deliveries headed for Western Europe less and less attractive to customers and causing costly machine idle times for companies in Ukraine waiting for consignments of spare parts, for example. The list of goods subject to customs duty is constantly altered, making every delivery a matter of luck: Have all the papers been obtained or does some confirmation or other still have to be taken to the border, as so frequently happens?

The customs authorities' arbitrary behavior seriously impacts the investment climate in Ukraine. There is an evidence of a number of cases that resemble the following one: after an investor had imported his basic product from abroad without having to pay customs duties for ten months of one year, the country in question was suddenly put on the list of countries from which imports were liable to duties. (Mollers, 1998, 157).

Corruption, criminal activity, and unenforceable contracts

Corruption follows directly from the degree of discretion officials have in granting approvals for private business. Unofficial payments have to be made at all stages of the licensing and permissions process. Once again it is local officials who are particularly notorious at extracting bribes, often to wave regulations that have already been abolished by the central government. World Bank survey results in 1995 revealed that small businesses with up to 10 employees were paying about \$800 per year in bribes, and larger firms with up to 1,000 employees were paying an average of \$3,500 annually.

Extortion by state officials merges naturally into criminal activity. The 1995 World Bank survey estimated that about 11 percent of private firms' profits were paid to the "mafia" and other criminal elements for protection. More recent surveys show that protection rackets are on the increase.

Conclusions

This thesis was devoted to the investigation of motives for FDI in Ukraine. It was discovered that market-seeking motivation is dominant in Ukraine, leaving other motives (including labor seeking) well behind.

The results of a Ukrainian survey undertaken during early 1999 show that the vast Ukrainian market and, more importantly, high trade barriers were the main reasons for decisions to invest in Ukraine. As seemingly a straightforward motive as low cost labor turned out to be insignificant in the overwhelming majority of cases. Though Ukrainian wages are lower than in other East European countries, labor productivity is significantly lower as well (due to a lack of capital, inferior management and regulatory burdens), making unit costs higher than in neighboring countries. Costly regulations and the impossibility of firing significant numbers of unproductive workers, and burdensome inheritance of social complexes erode the cost advantage of cheaper labor by making production in Ukraine more difficult and expensive.

The survey also evidenced that major factors constraining investment in Ukraine are, in descending order: uncertainty of the economic environment, ambiguity of the legal system, political instability, difficulty of negotiating with government, high restructuring costs and problems in finding a suitable partner.

The kinds of reforms that should be sought follow from the discussion of deterrents above. Ukraine should choose and pursue sound and consistent economic policy. The legal system should be made more transparent, more substantial, and more stable since it subjects foreign investors to limitless risks. The number of persons or agencies who can influence the future of an investment project has to be significantly reduced (the countries which have just one, or few, authorities to negotiate with are much more successful in attracting FDI than Ukraine is). The template for such reforms has been drawn up by the variety of foreign advisory agencies that are working in Ukraine. What has been lacking so far is the political will and commitment to implement them.

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Appendix 1.

Section I: A Profile Of The Foreign Affiliate

- 1. When was the subsidiary established? _____
- 2. What is the annual revenue (turnover) of the subsidiary? _____
millions
- 3. How many personnel does the subsidiary employ? _____
- 4. What is the total amount of your capital invested in the subsidiary? _____ \$
millions
- 5. What is your market share?

6. What is the strategic position of the Ukrainian subsidiary in your MNE group's operations?

Please evaluate each of the following objectives (roles) set for your subsidiary within the MNE group's operations:

- (1) a main objective**
- (2) a secondary objective**
- (3) not a part of our role**

- a) to help our MNE group to effectively extend the supply of its established products into Ukrainian and other CEEC markets. _____
- b) to benefit from more cost-effective production in order to improve the competitiveness of our MNE group in supplying existing products to its already established markets (e.g. Western Europe) _____
- c) to use local-specific creative assets (e.g. local market knowledge, original local technology) available to our subsidiary to develop new products for the Ukrainian and other CEEC markets _____

Section II. Decision To Invest In Ukraine

7. Why did you choose to invest in Ukraine? Please evaluate each of the reasons presented below:

- (1) a major reason
- (2) a minor reason
- (3) not have a reason

- a) availability of low-cost input factors (e.g. cheap labor; energy; raw materials). _____
- b) to establish a strong position in the Ukrainian market. _____
- c) to achieve access to a new regional (Central and Eastern European) market. _____
- d) to establish access to EU market. _____
- e) the skill quality of production labor. _____
- e) availability of scientific inputs. _____
- f) a chance to access particular national research and technological expertise available in Ukraine. _____
- g) to improve our competitiveness in supplying our established markets (e.g. Western Europe) _____

8. What do you think are the current problems facing potential investors in Ukraine?

Please grade each of the following according to their importance.

- (1) a major problem**
- (2) a minor problem**
- (3) not a problem**

- a) finding a suitable partner _____
- b) restructuring costs too high _____
- c) the political environment is too volatile _____
- d) the economic environment is too uncertain _____

- e) the legal system is too ambiguous _____
- g) difficulty of negotiating with government and/or privatization authorities _____
- h) problems establishing clear ownership conditions. _____
- i) problems establishing clear conditions of corporate governance _____
- j) lack of physical infrastructure _____
- k) backward technology _____
- l) lack of business skills _____
- n) problems in exporting to our MNE's established markets (e.g. Western Europe) _____
- o) problems in exporting to potential new markets (e.g. Eastern Europe) _____

8. Does the MNE company (the foreign investor) have investments in other Eastern European countries?

Yes _____ No _____

9. Did your operations in Ukraine increase or decrease as a proportion of your MNE's operations in the CEEC region in recent years? Please tick relevant answer.

- a) increased _____
- b) decreased _____
- c) no significant change _____

10. What percentage of your production is exported? % _____

11. What percentage of your exports go to other parts of your MNE group? % _____

12. What kind of products do you export to other parts of your MNE group? Please tick any relevant.

- a) component parts (for assembly elsewhere) _____
- b) goods requiring further processing _____
- c) final products (for distribution) _____

Appendix 2.

Cases:

?? Citibank Ukraine;

?? Credit Lyonnais;

?? DHL;

?? Kyiv Atlantic;

?? McDonald's;

?? Nestle;

?? Northland Power;

?? OTIS;

?? Owens-Illinois;

?? PepsiCo;

?? Procter & Gamble;

?? UMC.

Citibank

Citibank Ukraine was registered by NBU in May 1998. The branch is a full service commercial operation serving Citibank Global Relationship Clients, certain Ukrainian banks and, eventually, top tier local corporate clients. The Bank is being initially capitalized with \$25 mln aims for extension of the supply of its products into the Ukrainian and, what is of primary importance for the global financial leader, to new regional market (Central and Eastern Europe). To date Citi operates only in 3 CEE countries, namely Poland, Hungary and Czech Republic.

Being oriented on top tier corporate clients, Citibank does not intend to become a domestic financial leader, rather it is to develop new products for Ukrainian and other CEEC markets using local-specific creative assets. Furthermore, Ukrainian office should help CitiCorp in the improvement of its competitiveness in supplying already established markets.

The major impediments to operating in Ukraine are seen in high economic uncertainty, which hurts economic activity, impedes private business development and puts country into recession. The lack of private business and effects of recent financial crisis put the obstacles to Citibank operations as well.

Credit Lyonnais

Anticipating the flow of foreign investment into the new independent states (Ukraine), one of the leading financial boutiques bank Credit Lyonnais started to investigate the possibility of coming into this country right after USSR collapse in 1991. But only in 1993 CL got license for which they have applied in 1992. CL bet was on foreign companies, which upon entering Ukraine will need the full range of banking services and will prefer to do business with a well-known financial institution rather than with local commercial banks. CL, being the first foreign bank starting operations in Ukraine, serves 75% of foreign companies in Ukraine today. The bank does not narrow number of its clients by commitment to foreign companies only, but the major obstacle to co-operation with locals is a lack of credible accounting reports, i.e. trustworthy information about their performance (majority of Ukrainian companies does not use IAS).

CL improves its performance in Ukraine from year to year: the number of its clients is growing steadily as well as its profits. The figures in the beginning of 1998 are 400 and \$ 6.5 mln accordingly. What is more, despite fall 1998 financial crisis, Ukrainian branch turns out to be the most profitable among all Central and Eastern European offices of CL in 1998.

CL behavior in Ukraine fits well with the role of Client-Follower (I would say even Client-Prefollower). However, CL invested 10 mln Euro into Ukraine also attempting to

establish a strong position in the Ukrainian market and improve the competitiveness of CL group in supplying Western markets.

The major restraints to doing business in Ukraine for the bank are questions of volatility of local systems (political and economic) and ambiguity of legal regulation. But problems always follow businessmen; thus CL treats them as unavoidable obstacles and looks into the future quite optimistically.

DHL

The demand for international air express services has existed in Ukraine since Soviet time and was driven mainly by entry of multinationals into Ukrainian market. The establishment of Moscow office in 1984 was a first (brave!) step of the company into the unknown environment. With Ukraine's independence (in 1991) DHL extended its operations into this market by establishing its office in Kiev. But only in 1995 Kiev's office became fully independent (subordinated to the European Headquarter in Netherlands).

Currently, DHL employs over 200 people in Ukraine with 120 of them working in Kiev and the rest in 11 offices throughout the country. To date, with only US\$ 300,000 of

direct investments in the country, DHL has been the leading market performer - its market share is 66%, while its main competitor UPS services only 19% of the market.¹

The major motive of DHL coming into Ukraine is an attempt to provide air express services to its already established partners in Ukraine (behaviour of so-called Client-Followers). Client-Followers usually follow global market customers into their new markets. DHL does exactly the same - 60% of its customers are actually multinationals, but this share was as big as near 90% when company came into the market. This decline is an evidence not of losing old customers, but of acquiring new (local) ones (the number of DHL clients has significantly increased). Another important motive of DHL investment into Ukraine was nevertheless an establishment of a strong position in the new and potentially large market, which was successfully captured if judged by market share.

What are the other reasons of the investment decision? One could be surprised that common ones, such as cheap labor and access to a new regional (Central and East European) market are of DHL's low concern, due to specificity of the company (its share of labor costs is relatively small and the company has been already well-established in the East European market).

Currently, DHL like any foreign investor in Ukraine faces a bunch of problems, i.e. high volatility of political environment, economic uncertainty, legal system's ambiguity and

¹ According to "Research International", London. (1997)

difficulty of negotiating with government. Besides, there are also firm specific obstacles such as difficulty of negotiating with customs, problem of transparent regulation and lack of business experience among potential employees, which create additional problems for the business.

Therefore, considering high political and economic uncertainty in Ukraine, the company is not confident in its perspectives in this market, but as they joke, DHL “will be the last packing up from Ukraine”.

Kyiv Atlantic

Kyiv Atlantic, Ukraine is a Joint Stock Agribusiness Company which was founded in 1994 by the US and Off-Shore Investment Companies owned by David D. & Tamara J. Sweere of Wayzata, Minnesota, and the Ukrainian Bousnitsky Shareholders Association of Myronivka, Ukraine.

The Sweeres began their work in Ukraine in the summer of 1990 and developed a Joint Venture in Ukraine related to agricultural commodity trade called Sophia TransCon Industries, Ltd. In 1994 this company was reorganized into KAU with share of foreign capital near 90%.

In 1995, KAU was expanded with the inclusion of the European Bank of Reconstruction and Development as a equity partner and primary lender for the development of the, first of this kind in Ukraine, US\$ 25 million Integrated Agribusiness Center which is a modern greenfield project located in the District City of Myronivka, Ukraine. KAU held 'grand opening' of the first phase of the Integrated Center on August 1, 1997.

The completed portion of the Integrated Center consists of the first modern fully private grain elevator in Ukraine; a 50,000 ton per annum vegetable oil seed extraction plant and a modern Animal Health and Nutrition Center capable of manufacturing 65,000 tons of balanced feed concentrate and formulated 'pre-mix' per annum. In 1998 KAU completed the 'supply side' of the Integrated Center by adding a fuel depot, a crop chemicals warehouse, a full service farm equipment center and a technical services center.

The major objective of KAU activities in Ukraine is processing Ukrainian crops for sales (as one could be surprised) on the internal market. This strategy is justified by high domestic agricultural prices, which exceed those prevailing on export markets. Thus, being oriented on the internal market (KAU's exports only 30% of its output), company obviously attempted to benefit from more cost-effective Ukrainian production (i.e. cheap labor) and availability of and proximity to good quality primary materials (crops).

This policy perfectly matches the second major target – establishment a strong position in the Ukrainian agricultural products market. Providing high quality-low cost products KAU successfully increases its sales volumes.

However, this favorable situation has changed due to Ukrainian financial crisis. To date, owing to National Bank of Ukraine's attempt to support national currency, there are strict limits on foreign exchange sales that prohibit free conversion of hryvna into hard currency. This makes KAU increasingly rely on hard currency sales (anticipating financial gain of hryvna devaluation). As conventional hedging instruments are nonexistent in Ukraine, this strategy can also be regarded as hedging the currency risk through expanding export sales. Positively, KAU's exports are justified as well by favorable movement in the world vegetable oil prices (first time for 5 years they have exceeded Ukrainian ones).

In KAU opinion the major problems foreign investors face in Ukraine are lack of affordable financing, extremely high taxation and constantly changing Ukrainian laws. The first obstacle KAU overpasses owing to EBRD loan but the rest makes the company to spend time and resources in finding solutions. That's why it is not surprising that many Ukrainian companies work in shadow now. Nevertheless, company sees Ukrainian entrepreneurs' great potential, which has yet to be exploited when the environment will improve.

McDonald's

McDonald's is the world's largest global foodservice retailer with more than 24,800 restaurants, serving 40 million people each day in 115 countries. McDonald's opening in Ukraine highlights the company's ongoing commitment to growth and infrastructure development in its Central European region. "Our expansion in this region is an outstanding example of McDonald's continued growth potential in emerging markets around the world," said Jim Skinner, president, Europe Group, McDonald's International. "Since April, 1988, when we opened our first Central European restaurant, we have introduced McDonald's in 18 countries throughout the region and currently serve nearly one million customers per day in more than 500 restaurants." In Ukraine the company has opened 20 restaurants with the total amount of investment \$30 mln, particularly. In the coming years, McDonald's will open more than 16 restaurants with the number of investment rising to \$100 mln. Company came into Ukraine as long term investor; thus it does not count on profits in the nearest 7-10 years, being committed to the development of a strong position in the Ukrainian market.

Attracted by Ukrainian market potential, McDonald's intends to benefit from local creative assets exploitation as well. In the same time low cost inputs and skill quality of production labor are among insignificant factors for its investment decision.

McDonald's came into Ukraine with "open eyes" and was ready to difficulties, which did not make themselves waiting. The major was economic instability and ambiguity of legal system coupled by high level of bureaucracy, difficulties in product certification and negotiation with privatization authorities. However, the similar kind of problem faces the

domestic companies as well, so company treats them as inevitable part of Ukrainian environment. Thus, McDonald's is committed to enlarge its position in Ukrainian market despite the problems its currently suffers.

Nestlé

Nestlé is the world's Largest Food Company, which is truly dedicated to providing a complete range of food products to meet the needs and tastes of people from around the world. Having set up or acquired 495 factories in various countries, recently Nestlé made one more investment - in this time in Ukraine. The initial amount of investment is \$20 mln, which is to be increased to \$40mln if business runs successfully. In Ukraine Nestlé has acquired one of the most successful factories "Svitoch" in Lviv. Under Nestlé management this factory will keep to produce its own brand products for internal distribution (only 10-20% is going to be exported).

It is remarkable that Nestlé still operates through its representative office in Ukraine, though it is here since 1994 (the acquisition in Lviv was made through the establishment of another company). It does not pay to open a fully owned subsidiary in Ukraine, considers its General manager.

Nestlé objectives in Ukraine are two-fold:

- 1) as always, to supply Ukrainian market, and
- 2) to benefit from local specific creative assets (Ukrainians, especially on that particular factory, are quite well experienced with "sweet" business: their trade mark is one of the most famous in Ukraine, quality of its products is quite high, there is rather successful marketing strategy of this company and so on.)

The reasons for Food Leader coming into Ukraine are consistent with its goals, the formers are establishing a strong position in the Ukrainian market and exploiting qualified local production labor.

Problems with currency exchange are most essential for the company. However other common Ukrainian drawbacks are also significant, i.e. political and economic instability, problems in finding suitable partner, high restructuring costs and ambiguity of legal system. Although political instability is among major obstacles to doing business, company is confident in irreversibility of market reforms in Ukraine, be huge private interests involved in the system being made. It is only a question of speed with which Ukraine will approach market economy.

Northland Power

Northland Power is a leading Canadian developer, owner and operator of private power projects. Together with its engineering subsidiary, Cogeneration Associates, Northland Power is equipped to take complete control of a project, from initial concept, through financing, ownership and long term operation. Northland Power capabilities cover all

aspects of power generation. Besides its four projects in Ontario (Canada) with the total installed generating capacity of 330 MW, Northland Power has formed a joint venture with State Property Fund of Ukraine and Darnytsia HPP Ltd. to reconstruct and modernize Darnytsia Heat and Power Plant, a 300 MW project in Kyiv. The total amount of project is \$ 180 mln, to date \$ 30 mln is contributed and \$ 53 mln will be added by the end of the year.

Northland Power attempts not only to refurbish a 40-years old plant, but also to build a new one : if company negotiates an agreement with State Property Fund, the construction would begin in fall, 1999.

Northland Power's motives for coming into Ukraine are not so transparent: company does not attempt to become an energy market leader in Ukraine, electric power can not be exported and the company does not benefit from cheap labor, because it should employ 500 Ukrainian workers instead of 50 Canadians for the same operations (by General Director's words). However, Northland Power appreciates the high skill quality of production labor and availability of scientific inputs in Ukraine.

The company appeared in Ukraine attempting to make profits by supplying domestic market. Why Ukrainian one? My bet is that NP behaves as "Deal-Makers": existing relationships with governmental bodies and familiarity with Ukrainian environment similarly influence its decision (all managers are Ukrainians by origin).

However, as any foreign investor in Ukraine, Northland Power complains on the economic and political uncertainty in the country, ambiguity of legal system, problems in finding a suitable partner and in establishing clear ownership conditions and conditions of corporate governance. Furthermore, Northland Power faces specific difficulties with constantly changing Ukrainian Power Ministers. Since establishment of the company in 1997, 8 ministers have been changed. The problem is in incorporate structure of Power Agency, e.g. the successive minister does not approve or follow the documents signed by his predecessor. Usually it turns out that minister's signature on the documents is treated as his personal signature only, not as a certification by the Ministry.

OTIS

OTIS ZAT is a subsidiary of the OTIS Elevator Co., which employs 68000 workers throughout a world. It is the only "global" lift actor in the Ukrainian market, with market share making up to 50% of elevator's construction and 25% of the lift's maintenance markets.

Being oriented to extend its activities to FSU countries, OTIS Elevator Co. came to Ukraine straight away after USSR collapse. In 1992, they invested USD 17 mln in acquiring and modernizing a plant, and creating a Service Center and a Test Tower, all associated with transfer of OTIS technologies to Ukraine. To date subsidiary employs 3000 workers with annual turnover of USD 15 mln. Major part of its production is

consumed internally with only 25% of component parts exported to OTIS Group subsidiary in Russia for further assembling.

OTIS commitment to the establishment of a strong position in the Ukrainian market is rather remarkable and evidenced in presence in the country despite making no money since establishment. What is more surprising, company does not count on profits in coming years at that still staying in this market. Thus, major objectives of establishing Ukrainian subsidiary were not tied neither with achieving access to CEEC markets nor with improving the competitiveness of MNE group in supplying its already established markets. Though availability of both low-cost and scientific inputs facilitates business practice, yet it is not a determinative motif of investments into Ukraine.

So, if domestic market is so attractive, why Ukraine still faces huge lack of foreign investments? OTIS experts point out an economic uncertainty, legal system ambiguity, difficulties in negotiating with government and finding a suitable partner as major obstacles for potential foreign investors coming into Ukraine. For the company itself issues of economic uncertainty, ambiguity of legal system and too high restructuring costs are of major concern, together with another sore points, namely as nonpayment crisis and lack of affordable financing. High taxation is not seen as primary barrier to doing business in Ukraine (other countries have high tax rates as well), the problem is in widespread tax avoidance, which contributes to macro instability, consider OTIS managers.

Owens-Illinois

Owens-Illinois is the world's largest glass container manufacturer. Along with its affiliates company produces over 55% of all glass containers manufactured worldwide. A wholly owned subsidiary has been opened with an office in Kyiv to represent O-I interests and primarily offer the production from factories in Central and Eastern Europe. Attempting to be price-competitive with domestic glass container producers, O-I strongly wishes to acquire a domestic glass-works, but have to wait for Presidentialt elections to be ensured from nationalization of its acquisition. Political instability hurts company a lot, because even today company has already managed bookings from local consumers and negotiated an agreement about purchase of a domestic plant.

The key objective of the potential investor is to supply domestic market (this decision is independent from local cost advantages), i.e. provide the bottles and jars to enable Ukrainian producers to compete on a retail level with attractively packaged imported goods that are frequently of poorer intrinsic quality. While this is of crucial help for re-establishing Ukraine as a major exporter of food and drinks products (the glass container is an important part of the presentation of the product to international markets), the political uncertainty makes headquarters wait for relative stabilization before committing its capital into Ukraine. Another substantial obstacles facing O-I there are ambiguity of legal system accompanied by difficulties of negotiating with government. Economic uncertainty being a consequence of political volatility is seen as a minor problem by O-I managers.

PepsiCo

PepsiCo Ukraine Ltd., a Ukrainian limited liability company with 100% foreign investment, has been engaged since 1994 in the production, distribution and sales of Carbonated Soft Drinks and in the importation and sales of CSD concentrates to Ukrainian soft drink manufacturers who hold an appointment to produce CSD's which are the registered trademarks of PepsiCo Inc. and Seven Up International. With 40 mln investment and 60 employees in the country PepsiCo market share is only 9%. PepsiCo managed to acquire a production line in Chernovtsy, with company's bottlers (companies, which buy CSD concentrate, bottle and distribute soft drinks) located in 4 another Ukrainian cities.

Being attracted by possibility of extending MNE group's supply to the new market, PepsiCo neglected low cost inputs and local-specific creative assets motives in taking its investment decision.

PepsiCo's problems are not different from the common problems of another investors, e.g. economic and political uncertainty, ambiguity of legal system, difficulty of negotiating with government, problems of establishing clear ownership conditions, followed by high restructuring costs and problems in finding a suitable partner.

Procter & Gamble

Procter & Gamble is a worldwide leader in consumer products manufacturing and marketing. Its representative office has been opened in Ukraine in 1993. Besides its marketing activities, Procter & Gamble has acquired a factory at Borispol in 1997. To date the total amount of investment into Ukraine is about \$ 20 mln.

The main objective of establishing *P&G* operations in Ukraine was, as always, new market with minor goal in local-specific creative assets exploitation. The low-cost input factors turns out to be of no importance for the company. However, availability of scientific inputs and skill quality of production labor is another quite important reasons for investment decision.

Even though *P&G* is considered one of the most flourishing companies in Ukraine, it encounters with specific problems. The point of major concern is low purchasing capacity of Ukrainian market as a result of deep recession in the country. Despite facing rising market shares, *P&G* sales are falling due to general decline in demand.

Surprisingly, other common obstacles for business are negligent for the company. In the town, where its plant is situated the local authorities and population considers *P&G* as major breadwinner, so company enjoys highly hospital environment there. The issues of political instability, ambiguity of legal system, high restructuring costs are of minor significance for *P&G* . Therefore, its future is linked closely to general economic situation in Ukraine, which is not encouraging meanwhile.

UMC

Ukrainian Mobile Communications is Ukraine's leading cellular operator. Founded in 1992 the Ukrainian (51%), German (16.3%), Dutch (16.3%), Danish (16.3%) joint venture is an excellent example of successful co-operation between Ukraine and Europe's leading telecommunications companies. UMC was the first to introduce cellular communications in Ukraine and to date remains the major market participant (its market share is above 75% according to Ragan World Media).

UMC employs more than 650 highly qualified specialists in 27 branches throughout Ukraine with number of clients augmented from 500 (in 1993) to 55,000 (in 1997). The amount of investment grew significantly from \$ 6 mln (1993) up to \$ 200 mln (1998), accompanied by increase in revenues from \$ 1.3 mln (1993) to \$ 103 mln (1997). It is worth to point out that company runs its business very successfully: its profits rose from \$11.5 mln in 1996 to \$14.4 mln in 1997, despite the fact that UMC became a corporate profit tax payer for the first time in 1997.

Such flourishing (by Ukrainian standards) performance is a result of first and fast entry into the country, where demand for mobile communications services has already existed. That was accompanied by realization of UMC's key objective: extension of mobile service supply into the virgin Ukrainian mobile communications' market.

UMC masters to be successful despite number of problems it currently faces, namely political and economic uncertainty, too high restructuring costs, problems in finding a suitable partner and establishment of clear ownership conditions, ambiguity of legal system and difficulty of negotiating with government. Nevertheless, the company is optimistic about its future and will keep raise investment into Ukrainian economy attempting to justify its motto: UMC is there, where you are.