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The Impact Of Foreign Direct Investment On The Performance Of Small And Medium Enterprises In Ukraine

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ABSTRACT

Ukraine is the second biggest state in Europe Because of the wealth of natural resources, and fertile farmland, cheap labor and high demand for products of many industries, Ukraine is the interesting territory for foreign investors. On the other hand, Ukraine is the country with the instable legislation, unstable internal policies, unstable exchange rates. That affects the level of trust of potential foreign investors, who could be willing to carry out foreign direct investment (FDI) in that country The aim of this article is to present the analysis showing the structure and directions of development of the FDI (foreign direct investment) in Ukraine and Foreign economic activity of enterprises in Ukraine has been analyzed. The main problems of foreign economic activity realization have been examined.

1. Introduction

Foreign economic activity of an enterprise is one of the spheres of its economic activity, which is closely linked to foreign trade, export and import of goods, foreign loans and investments, realization of mutual projects with enterprises of other countries. Expansion and deepening of foreign economic connections are characteristic for modern period of the world economy development. Through foreign economic connections international division of labor is performed, the goal of which is saving social labor during production and exchange of its results between different countries. Without effective division of labor the world economy could have never reached high level of development. Therefore the research and analysis of foreign economic activity of an enterprise are important and require attention.
Analysis of recent researches and publications. The attention to the problems and necessity of activation of foreign economic activity of enterprises in Ukraine was paid only at the end of 80-ies - beginning of 90-ies of the last century, when Ukrainian enterprises started to enter the foreign markets. However the proper attention to the analysis of foreign economic activity of enterprises of different regions of Ukraine has not yet been paid. The objective of the paper. The objective of this paper is to analyze foreign economic activity of enterprises in Ukraine.

1. Institutions and economic activity(Concepts)

Institutions encompass formal rules such as laws and regulations and informal conventions such as mores and customs. These conventions shape the behaviour of members of a society as well as expectations about behaviour. They determine the types of activities that are encouraged or prohibited as well as the rewards and sanctions associated with undertaking these activities. Institutions govern activities in all spheres of society, including economic activity. North (1991) suggests that institutions provide the incentive structure of an economy and that, as the structure evolves, it shapes the direction of economic growth towards growth, stagnation or decline.

1.2 Geography, policies and institutions

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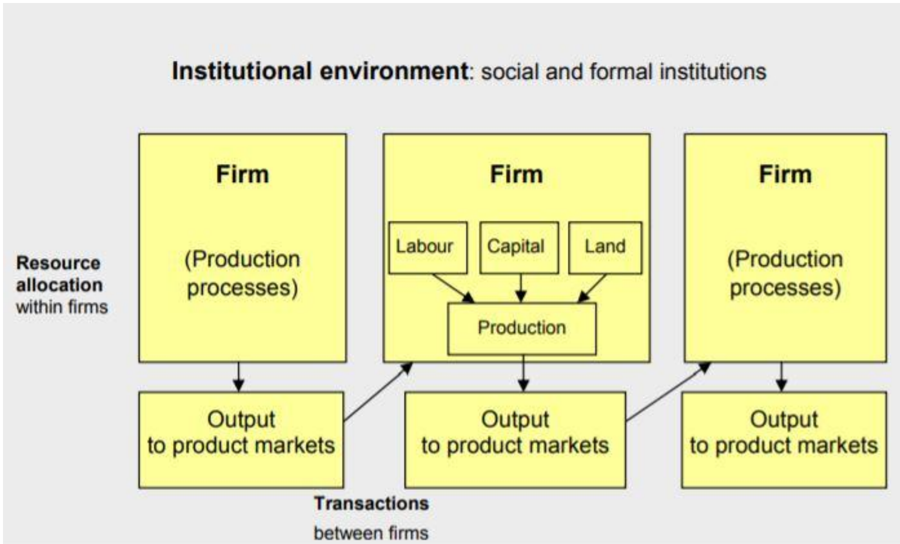
Three underlying forces that are thought to drive a country's economic growth: its geography; its economic policies; and its institutions. There is debate about the relative importance of each in terms of their contribution to economic growth, but there is general agreement that well performing institutions are associated with economic growth. Geography affects the potential of a country to grow through its location relative to other countries and its endowment of natural resources. Easterly (2003) notes that theories on a country's geography/endowments suggest that the environment directly influences the quality of land, labour and production technologies. Geographical features may also limit a country's opportunities for accessing large economic market, such as, in Ukraine case, its distance from its markets. The economic policy view does not consider historical legacies to be particularly important, believing that historical settings can be easily reversed. It emphasises current knowledge about economic development and political forces rather than history or factor endowments. This view holds that sound macroeconomic policies, openness to international trade and the absence of capital account controls will tend to foster long-run economic success. Proponents of the importance of institutions hold that the formal and informal practices that a country has developed to guide interactions between the members of a society affect the ease with which economic activity can take place. Institutions that are seen to support a country's economic development include institutions that protect private property rights and the operation of the rule of law, lead to low levels of corruption and facilitate all private interactions rather than protect a small elite. The broad environment (including factor endowments, social arrangements and colonial power) has powerful effects on the sorts of institutions that evolve. Historically, geographic characteristics have often had an impact on the nature of a country's institutions. Countries with hospitable climates often led to settlement by colonists and attendant institutions that supported the economic development of a country (Easterly and Levine 2003). Countries that were less geographically hospitable instead tended to see "extractive" institutions implemented that supported the removal of economic resources from the country to the colonial power. The quality of a country's institutions, as introduced by European colonisers, tended to be lasting or exploitative depending on the suitability of the country for European settlement (as measured by mortality rates) (Acemoglu et al 2001). A study by Engerman and Sokoloff (2003) found that geography seems to have played a greater role in determining the institutions adopted by colony countries than the particular country they were colonised by. In considering the effects of geography, Easterly and Levine (2003) conclude that geography/endowments explain cross-country differences in economic evelopment but only through their impact on institutions. Policies do not explain cross country differences once the impact of endowments on institutions and on economic development have been controlled for. Thus, correcting bad policies without correcting the institutions will bring little long-run benefit. The IMF (2003)1 notes that there are important interactions between institutions and economic policies, with the quality of institutions influencing the strength and sustainability of policies and vice versa. The interplay between these two drivers is important for economic growth but it makes it difficult to identify their individual contributions. Rodrik, Subramanian and Trebbi (2002) found that the quality of institutions is most important in driving economic growth, with geography and policy having, respectively, weak and negative effects on economic growth. Sachs (2003) disagrees in regard to geography. He notes the direct effects of geography on production systems, human health and environmental sustainability and looks specifically at the relationship between the prevalence of malaria and GNP per capita. He concludes that "there is good theoretical and empirical reason to believe that the development process reflects a complex interaction of institutions, policies and geography." (2003: 9).

1.3 Firms and institutions

There are four principal categories of institutions that shape the economic activity of firms (Williamson 2000). They are conventions in the social environment such as customs, norms, and social networks; formal institutions such as the polity, judiciary, bureaucracy; the "rules of the game", especially those related to property; institutions governing the "play of the game" such as transactions between firms and the governance of transactions, especially contracts; and institutions related to resource allocation and employment within firms. Both formal and informal institutions provide the underlying environment in which economic activity takes place. The effect they have is broad, affecting all aspects of economic activity, and long term, as they change very slowly. By shaping the environment for economic activity, these institutions influence the level of income a country can attain. Specific institutions govern the activities carried out by firms in the course of producing output and engaging in transactions with others. The institutions associated with these activities affect firm decisions about using resources and undertaking transactions. These introduce structure into the operation of markets in order to improve the way in which they function. Institutions at these levels directly affect economic activity and therefore economic growth. The relationship between institutions and firms are illustrated in

Figure 1.

Figure 1 *Institutions and economic activity*



Source: *Williamson 2000.*

2. Theoretical aspects of taking the FDI through enterprises.

OECD has elaborated the model definition of FDI. Model includes investments aimed at obtaining an investor's lasting impact on a foreign company. The result is establishment of a long-term relationship between the investee and the company. According to the OECD, "a direct investment company is an entity in which a foreign direct investor holds at least 10% of the ordinary shares (i.e. shares in capital) or entitles to 10% of voting rights at the General Meeting of Shareholders or otherwise has an effective effect on the management of the company " (OECD, 1999). The motives and aspects, motivating factors for entrepreneurs to undertake FDI are widely analyzed in the literature. Particularly important seems to be the following conceptions - made by S. Hymera theory, followed by F. Knicerbrocker, which establish, that a company investing outside its home country has some losses compared to competitors from its host country. That is why the foreign investors will seek compensation, which is only possible if he has some advantages over local companies. Having these advantages is the reason and a condition for achieving its specific c benefits (Karaszewski, 014). The conception of inside transactions, made by M. Casson, P. Buckley, A. Rugman, S.P. Magee is saying, that the enterprise internalizes its activities in the form of FDI when the costs of contracts with contractors or transactions on the market, are lower than those within the company (home, national) (Buckey, 2002). S. P. Magee, the author of concept of appropriateness, underlines the same aspects and factors of the business activities, but it has brought them to the situation of innovative companies, which have their advantage over other organizations on the market owing to their technical knowledge and high production technology. They are making a foreign expansion through creating your own branches to provide them with the right level of protection for your technology and prevent it from spreading to your competitors, thus allowing you to get a better return on your investment (Gorynia, 2007). The product life cycle theory created by M. Posner, expanded to the FDI by R. Vernon, analyzes this phenomenon from the product side of the company and its existence on the domestic and foreign markets. The product goes through three stages: innovative, mature and standardized product. The first stage is when a company starts producing a new product, usually in a developed country, where it is possible to raise capital, and consumers have adequate income. Production and sales are made in one country (Gorynia 2007, p. 98). The next stage is the mature product. This stage begins when the price elasticity of demand is increasing and the company, seeking cheaper solutions, starts production in countries where it has previously exported its product, and where its production is cheaper. This usually means that it starts direct investment in these countries, creating its own new affi liates. The fi nal phase is a standardized product. At this stage, the company loses its technological edge over its competitors and has to seek other solutions. Competition is based on price, so the company transfers the production of a given product from the country of current foreign investment to the developing countries, where the cost of producing it is the lowest (Pilarska, 2005, p. 22). The consolidation of following theoretical conceptions is the "OLI paradigm" developed by J. Dunning. It presents a hypothesis indicating that the company is pursuing its foreign expansion in the form of FDI, if the conducting the business abroad is more profi table than in its home country. For this to happen, a company must have certain specifi c strengths that give it an edge over its competitors (Przybylska, 2001). To those edges belongs: ownership advantages (Pilarska, 2005), dominance over competitors through patented technology, trademarks, company size, advantage resulting from internationalization (reduction of transaction costs and others), and location advantages (e.g. local availability, investment climate in the host country, market size, and so on). J. Dunning has drawn from the aforementioned theories (and others) that the greater the profi tability of these advantages abroad, the more the company will seek to invest directly outside the home (Rymarczyk, 2004).

2.1 Condition for operating in the form of FDI in the Ukraine

For undertaking the business activity trough foreign entities in a given country the administrative and legal conditions are very important. From those conditions depend largely on, if the infestation will be profi table and the country attractive for the future investors. The main normative act in Ukraine in this regard is the Constitution - passed in 1996, which in Article 42 authorizes doing business in that country, and in Article 26 extends this right to foreigners. Very important for the foreign investors in the acts regulating the issue of FDI in Ukraine are also the Commercial Code and the Civil Code of Ukraine, as well as the law on joint stock companies, commercial companies and the principles of foreign investment (Sobczak, 2007).

Foreign entrepreneur (the same as Ukrainian citizens) is able to start the business activity in this country through: to start from scratch on the Ukrainian law of a new entity, to buy in part or in full the existing Ukrainian company, to establish an agency or subsidiary (brunch) and to enter into an agreement with an existing Ukrainian entity. Foreign entrepreneur (as well as Ukrainian citizens) can start a business in this country by: starting a new Ukrainian entity from the ground up, buying in part or in full the existing Ukrainian company, setting up a representative office or branch and concluding an agreement with an existing Ukrainian entity activity.

On 3 February 2021, the Draft Law of Ukraine No. 5011 "On Foreign Investment in Legal Entities of Strategic Importance for National Security of Ukraine" (the "Draft Law") was registered in the Ukrainian Parliament upon the submission by the Ukrainian Government. The Draft Law aims to introduce the industry-specific screening and control mechanics for foreign investments in strategic sectors and protect domestic security interests in such sectors. According to the Draft Law, the list of activities of strategic importance (the "Strategic Sectors") includes certain activities in military and defiance, aviation and aerospace, use of nuclear power and nuclear waste, geological studies of subsoil, the business of monopolies in telecom and ports, and the business of natural monopolies (with certain exceptions), among other sectors. The introduction of the screening and control mechanisms contemplated by the Draft Law follows the European trend towards enhanced FDI screening for strategic assets, which was implemented (in turn) based on the new EU FDI legal framework. A foreign investment into a company that has been operating in any Strategic Sector in the last three years (an "Investee Company") will be subject to mandatory screening and control requirements, as proposed by the Draft Law, as follows:

1. Each qualifying foreign investment in an Investee Company (an "FDI Transaction") will be subject to screening by the Ministry for Development of Economy, Trade and Agriculture of Ukraine (the "Ministry"). The Draft Law sets out different thresholds that will trigger the screening requirement, depending on the investment type, including those, for example:
2. resulting in the foreign investor's ability to manage more than 25% of total voting shares or the acquisition of 10% and more shares in the Investee Company; allowing the appointment of the Investee Company's management (i.e. Investee Company's sole manager and/or more than 25% of the Investee Company's collegial executive body, and/or more than 25% of the Investee Company's supervisory board or other management bodies) and/or the blocking of decisions of Investee Company's management bodies; resulting in the ownership or use of the Investee Company's fixed assets, which value is equal to 25% or more of total fixed assets value of the Investee Company; and establishing the foreign investor's intent to acquire/reach 10%, 25%, 50%, 75% or more of total voting shares

of the Investee Company or acquire ability to exercise decisive influence over such Investee Company (irrespective of the formal shareholding).

3. A foreign investor will be required to submit a request for approval of a FDI Transaction to the Ministry and all supporting documents (including audited financial statements for the last reporting period, an ownership structure, official data on its income and taxes paid in the last two years and a draft agreement for the FDI Transaction).
4. The Ministry will review the documents within ten business days and notify the foreign investor of its decision within five business days as to whether a further impact assessment is required and, if yes, will pass the documentation to the Interagency Commission on Impact Assessment of Foreign Investments (a new controlling body to be created by the Ukrainian Government pursuant to the Draft Law) (the "Commission").
5. The Commission will then carry out its impact assessment of the FDI Transaction according to criteria to be approved by the Ukrainian Government.
6. If the Commission approves the FDI Transaction, the foreign investor will be able to proceed with it, and vice versa. Notably, the foreign investor will have an opportunity to challenge the Commission's decision in court.

Currently, the Draft Law does not set an overall timeline for screening an FDI Transaction, except for the privatisation procedure, where the term should not exceed 45 calendar days from the day when the Ministry received the investor's request. In any event, a foreign investor should refrain from any actions regarding an FDI Transaction prior to receipt of the Commission's approval (with certain exceptions in the course of a privatisation procedure).

If the FDI Transaction is also subject to a merger clearance, the Antimonopoly Committee of Ukraine will only be able to issue its clearance if the Commission has previously approved such FDI Transaction.The Draft Law has not yet passed the first reading in the Ukrainian Parliament. CMS will continue to closely monitor the status of the Draft Law and produce further updates in due course.(the Draft Law of Ukraine No. 5011 dated 3 February 2021 "On Foreign Investment in Legal Entities of Strategic Importance for National Security of Ukraine").

3. Analysis of foreign investment in institutions and companies in the Ukraine

3.1 State-Owned Enterprises

The Government of Ukraine operates 1,600 state-owned enterprises (SOEs) out of 3,358 registered SOEs, with an economic output of approximately ten percent of GDP. While the government lists 3,358 enterprises, more than 1,700 of them no longer operate as functioning businesses. SOEs in Ukraine are defined as companies in which the state owns at least 50-percent plus one share. SOEs are active in areas such as energy, machine-building, and infrastructure. Some of the companies have significant environmental problems, legacy legal issues, or oligarchs as minority owners. There is no common public list of all SOEs in Ukraine and each ministry publishes a list of SOEs under its respective management. The Ministry of Economic Development and Trade periodically updates information on annual financial reports of significant SOEs (100 of the largest SOEs), which it publishes on the ministry website.

Most SOEs rely on government subsidies to function and cannot directly compete with private firms. Several SOEs capable of making a profit have already been privatized, and the result has been that the most inefficient firms have remained in government hands. The Ukrainian government continues to heavily subsidize state-owned enterprises (especially in the coal mining, rail transportation, gas, and communal heating sectors) and has sometimes paid outstanding debts of some SOEs with sovereign loan guarantees. SOE access to extensions of tax payment deadlines remains nontransparent, especially where SOEs are directed to sell their products at below-market prices.

3.2 Money and Banking System

Ukraine's banking sector has seen remarkable progress following the 2014-2015 crisis thanks in large part to banking sector cleanup, which resulted in the closure of over 100 banks for insolvency or money laundering activities, and the professionalization of Ukraine's central bank, the National Bank of Ukraine. At the end 2020, 73 solvent banks were operating in Ukraine. Partly due to the Covid-19 pandemic, the number of unprofitable banks ticked up in 2020. Eight banks were unprofitable in 2020 compared to six in 2019, and two banks were declared insolvent due to non-compliance with capital requirements. The banking sector in Ukraine reported net profit of UAH 41.3 billion ($1.4

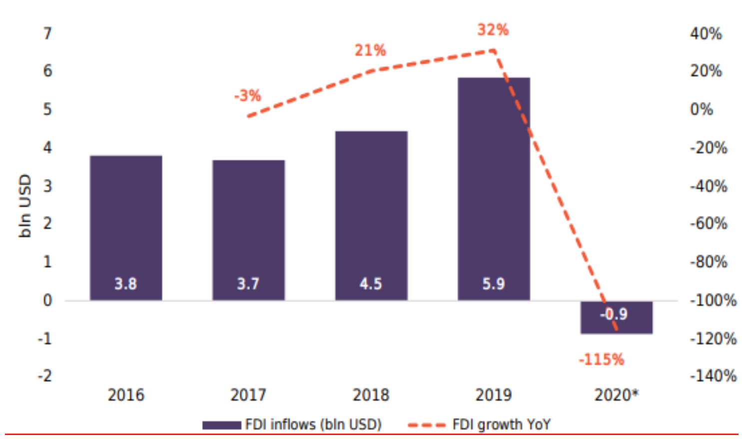
billion) for 2020, roughly a quarter of the profit reported in 2019. State-owned PrivatBank accounted for more than half of the banking sector's total profits. In 2020, banks' total assets increased by 22 percent to UAH 1.8 trillion ($64 billion), the total amount of loans decreased by 6.8 percent to UAH 963 billion ($34 billion), while total obligations increased by 24.6 percent to UAH 1.6 trillion ($21 billion). Non-performing loans (NPL) decreased from 48.4 percent in 2019 to 41 percent in 2020 but remain one of the biggest unresolved issues in the banking sector. State-owned banks wrote off UAH 30.6 billion ($1.1 billion) in local currency loans and $3.1 billion in dollar-denominated loans in 2020, reducing their share of NPLs from 63.5 percent to 57.4 percent. The share of NPLs in foreign commercial banks decreased from 16 percent to 12.3 percent, and in Ukrainian commercial banks from 18.6 percent to 14.6 percent. Greater oversight by the National Financial Stability Council, along with the National Bank's new criteria for writing off distressed assets, has improved the banks' NPL strategies. Foreign-owned banks may carry out all activities conducted by domestic banks, and there are no restrictions on their participation in the banking system, including operating via subsidiaries. A foreign company can open a bank account in Ukraine for the purposes of investment operations; otherwise, it needs to register a representative office in Ukraine. A nonresident private person can open a bank account in Ukraine. A foreign investor may open an account in a bank operating in Ukraine and transfer in funds for further investment or invest directly into an account of a Ukrainian resident company.

3.3FDI stock data revision

The COVID-19 pandemic and the subsequent Great Lockdown have affected investment flows all over the globe, especially in emerging markets. According to UNCTAD1, global Foreign Direct Investment (FDI) flows dropped by 35% in 2020, to $1 trillion, from $1.5 trillion in 2019. This is almost 20% below the 2009 levels after the global financial crisis. Moreover, the number of newly announced greenfield projects in developing countries declined by 42% in 2020 compared to 2019. To assess the impact of the crisis on the FDI flows in Ukraine, it is crucial to have a snapshot of the pre-crisis situation along with developments in 2020 .

In 2019, FDI inflows in Ukraine amounted to $5.9 bln, the highest figure throughout 2016-2020. Moreover, compared to 2018, FDI increased by 32%, which was also the highest over the period. Over the years 2016-2019, the share of reinvestment in FDI inflows gradually increased from 14% to 55%. In 2020 however, Ukraine recorded negative FDI inflows of $0.9bln, declining by approximately $7 bln, or 115%, compared to the 2019 figure. UNCTAD highlights two major projects initiated in Ukraine in 2020, despite the overall decline. An agreement has been signed with Chinese investors on building a $1 bln 800 Megawatt Donetsk onshore wind farm, while German Kostal started a $170 mln project to produce automotive components.

Figure 2 *Net FDI inflows in Ukraine and its growth rate*



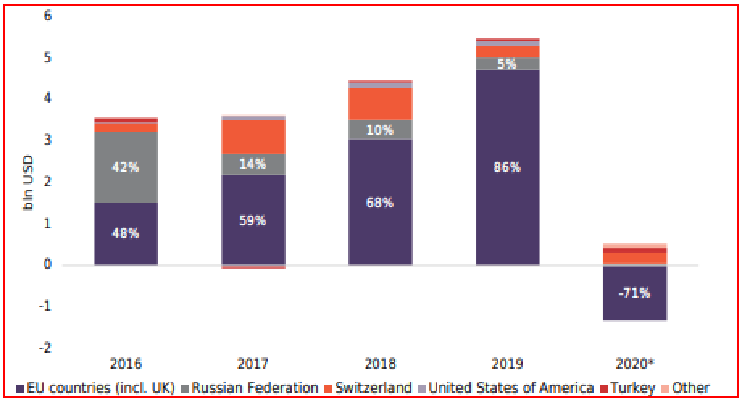
Source: *National Bank of Ukraine*

According to UNCTAD, in 2020, Ukraine initiated the provision of fiscal incentives such as tax exemptions, import duty exemptions, preferential land access, and construction of necessary infrastructure for large investment projects.

3.4. FDI by Countries

From 2016 to 2019, the share of EU countries in yearly net FDI inflows has increased significantly, while investments from Russia witnessed a sharp drop during this period. More specifically, the share of the EU countries and Russia were 48% and 42%, respectively in 2016. However, in 2019 the share of the EU countries amounted to 86% of total flows, while Russia's share shrank to 5%. It is noteworthy that in 2017 and 2018 Switzerland's share in total FDI flows increased significantly and amounted to 22% and 16% correspondingly, however, in 2019 it dropped back to 5%. In 2020, due to the COVID-19 pandemic, net direct investment inflows from EU countries sharply decreased. Notably, FDI outflows by EU countries accounted for -71% of total FDI flows in 2020.

Figure 3 *Net FDI inflows in Ukraine and the shares of countries in total FDI flows*



Source: National Bank of Ukraine

Looking at FDI positions, or stock of investments in the Ukrainian economy by countries, by the end of 2020, Cyprus was the biggest FDI partner of Ukraine in terms of accumulated FDI over time with a share of 31% in total FDI stock in Ukraine. Cyprus was followed by the Netherlands, which accumulated 20% of FDI stock. It is worth noting that by the end of 2020 Ukraine's FDI stock was characterized by a lack of diversification, which is manifested by the fact that Cyprus and the Netherlands amounted to 51% of total FDI inflows. Interestingly, by the end of 2020, the vast majority of the top 10 FDI partners of Ukraine were the EU states (excluding the UK, Russia, and Switzerland). Only two of the neighboring countries of Ukraine (Poland and Russia) were found among the countries with the highest FDI stock by the end of 2020.(National Bank of Ukraine)

3.5 Obstacles to FDI in Ukraine

The most prominent obstacles that prevent the process of attracting investments in Ukraine are:

- Corruption, poor infrastructure and weak protection of property rights are some of the main obstacles for foreign investors in Ukraine
- The conflict with Russia is one of the main impediments to foreign investment in the country, with infrastructure in the areas occupied by Russia severely damaged.
- Freight rail, mines and industrial facilities are some of the infrastructures in poor condition due to the conflict.

Conclusions.

Investment is central to growth and sustainable development. It expands an economy's productive capacity, creates jobs and raises income. Under the right conditions, foreign direct investment (FDI) can provide additional advantages by bringing new knowledge and more sustainable business practices to recipient countries, and ultimately improve their citizens' standard of living. These benefits do not occur automatically, and an adequate policy framework is necessary both to attract investment and to maximise positive FDI spillovers. FDI in Ukraine has grown considerably over the last two decades, and is associated with greater innovation capacity. Yet, already below potential compared to neighboring regions, FDI flows to the EaP countries are likely to drop sharply as a consequence of the coronavirus (COVID-19) pandemic and resulting global economic upheaval. There remains considerable scope for improving the investment climate, in order to retain existing investors, attract new ones, and mitigate the expected drop in FDI inflows.

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