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NEWS OF THE MONTH

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Budapest, Hungary, Phone: +36 1 248 1160, +36 1 248 1161 Fax: +36 1 319 0628
E-mail: office@icegec.hu Website: www.icegec.org

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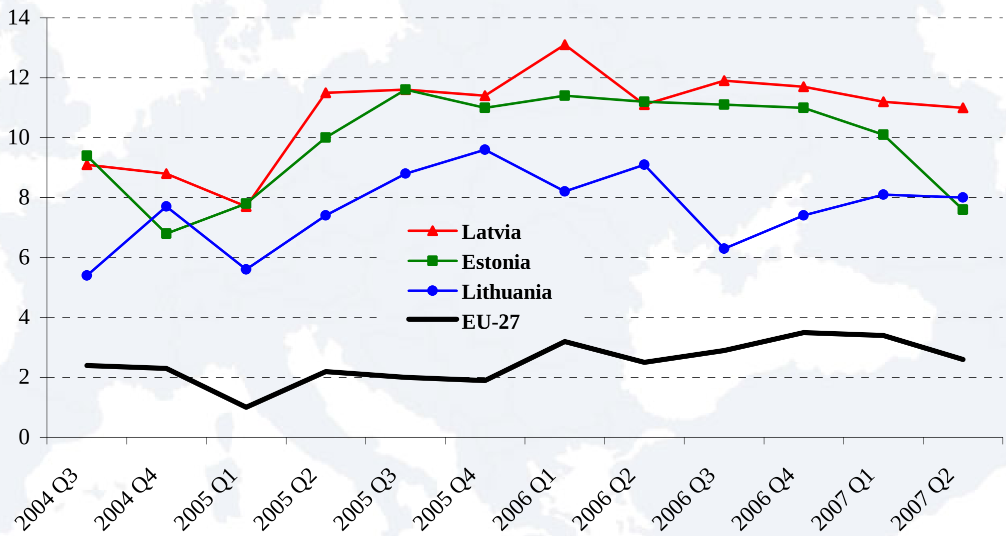
TOURISM IN THE BALTIC STATES – MORE VISITORS, HIGHER GDP GROWTH RATE?

On 1 May 2004, the three Baltic States, Estonia, Latvia and Lithuania joined the European Union; as a result, the tourism industry has excelled during the last years, exceeding the combined tourism growth[1] for the 25 EU states of 1.6%. In the last 12 months, the three former communist states' GDP per capita increased the most considerably in comparison to the other members of the union, recording an average of slightly more than 10% growth in 2006. The analysis examines the correlation and causality between the aforementioned, most notably boosting indicators of fastest growing economies of the EU.

RECORD GROWTH IN NORTH EAST EUROPE

Estonia, Lithuania and Latvia inherited small public debt from the former Soviet Union, furthermore, a determined and strict fiscal policy have been conducted in the last decade. Estonia was the example in the region, as a great financial stabilization was done after the change of regime. They liberalised the officially pegged prices and opened their markets ahead of foreign – mostly Scandinavian – capital. They established a currency board and the tax system was also reformed, a simpler, linear personal income tax system was introduced. This model proved to be so successful, that Latvia and Lithuania followed the same route after Estonia.

Chart 1. Real GDP Growth of the Baltic States and EU-27 in 2004-2007 (%, y-o-y)



Source: Eurostat

One of the main factors behind these countries' growing prosperity was the opening up of their property markets to foreign investors. There are no restrictions on foreigners owning property in the Baltic States. As a result, stable and rapid growth characterises all three countries, especially Latvia; its growth rate was never below 11% since 2005.

[1] Statistical Office of the European Communities (Eurostat)

However, serious problem of the Baltic economies are the challenges originated from current account and price developments, that threatens its ability to join the euro area.

TOURISM PROCESSES IN THE BALTIC STATES

The number of tourists has increased in all three Baltic countries since 2004. Before 1991, the three countries along the Eastern coast of the Baltic Sea were very popular destinations for inhabitants of Soviet Union. As a matter of fact, the development of tourism was mainly focused on local tourism. After regaining independence, especially incoming tourism has become a significant economic sector in the region. In 2004, revenues from incoming tourism in the Baltic States amounted to EUR 1,763 million, corresponding to 4.7% of the Baltic States' combined GDP.2

Before 1991, the nature, culture and historical heritage of the Baltic Three were not discovered. After joining the EU, more attention was paid by the mass media, the membership is also considered as a free international advertisement. The fact that Estonia, Latvia and Lithuania are all transit countries, previously people were attracted mainly for transit purposes, being offered an enjoyable one-day stay. However, the number of overnight international visitors almost doubled since 2000 due to well-coordinated and sustainable tourist development. In addition, growing number of transport connections to the Baltics appeared. Only in 2006, 14 new flight destinations have been opened from Riga, Latvia – the busiest air transport junction in the region, - and 4 destinations from Vilnius, Lithuania.

Table 1. International Visitor Numbers in the Baltic States

International visitor (thousands)	Estonia			Latvia			Lithuania		
	2000	**2006**	**2010***	**2000**	**2006**	**2010***	**2000**	**2006**	**2010***
Cruise	109	326	393	36	102	122	5	27	32
Same-day	1981	2500	3010	1337	2854	3437	3004	3165	3811
Overnight	1220	1851	2229	509	1395	1680	1083	2162	2603
Total	***3310***	***4677***	***5632***	***1882***	***4351***	***5239***	***4092***	***5353***	***6446***

** 2010 estimations by WTTC*
Sources: World Travel and Tourism Council

According to the World Tourist Organization (WTO) data, in 2005, Latvia became the European leader by growth of international tourism. The average growth of tourism in the EU was 4%, while international tourism in Latvia grew by 20%, in Lithuania and Estonia by 15% and 7%, respectively. In 2006, 5.41 million foreigner overnights were recorded by Baltic accommodation establishments. The number of overnight international visitors has almost tripled in Latvia since 2000, and estimations indicate that the trend will continue in the future. Similar conformation of data can be noticed in Estonia and Lithuania.

The most valuable markets for the overall Baltic region today appear to be Finland, Germany, Russia, Belarus, Sweden, Poland and United Kingdom. Majority of the growth has come from the EU countries, but the number of Russian travellers could increase in the future too. It is important to mention, that for example Lithuania offers favourable regulations for obtaining visas for travellers from Russia and Belarus since April 2006. Each Baltic state has defined their priority markets in state tourism planning documents. Priority is given to neighbouring

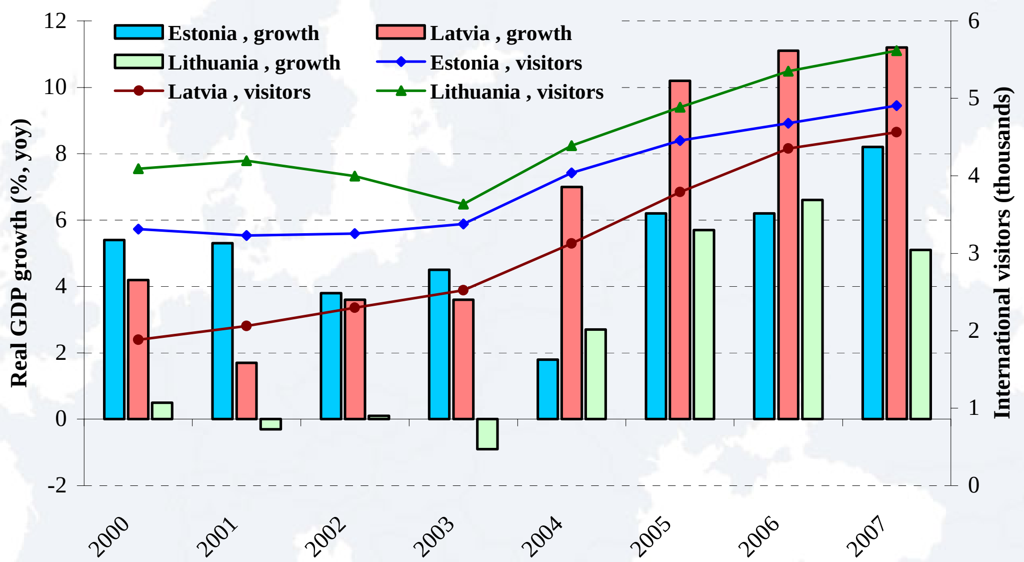
[2] Consumetric, 2005

tourism markets, such as Russia, Scandinavian countries, Germany and Poland. Perspective tourism markets are the United Kingdom, France, Spain, Italy and the Benelux countries.

TOURISM IN GDP GROWTH

Tourism is an important source of income, a generator of employment and a significant factor for regional and social development. Income from tourism is gradually increasing because of increasing number of foreign travellers. The WTO forecasts that the volume of tourism can double within the next 20 years in the Baltic region. Even if the tendencies of tourism income show a gradual increase, it does not exactly mean that the benefits from tourism and travel industry have increased by the same amount. Many tourists are spending a small amount of money or they are not spending at all. This can be explained by the fact that over 20% of the population of the region is Russian - because of the mass migration from Soviet times. Many international visitors are visiting relatives and are not potential tourists. Moreover, increasing tourism attracts more private investments from outside - since new places for accommodation, e.g. hostels, hotels and camping sights are needed to be built – which leads to outflow of income to foreign private companies.

Chart 2. Real GDP Growth and Number of International Visitors, 2000-2007



Source: World Travel and Tourism Council

Although *Chart 2* shows that the trend of the GDP seemingly follows the trend of the number of international visitors - which is of course, not a random coincidence, - however, the conformation of the two indicators does not explain each other significantly. More clearly, there exists some correlation between the number of foreign visitors and the rate of GDP, but the rapid growth rate in all three countries - especially in Latvia - is not a direct result of the increase in the number of international visitors.[3] After analyzing the results of the Granger

[3] Correlation does not necessarily imply causation in any meaningful sense of that word. The Granger (1969) approach to the question of whether 'x' causes 'y' is to see how much of the current 'y' can be explained by past values of 'y'.

causality tests[4] on the three countries, it has become evident that each of the three pairs of causalities was rejected, none of the time series cause the tendency of the GDP.

The explanation for the result of the tests lies beneath the structure of the GDP. For example in 2005, the tourism sector contributed to nearly 2% of Latvia's GDP, which is prosperous of course, but considered insignificant in shaping the tendency of the growth rate. Furthermore expenditures of the governments on tourism increased gradually and counterbalanced the income as expenditures of foreign travellers increased during the past years in the Baltic States.

The rapidly introduced market economy, the support of inflow of foreign capital and the significant growth in private consumption – which is supported by high liquidity and an increase in real wages - are the real driving forces behind the GDP. Possibly the fact that confirms the most the results of the causality tests is the negatively correlating tendency of forecasted data on GDP and international visitors in the Baltics: while *Table 1* points out that the number of visitors will constantly increase in the future, the GDP in each country has already started to decrease, and will follow the same tendency in the future. Finally, as the foreign direct investment volumes are expected to decrease gradually in the future, it could be more logical that the cause behind the fall of GDP is the drop of the FDI and not the trends of tourism indicators.

[4] Granger causality tests were carried out with Eviews 5.0. The tests are not authoritative, since the samples were small, non-representative.

The Czech Tax Reform in the Light of Competition for FDI among NMS-8

The World Bank published Doing Business Report 2008 (DBR), ranking 178 states of the world. The scoreboard refers to the national policy that renders the business environment easier or more difficult. According to the report, there is globally increasing pressure on national governments to simplify and quicken the public administration procedures related to the start-up and operation of firms, and to reduce the tax burden and the administration costs related to taxation. The pressure is induced mostly not by the corporate sector, but the ongoing reforms of countries competing for FDI.

The survey of the World Bank confirms the economic policy assumption, that the eased public procedures and the lower tax burdens create a more favourable business environment. The return on investments correlates significantly with positive and negative reforms in the world influencing the willingness to launch an enterprise. Nevertheless, it determines the economic growth, the rise of employment and the size of informal sector.

Competition for More Attractive Business Environment in NMS-8

By DBR, in Central and Eastern Europe and in other post-soviet member states, there has been a shocking wave of deregulation and liberalization in the public prescription on business sector, what resulted for example pushing ahead 21 positions for Hungary (45.) in the global order, outpacing the Czech Republic (56.), Slovenia (55.) and Poland (74.) among the most important rivals, but lagging behind the Baltic states and Slovakia (32.).

The significant improvement of the Hungarian position is not amazing, if the business environment reforms have been followed. The new Business Corporations Act, Cooperative Act, Business Act in 2006 eased the business start-up and the data service significantly, beside, introducing the Business Service for better information redistribution and faster public administration. Moreover, the new Bankruptcy Act in 2005 quickened the procedures and strengthened the protection of investors' and creditors' interests. The option for electronic firm register introduced in 2007 makes the registration of new firms quicker and cheaper. Also, the decrease of minimum capital requirement improved the DBR business environment rank. Meanwhile, the tax increase on corporate return and labour cost and the increasing business administration burden related to VAT-return in the 3rd quarter of 2006 meant negative reforms in the World Bank's evaluation.

Since the DBR Scoreboard shows permanently changing relative positions in business regulation, neither Hungary nor its main rivals can feel their business attractiveness in safe. Among the NMS-8 Czech Republic plans the most significant easing in the corporate and labour tax burden for 2008.

Changes in Czech Tax System

Until the end of 2007, the Czech Republic has had a progressive personal income tax scale with fore different rates (12% the lowest, and 32% the highest above EUR 11,800 income). Besides, there have been high rates of social security charges, 12.5% on employees and 35% on employers. On 21 August 2007, the Chamber of Deputies of the Czech Parliament passed the reform package for stabilisation of public budgets submitted by the new coalition government. The announcement on tax system reform, getting in force on 1 January 2008, includes the introduction of 15% flat individual income tax rate which will drop further to 12.5% as from 1 January 2009, the diminishing of tax on return and interest, and the gradual corporate tax cut from 24% to 21 % in 2008, to 20 % in 2009 and to 19 % as of 2010. The current 25% national withholding tax rate for royalties, rental income and income from payments for services provided in the Czech Republic will be reduced to 15 % from 1 January 2008 and further to 12.5 % from 1 January 2009. An exception will be the income from financial leases being subject to a 5% withholding tax (currently 1 %).

Table 2. Tax Burden on Different Capital Incomes in NMS-8, 2005 (% of GDP)

Country	**Corporate tax**	**Self-employer tax**	**Tax on households' capital related income**	**Property tax**
Czech Republic	4.5	1.7	0.1	0.7
Estonia	1.4	0.1	0.3	0.6
Latvia	2.0	0.1	0.0	0.7
Lithuania	2.1	0.2	0.4	0.6
Hungary	2.2	0.3	0.6	1.3
Poland	2.5	3.5	0.2	2.2
Slovenia	2.9	0.8	0.2	1.0
Slovakia	2.8	1.2	0.0	0.7

Source: Eurostat

However, tax cuts must be compensated concerning public budget revenues. The reform sets two directions to anticipate the loss of tax incomes in public finances. On one hand, it loads more burdens on the middle class. Tax reform will cause the loss of some tax relief, such as the exemption for temporary expatriate housing. The minimum tax base for taxpayers with business or professional income will be abolished. The joint taxation of households introduced only in 2005 will again be abolished, too. The amendment extends the minimum duration of financial lease as condition for tax deductibility of lease rental payments on part of the lessee, as follows: (1) for movable assets to a time period equal to the minimum period of depreciation (currently, only 20 % of the minimum period of depreciation, at least 3 years) (2) for immovable assets to 30 years (currently, 8 years). As complementing the tax reform, the public financing of health care services will be restricted[5], and the age of retirement will be increased in the pension system.

On the other hand, as a European trend either in Germany or in Baltic States, the Czech government announced the eco-tax on electricity, natural gas and solid fuels. The expected green tax revenues should counter-balance the possible shortfall of corporate and personal income tax. Beside the budgetary balance impact, the eco-tax advantageously forces the national economy to save on energy consumption and reduce the environmental pollution. Meanwhile, it leaves higher room for business manoeuvres with lower direct corporate tax rate for the enterprises using clean technology.

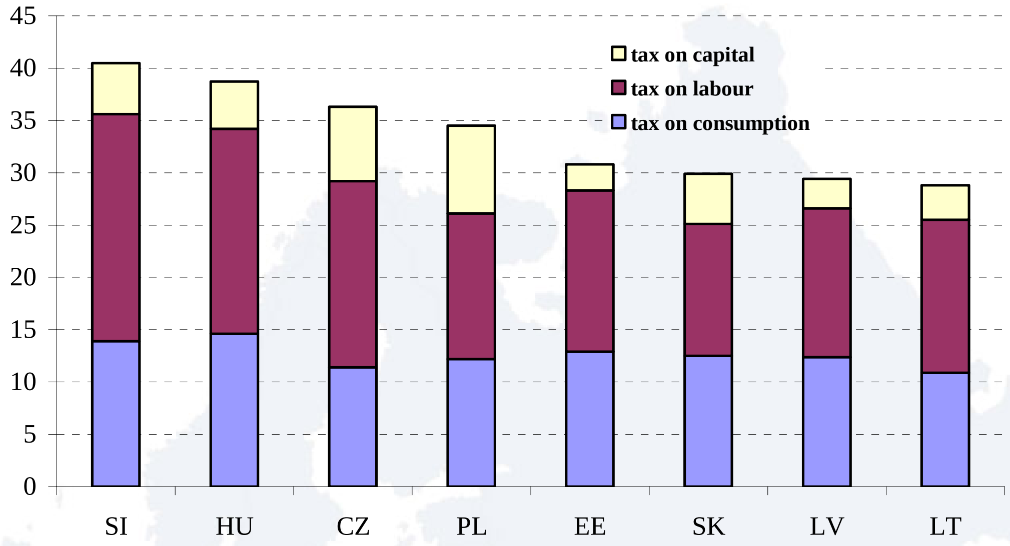
The lower rate of VAT will be increased from 5 % to 9 %. The ordinary tax rate remains at 19 %. As a new feature, it will now be possible to obtain a binding ruling from the tax authorities in respect of the VAT rate applicable to the taxable supply concerned. In the area of excise duties, an increase in tobacco tax has to be followed with attention.

[5] Deductible of CZK 30 /~EUR 1.10/ for visits to the doctor and prescription charge of the same amount. Daily deductible of CZK 60 /~EUR 2.20/ for hospital in-patient treatment. Introduction of an upper limit for social insurance contributions in case of high incomes. Reduction of certain social services and stricter criteria for qualification. No sick pay for first three days of an illness, thereafter between 60 and 69% of salary.

CZECH POSITION IN TAX COMPETITION

Through the tax reform, Czech Republic makes up her lag in investment- and business-friendly tax system in comparison to Slovakia and Hungary. The Slovakian tax system reserves its business environment advantages rooted in its simplicity.

Chart 3. Distribution of Tax Burden in NMS-8, 2005



Source: Eurostat

The Baltic States are absolute leaders in the Eastern European tax competition with extremely quick pace of PIT – 1 percentage point rate decrease in each year till 2011. However, they are interested more in Russian capital resources, thus they are less important rivals in the Central European competition for direct investment. It seems, after Slovakia, the Czech Republic will be also more favourable for enterprises than Hungary in consideration of taxation on corporate incomes and labour. This forced the Hungarian government to announce the reform of tax simplification in tax-return related business administration. But there is no complex governmental tax reform announcement that could be executed expectably in a year.

The Czech move in tax policy implies the assumption of more expectable direct and indirect tax cuts on business, in the NMS-8 region. The already intensive policy competition for investments will force the high-redistributing Slovenian, Hungarian and Polish governments to restructure their tax revenue structure, and re-weight the different tax incomes or introduce new types.

There is also need for new method and attitude in the public tax administration to uncover the informal economy and the tax frauds, as the current regulation on business administration presumes every tax payer to be tax dodger, and tries to achieve results with generally extended rules that cause more recording trouble for enterprises, while they are not appropriate to catch individual free riders.

TEN-YEAR RECORD INFLATION RATE IN LATVIA

Consumer prices soared in September throughout the Baltic region sparking new fears of macroeconomic imbalances that could eventually lead to hard times. Surpassing analysts' expectations, Lithuanian and Estonian annual inflation reached 7.1 and 7.2%, while Latvia's annual inflation rate rose to a 10-year high of 11.4% in September. Price increase in Latvia, the EU's fastest-growing economy (11-12%) is picking up at more than five times the average pace of the 13 nations sharing the euro.

The government was forced to abandon its 2008 target date for adopting the euro as economic growth pushed consumer prices beyond targets required for the currency switch. Euro adoption is limited to countries that meet targets on inflation, budget deficits, debt, interest rates and currency stability. Inflation must be within 1.5 percentage points of the 12-month average rate of the three EU nations with the slowest consumer price growth.

SEASONAL PRICE SHOCKS AT THE BEGINNING OF AUTUMN

According to the Latvian national statistical office, the rise in the prices of wearing apparel and footwear, education and catering services, heating energy, as well as milk and dairy products had the greatest impact on consumer price changes in September. Summer has passed and as the seasonal discounts terminated and goods of new season entered the market, the prices of wearing apparel increased by 7.8% and prices of footwear by 17.6% from August to September. Besides, with the beginning of the new school year, the education services on average increased by 16.2%.

In the food commodity group the highest increase of prices was recorded for milk and dairy products. The prices increased for meat and meat products, grain products, bread, vegetables, cheese, eggs, fats and oils. Alcoholic beverages became more expensive, especially the strong alcoholic beverages and vines. The prices increased for housing maintenance and repair, household services, railway services, driver's courses, recreational and sports services, services of personal care institutions, insurance. (*Table 3*)

Table 3. Latvian CPI in September 2007

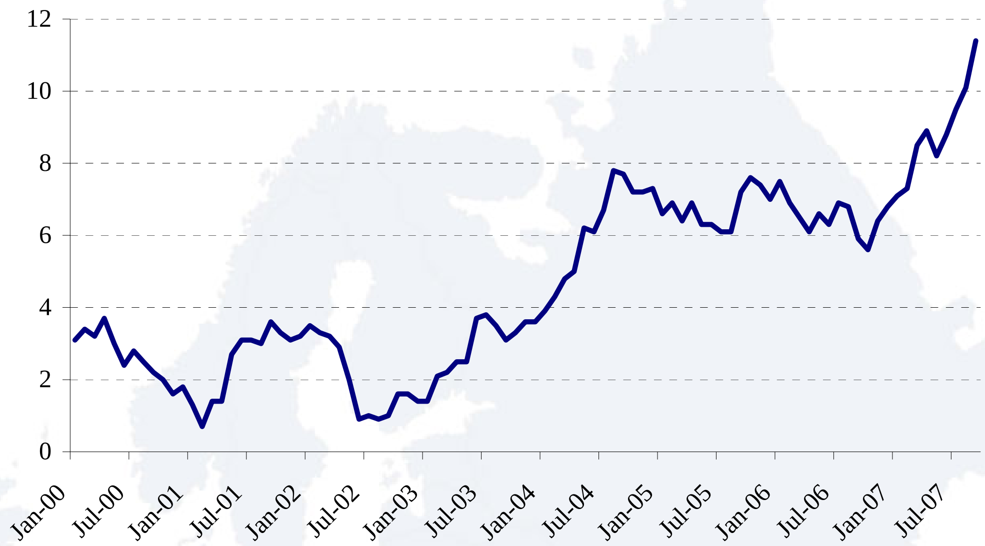
Commodity group	**year-on-year**	**month-on-month**
Food	14.8	1.3
Alcoholic beverages and tobacco	18.5	0.7
Clothing and footwear	4.8	10.3
Housing, water, electricity. gas and fuels	16.7	1.4
Furnishing, household equipment and operation	5.1	0.5
Health care	7.0	0.9
Transport	9.1	0.0
Communication	-6.7	0.0
Recreation and culture	5.2	0.8
Education	18.6	16.2
Hotels and public catering	20.1	3.7
Miscellaneous goods and services	12.0	1.9
Total	**11.4**	**1.9**

Source: Statistical Office of Latvia

DETERMINANTS OF RISING PRICES IN LATVIA

Chart 4 reports the typical measure of inflation, year-on-year increases in the Consumer Price Index (CPI) of Latvia from January 2000. The data includes the successful disinflation policy period pursued since fixing the lat (Latvian currency) in 1994. The current surge in inflation is the result of 11 months of nearly consecutive increases from 5.6% in October 2006 to 11.4% in September 2007.

Chart 4. Latvian CPI in 2000-2007 (%)



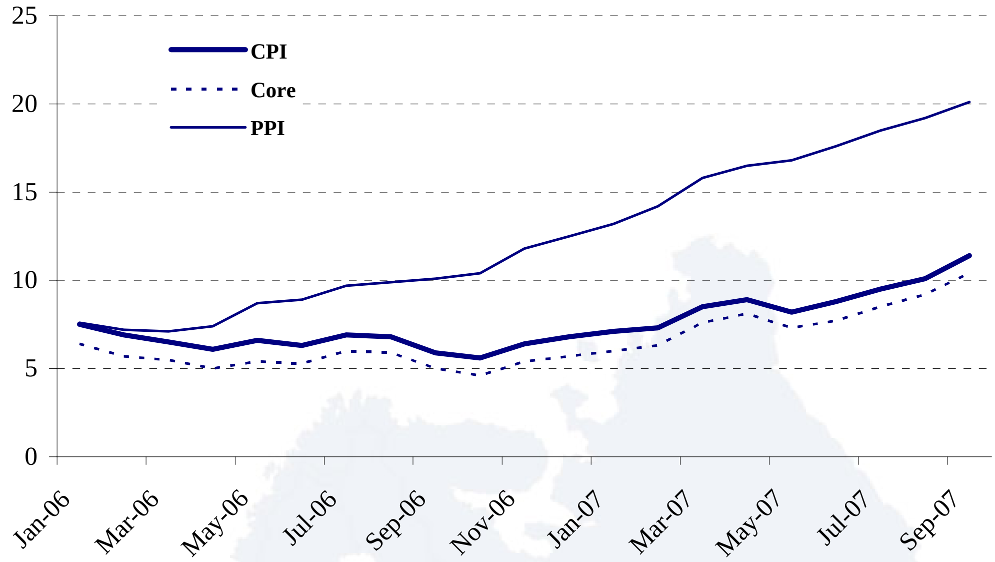
Source: Statistical Office of Latvia

The only previous periods of such long sustained increases were January 2003 – July 2003 (six months where inflation rose from a very low base of 1.4% to 3.8%) and September 2003 – May 2004 (eight months of consecutive increases from 3.1% to 6.2%). These increases are well explained by e.g. exchange rate developments (appreciation of the euro, thus depreciation of the lat, thus higher import prices), changes in administrative prices and, for the latter, widespread expectations of higher prices due to EU accession, which seemingly made it easy for firms to charge higher prices.

The latest surge in inflation cannot be explained on a low base, EU accession or on unfavourable exchange rate developments (as the lat is now pegged to the euro). Rather, it is the result of overheating in the labour market as well as of higher inflation expectations. Latvia today is a country with substantial inflation, people know this and build it in their wage demands, which in turn add to the production costs of firms and end up in higher prices.

Whereas CPI inflation is the relevant measure for consumers, core inflation is more relevant for policy makers as it excludes prices that are affected by discretionary administrative decisions (regulated prices), by external factors (fuel prices) or by seasonal or weather factors (prices of unprocessed food). It should thus provide a purer picture of price pressure. However, *Chart 5* shows that core inflation does not deviate much from CPI inflation and it can be concluded that the two are largely driven by the same factors.

Chart 5. Latvian CPI, PPI and Core Inflation, 2006-2007 (%, monthly, yoy)



Source: Statistical Office of Latvia

A closer look at the development of producer prices is even more revealing. The Producer Price Index (PPI) measures the development of prices of most goods produced in the country. The major difference between CPI and PPI is that the latter excludes imported goods as they are obviously not produced within the country. In the case of Latvia imported goods are very important for CPI since imports account for over half of Latvia's GDP. PPI inflation has been surging much more dramatically than CPI inflation, climbing from 6% to over 20% in the past two years.

Wage increase y-o-y for the first quarter of 2007 reached a staggering 32.8%, far ahead of productivity growth and thus implying more inflation to come. Due to the great amount of emigrants, the labour market is very tight in the Baltic and workers are therefore increasingly successful in wage demands, which they raise when they expect higher inflation. In this way, inflation is affected by higher expected inflation and accelerated price dynamics might become persistent.

Discussion

We see wage growth as feeding into producer prices and this in turn feeds into export prices entailing a loss of competitiveness. Export has fallen dramatically during this year. In March 2006 the Latvian government implemented a fiscal policy plan to curb inflation (the re-elected government is going to lead the country until October 2010). They intend to reach zero-deficit budget in 2007, no deficit in 2008 and budget surpluses for 2009 and 2010. Besides, the government intends to impose a tax on income from the sale of real estate. As one of the main reasons driving inflation is the rocketing consumption and the lending boom, the third set of key measures aims to start exercising control over the growth in lending. Thus, commercial banks and leasing companies will be required to determine the purchasing power of customers and to make loans available exclusively on the legal income of clients.

The government plan attempts to solve inflation problems with essentially one instrument, namely fiscal policy. The central bank has no effective measures since the Latvian monetary regime is practically a fix exchange rate regime (the lat is pegged to the euro with plus minus 1% change) and the capital markets are free. Thus, it is not likely for the central bank to have an effective inflation goal too. The fiscal policy attempts are likely to result in a long and costly process of deflation as has been done by e.g. Germany over a six-year period, the price being substantial unemployment. Germany being in the euro zone no longer had the option of using the exchange rate instrument whereas Latvia still does. Latvia may eventually find itself in a situation where the pain of a long and costly period of deflation may be weighed against the cost of altering the peg to strengthen competitiveness – and where the latter may be the rational and less painful choice.

Inflation in the Baltic is indeed a result of phenomenal economic growth sparked by domestic demand and inexpensive credit, as well as years of a booming property market and rocketing wages. In the upcoming months, rising energy prices (Russia's Gazprom is charging more for a 1000 cubic meters of gas) and soaring food prices are expected to lead consumer prices even higher. No one is expecting the rate of increase in consumer prices to fall anytime soon. Some have said the first signs of a fall may occur only in the spring.

STABLE FDI PERFORMANCE DESPITE POLITICAL TURBULENCES IN UKRAINE

Ukraine, the second largest former Soviet Republic, is becoming more and more attractive for foreign investors, despite the permanent political turmoil. Since 2005, net foreign direct investments (FDI) in the country have stepped to a higher level that means USD 5-6 billion annually. It seems that the current year will not curb this trend, as by the freshest data from the National Bank of Ukraine (NBU) in the first two quarters of 2007 record sum of FDI arrived (net FDI USD 3.3 billion).

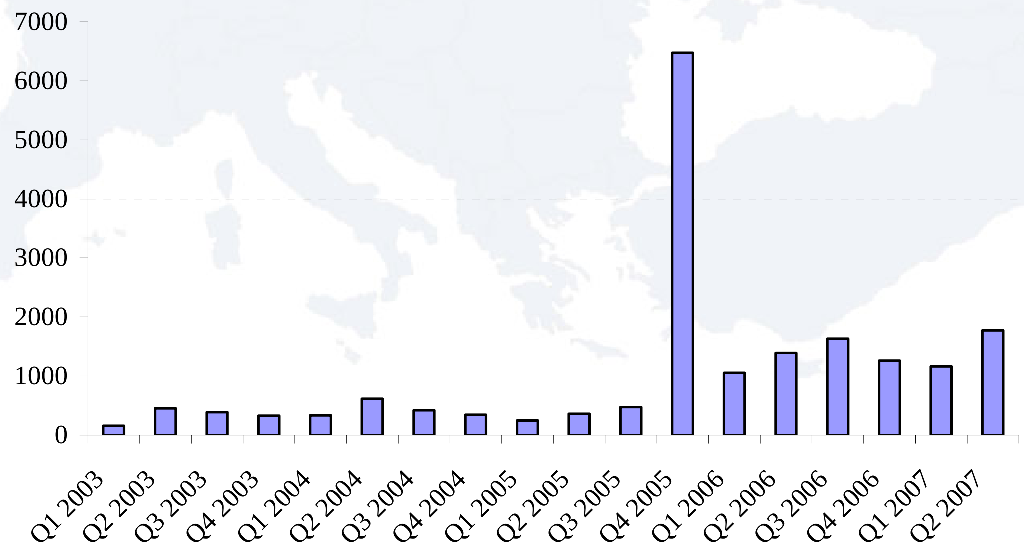
POLITICAL PROCESSES

By the latest information the Yulia Tymoshenko Bloc and the Our Ukraine – People's Self-Defence Bloc signed the coalition agreement on the new government, as the majority of votes culminated in the hand of former allies in Orange Revolution in 2004, while the Regions Party won the elections but with insufficient result for governing. This result may cause some balance at least between the "one-coloured" President and government, however concerning Ukrainian political life nothing is sure. The Tymoshenko Prime Minister and the Yushchenko President tandem, despite of the common objectives in 2004, was ruptured once. However it seems that despite of political shake-ups, the country has not been lost the interest of foreign capital.

INWARD FDI ON TRACK

In the period of 1998-2004 the annual net FDI averaged at around USD 1 million, while 2005 and 2006 saw significant change with USD 6.5 and 5.3 billion respectively. Even the year 2007 keeps this trend by already known data, as in the first half of near to USD 3 billion FDI arrived to the country.

Chart 6. Foreign Direct Investment Inflows (USD million, quarterly)



Source: State Statistics Committee of Ukraine

If sophisticating the processes by *Chart 6* and its quarterly FDI data, one can see as a turning point the last quarter of 2005, when USD 6.5 billion were invested in Ukraine that is more than 85% of total FDI in 2005. Since the first quarter of 2006, the quarterly FDI stabilised at around USD 1-2 billion in comparison with USD 0.5-1.7 billion before 2005.

This attractiveness of the country led to by almost 190% higher, USD 24.2 billion stock of FDI by the first half of 2007 as compared with the volume of USD 8.4 billion at the end of 2004.

STRUCTURE OF FDI

It is worth to investigate the structure of the FDI stock, first of all by countries of origin, as it bears importance to understand the political and policy changes. *Table 4* shows that the European Union managed to increase its share to almost 77% of total in the first half of 2007. In two and half years Germany increased its FDI stock nine times owing 23.5% of total, Austria six times by its 8% share, the mainly by its offshore opportunities famous Cyprus four times (17%). All other countries increased their stock but by decreasing shares. Russia keeps its 5% official share, while it is likely that behind investments originated in Cyprus and Virgin Islands, a lot of Russian investors stay.

Table 4. FDI by Countries of Origin 2005-2007

Q2 2007			Q4 2004		
Country	**USD million**	**%**	***Country***	**USD million**	**%**
Germany	5677.9	23.5	United States of America	1153.7	13.8
Cyprus	4130.4	17.1	Cyprus	1035.6	12.4
Austria	1957.0	8.1	United Kingdom	895.9	10.7
Netherlands	1864.3	7.7	Germany	631.6	7.6
United Kingdom	1796.8	7.4	Netherlands	548.3	6.6
United States of America	1380.7	5.7	Virgin Islands (British)	543.8	6.5
Russian Federation	1236.2	5.1	Russian Federation	457.5	5.5
France	935.4	3.9	Switzerland	411.3	4.9
Virgin Islands (British)	813.0	3.4	Austria	345.6	4.1
Switzerland	580.5	2.4	Poland	192.3	2.3
Poland	482.6	2.0	Hungary	179.1	2.1
Hungary	360.8	1.5	Korea, Republic of	172.4	2.1
Other countries	*2956.2*	*12.2*	*Other countries*	*1786.8*	*21.4*
European Union	***18518.6***	***76.6***	***European Union***	***4652.4***	***55.7***
TOTAL	**24171.8**	**100**	**Total**	**8353.9**	**100**

Source: State Statistics Committee of Ukraine

FACTORS BEHIND

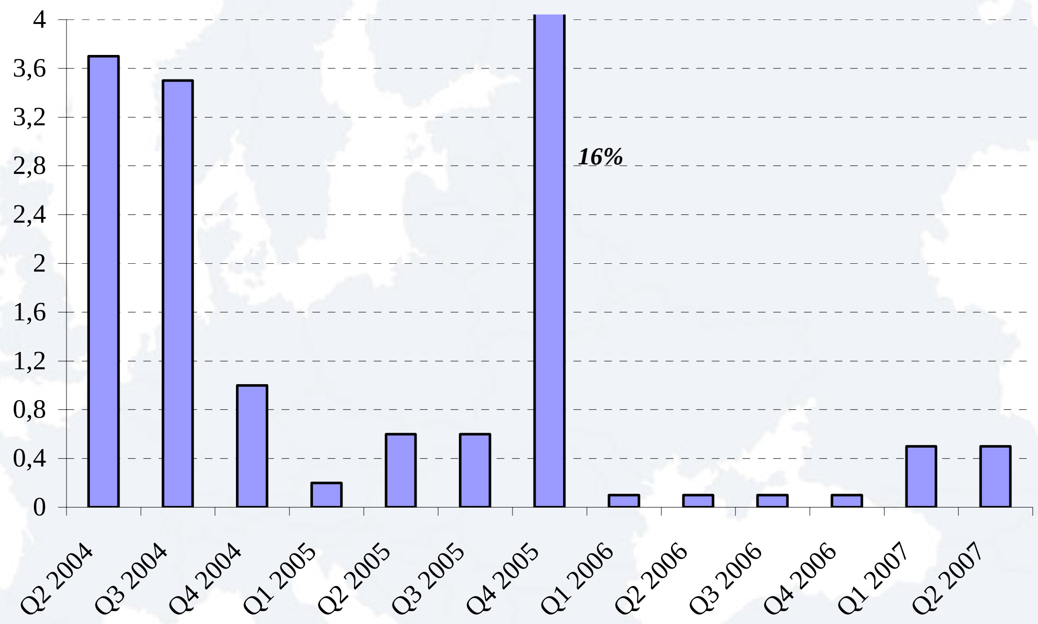
First of all it is likely that the political changes encouraged also by the high levels of US and the EU in the country led to increased interest of the investors of the European Union, particularly from Germany, The Netherlands, Austria, but also from the United Kingdom, France and the new EU countries like Poland and Hungary as well.

Other factor is Ukraine's efforts on getting WTO membership, that bears crucial importance proving appropriate and unified environment for foreign investors by harmonisation of regulations, increased transparency and intensifying trade activities, opening markets (*for details see News of the Month, July, 2007*).

One of the pulling factors of the accelerating Inward FDI was the changed relation of economic policy to privatisation. At the end of 2005 it is started with the re-privatisation of Kryvoryzhstal's 93.02% shares to the Mittal Steel Germany GmbH for USD 4.8 billion. This was not only a more transparent, efficient, but also the biggest deal in the history of independent Ukraine. It seems since, that the threats of analysts of not stable property rights and deteriorating investment climate after re-privatisation was wrong.

However it is good news, that the increased FDI is not only the result of increased privatisation, but also an outcome of so called Greenfield investments. The proof of it is given in the *Chart 7* referring to the privatisation receipts of consolidated budget.

Chart 7. Privatisation Receipts of the Consolidated Budget in 2004-2007 (% of GDP, quarterly)



Source: State Statistics Committee of Ukraine

Other possible motivation could be the continuously attractive macroeconomic environment. Ukraine has performed high rates of growth with a temporary shock caused by energy price hikes reasoned by world market processes and changing conditions of supplying (Russia). 9.6% real GDP growth in 2003, 12.1% in 2004, 2.7% in 2005 and 7.1% in 2006, while 7.9% in the second quarter of 2007. The public finances seems to be balanced, as in the last three years the fiscal balance to GDP ratio decreased to 0.9% deficit, while the state debt to 15% of the GDP. The external balance, measured by the current account deficit is moderated, even if it is true that 2006 was the first year in the last eight years, when the sheets sawed deficit (-1.5%), the external debt also very low with its 11% in 2006 and decreasing. The only, but not negligible problem of the economy is the still high, double digit inflation.

CONCLUSIONS AND EXPECTATIONS

It is clear that Ukraine is a target of fierce political and economic fight between the EU and the nowadays waking Russian Federation. By the latest parliamentary elections the EU seems to have an edge on, but Russia will match, as it still bears the gun of fossil fuels that is surely more important on the west than Ukraine. This was the case in January 2006, in the Ukrainian-Russian gas dispute (*see News of the Month, January, 2006*). Russia is promoted also by Ukraine's large Russian minority, especially concentrated on the Eastern part of the country, and represented in political (Regions Party) and economic authority.

The current political situation, the vigorous political competition seems to have some favourable effects on the economy. The sharp and balanced opposition gives floor not only for consensus decisions, but also for delivery of such measures, that strengthens democratic institutions, decreases corruption etc. The process of economic integration into the WTO also encourages it.

The increased FDI is the outcome of not only better macroeconomic performance, but also as a result of higher credibility of Ukrainian economy abroad. Due to the considerable and well educated labour force, the consumer market potential, and possible productivity gains, Ukraine could be the winner of international tendencies of capital movements. It is even true, if by UNCTAD Ukraine performed well above its potential in inward FDI.

It is also important to mention the outward FDI, as it is growing, but its volume is still insignificant. But with economic and trade integration, and with stabilised economic and entrepreneurial performance, the accumulated capitals can be placed from one side in the Caucasian and Central Asian countries, but also and first of all in the new EU member states.