

# THE FINANCIAL MARKET OF UKRAINE AND THE ROLE OF FOREIGN DIRECT INVESTMENT

Igor Lyutiy, Mariya Borovikova\*

*Taras Shevchenko National University of Kyiv, Ukraine*

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**Abstract.** *The main objective of this paper is to investigate the characteristics of the institutional structure of the Ukrainian financial market and to analyze the impact of foreign direct investment on it. The following methods of research were used by the authors: economic-statistical, tabular, and comparative (in empirical analysis; to make comparisons across different types of financial institutions, to investigate and evaluate the volumes of foreign direct investment by countries and their relation to the size of the domestic financial sector); systematic and logical (determining and analyzing the scope of the positive and negative effects of foreign investment on the financial market of Ukraine).*

*The conclusions are as follows: the structure of the financial market of Ukraine is rather nonbalanced and fragile; most foreign investors have changed their strategies on the Ukrainian financial market from aggressive to share-keeping; more attention should be paid to the development of the constructive policy concerning FDI to ensure the stability and even the development of the domestic financial market as well as to raise its investment attractiveness.*

**Key words:** *financial market, commercial bank, non-bank financial institutions (NBFIs), foreign investment, investment attractiveness*

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## Introduction

Participation of Ukraine in the international economic cooperation and international regional integration determines the current direction of the development of the national economy, activates investment processes and an appropriate financial support in the country. Thus, the domestic sources of investment are not enough to meet the growing demands of the Ukrainian economy. One of the ways of solving this problem is the attraction of foreign investment.

Academic studies show that, among all other sources of foreign funding, foreign direct investment (FDI) influences most significantly the economic growth through the accumulation of internal savings, the lower cost of capital, transfer of innovative technologies and development of domestic financial institutions (Prasad, 2003). In the

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\* *Corresponding author.*

Faculty of Economics, Department of Finance, Taras Shevchenko National University of Kyiv,  
60, Volodymyrska Str., 01033 Kiev, Ukraine;  
e-mail: marbor24@yandex.ru

times of financial globalization, the scope of potential foreign investors and financial alternatives for the countries that require financing increases and the cost of capital decreases. FDI not only meets capital needs and enhances the quality of debt capital within the national economy; its involvement also contributes to the expansion of production volumes, updating the methodological and technical base, creating and preserving the existing jobs, etc. Evidences in support of the idea that FDI facilitates the development of the economies of the countries-recipients have also been found by Blomstrom (1994), Caves (1996), and Borensztein (1998) who investigated various countries in attracting FDI and the effects it had on their financial market and economy.

Given the above, we can conclude that FDI has only positive effects and is a major factor in accelerating the economic growth in developing countries. However, other empirical researches conducted to determine the results of foreign investment in some countries do not always prove it in practice (Masashi Saito, 2010). The lack of clearly proven in practice positive impact of foreign investment on the economic growth of a country is the reflection of the fact that, along with the benefits of foreign investment, there are also the disadvantages that diminish the positive impact to some extent. The generally accepted negative consequence of the FDI is enhancement of the macroeconomic volatility (Sebnem Kalemli-Ozcan, 2010). According to the research of Lipsey (2002), FDI has mainly a negative impact and only a few positive effects on economic development, especially in the financial market.

Financial globalization increases the sensitivity of the economy to external shocks and facilitates the dissemination of financial crises from developed countries to developing ones and vice versa. The most significant contribution to the study of the impact of FDI on the economic and financial market safety of Ukraine in the context of financial globalization and integration has been made by the Ukrainian academician Geyets (2010) who chairs the Institute for Economics and Forecasting of the National Academy of Sciences of Ukraine.

Given the current interest to the topic and controversial opinions on the impact of FDI in financial and scientific circles, the objectives of the article are the following: investigation of the dynamics of the Ukrainian financial market development, analysis of the impact of FDI on the financial sector of Ukraine, disclosure of the main advantages and disadvantages of investing, as well as identifying the obstacles that prevent FDI inflows to the economy of Ukraine during the post- crisis period.

## **The institutional structure of the financial market of Ukraine**

Financial markets play an increasingly important role in the economic transformation that take place in every country, including Ukraine. As a centre of accumulation and redistribution of financial resources it ensures the functioning of the investment and production spheres of the economy, as well as the entire system of social and economic relations.

Determining the accession to the European Union as a priority, Ukraine has to solve the urgent problem of accelerating the development of the domestic financial market, which is a prerequisite for the development of the real sector of its economy. Existence of effective financial institutions (banks, insurance companies, pension funds, credit unions, etc.) promotes the sustainable development in all economic processes in society.

Accumulating significant amounts of money, financial institutions are a powerful source of investment in the economy. In Ukraine, banks are the most powerful financial institutions. The proportion of their assets in the institutional structure of the financial market remains almost unchanged over the past four years and in 2011 was about 93% (Table). Non-bank financial institutions (NBFIs) in Ukraine are poorly developed; their total share in 2011 was about 7%. The leading position among NBFIs belongs to insurance companies; the proportion of their assets in the total assets of all financial intermediaries has also remained unchanged for several years and was 4% in 2011. Private pension funds, which in many countries play an important role in financial intermediation, are just slightly developed in Ukraine due to the lack of a coherent pension reform and the low public confidence in the pension accumulation in general. They present only 0.1% of the total assets of financial institutions.

TABLE. The structure of the financial market of Ukraine by total assets of financial institutions

Financial institution	2008		2009		2010		2011	
	Assets, in US \$ mln	%	Assets, in US \$ mln	%	Assets, in US \$ mln	%	Assets, in US \$ mln	%
<b>Total</b>	123 469	<b>100.0</b>	117 894	<b>100.0</b>	126 500	<b>100.0</b>	141 780	<b>100.0</b>
<i>Banks</i>	115 761	<b>93.8</b>	110 038	<b>93.3</b>	117 850	<b>93.2</b>	131 787	<b>93</b>
<i>Insurance companies</i>	5 241	<b>4.2</b>	5 246	<b>4.4</b>	5 654	<b>4.5</b>	5657	<b>4</b>
<i>Finance companies</i>	752	<b>0.6</b>	947	<b>0.8</b>	1 278	<b>1.0</b>	2199	<b>1.5</b>
<i>Credit unions</i>	758	<b>0.6</b>	527	<b>0.4</b>	429	<b>0.3</b>	304	<b>0.2</b>
<i>Pension funds</i>	77	<b>0.1</b>	107	<b>0.1</b>	143	<b>0.1</b>	163	<b>0.1</b>
<i>Other</i>	881	<b>0.7</b>	1 028	<b>0.9</b>	1 145	<b>0.9</b>	1675	<b>1.2</b>

Source: National Bank of Ukraine and State Commission for Regulation of Financial Services Market of Ukraine.

Such a structure of assets is not considered quite rational in the world in terms of the performance effectiveness of the financial market, since life insurance companies and pension funds should be able to accumulate the crucial volumes of long-term financial resources to invest in the domestic economy. The modest size of the insurance market and pension funds is one of the major obstacles for the development of the financial market of Ukraine since the demand from these institutional investors is expected to be the major force for stock market activity (Liubkina, 2012).

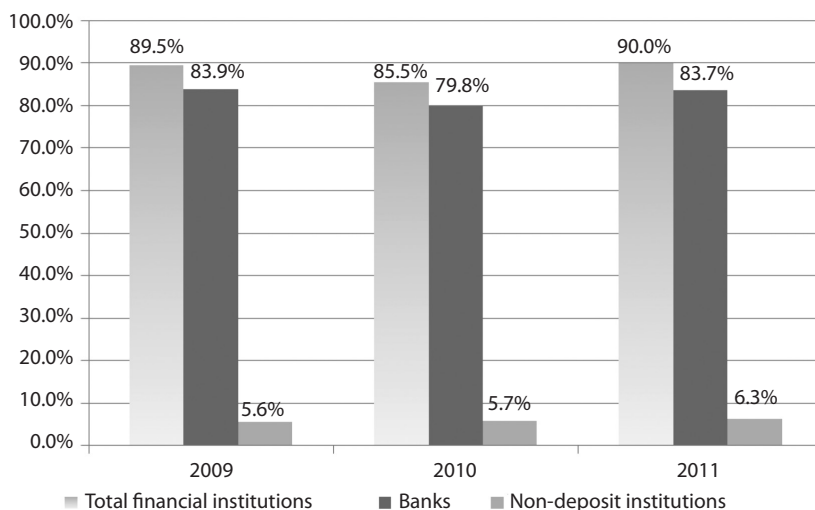


FIG. 1. Ratio of assets of financial institutions to the GDP of Ukraine

Source: National Bank of Ukraine and State Commission for Regulation of Financial Services Market of Ukraine.

An important indicator of the activity of the financial market is the share of assets of financial institutions in the country's GDP. In Ukraine, the assets of all financial institutions in 2011 accounted for about 90% of the GDP (Fig. 1). There is an obvious dominance of banking assets in the country's GDP, which have increased since the previous year and accounted for 83.7% of the GDP in 2011. The ratio of assets of NBFIs to the GDP was 6.3%, respectively. Moreover, the largest share among NBFIs belongs to insurance companies whose share in 2011 was about 4% of the GDP.

Admittedly, these data are fairly low as compared with those of developed economies. In most of developed countries, the proportion of assets of financial institutions to the GDP remains at 240–400%. For example, in Germany, early in 2011, this figure was 280%, and its average in the EU is 290–340% from year to year (International Monetary Fund, 2011).

The disproportionate growth of assets of different market segments happens due to different stages of their development and for other reasons. First, pension funds and financial companies have just started building up their assets with a relatively small financial base; secondly, studies of the World Bank have stated that “the dominance by banks in most financial systems of developing markets is associated with a lower use of financial services by firms and individuals and a lower use of financial services in low-income countries” (World Bank, 2011).

### Foreign institutions in the financial market of Ukraine

In the context of the transitional processes in the economy of Ukraine, its financial market should become a powerful source of investment resources, ensure an effective

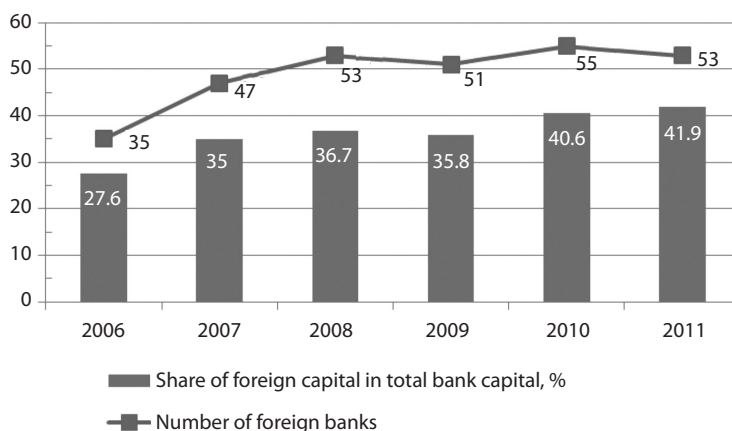


FIG. 2. The number of banks with foreign capital and the share of foreign capital in the banking sector of Ukraine, %

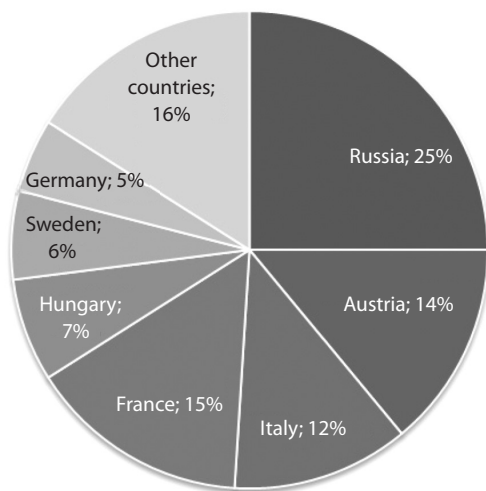
Source: National Bank of Ukraine.

accumulation of funds and meet the demand of the real economy in financial resources in both short- and long-term nature. Thus, one of the main achievements of financial globalization, according to the economist S. Schmukler, is the creation of conditions to attract significant amounts of international financial resources to developing countries, which in turn stimulates and accelerates the development of domestic financial markets in these countries and promotes the development of the adequate financial infrastructure (Schmukler, 2007).

The objectivity of this idea is proved by the inevitably increasing role of foreign financial institutions in Ukraine. In the beginning of the 21<sup>st</sup> century, the economic growth and rapid development of the domestic financial market turned Ukraine into one of the most attractive countries in Eastern Europe for foreign direct investment. With the powerful international financial capital inflow, especially in the banking and insurance sectors, as well as in the stock market, the processes of integration and convergence in the domestic financial market of Ukraine have sharply intensified.

Foreign financial institutions are powerful financial intermediaries in all segments of the financial market of Ukraine, including the most developed banking sector. This situation exists mainly due to the insufficient capitalization of the banking system of Ukraine and its significantly lower volumes as compared with the banking systems of developed countries.

Since 2006, in Ukraine, there has appeared more than a dozen foreign financial institutions that invested in domestic banks more than \$US 10 billion. In the years 2006–2011, the number of banks with foreign capital increased from 35 to 53 (including 22 banks with 100% of foreign capital), and the share of foreign capital in the banking system raised from 27.6% to 41.9% (Fig. 2).



**FIG. 3. Asset allocation in the bank sector of Ukraine by countries (as of 01.01.2012)**

*Source: National Bank of Ukraine.*

Today, the largest percentage of foreign assets in banking is controlled by investors from Russia, France, and Austria (Fig. 3). In Ukraine, French investors have the multifunctional UkrSibbank (BNP Paribas), the corporate Calyonbank (Calyon Group), and the retail Indeksbank (Calyon Group), as well as smaller ProFinBank (Société Générale Group). The Austrian capital is represented in the Ukrainian financial market by three bank holding companies – Raiffeisen, Erste, and Volksbank. The shares of Italian, Hungarian, German, and Swedish investors are also quite significant. Two Italian rivals, both of whom prefer investing in CEE countries, also have their subsidiaries in Ukraine: the financial group “Unicredit” owns the UkrSotsbank and Unicreditbank, “Intesa Sanpaolo” owns the Pravexbank. This situation indicates that financial institutions from the European Union are interested in investing in the Ukrainian banking.

In addition, the aggressive policy of the Russian banks on the financial market of Ukraine during the recent years has led to an increase of their share in the total bank assets. Today, the Russian capital in Ukraine is presented by 10 banks which control about 10% of the assets of the banking sector. Moreover, a large share of assets of these mother banks belongs to the state.

As we can see, the dominance of any single country in the domestic financial market (as in Estonia where over 80% of banking assets are controlled by the Swedish holdings) is not observed. Such a diversification can be considered as a positive feature of the Ukrainian bank system, because in this case it is less dependent on the economic and political conditions of a single state. Today, there are different kinds of financial institutions in the financial market of Ukraine – global, regional, and even some national leaders. Some of them operate only in one certain segment of the financial market, and others in two and more sectors (banking, insurance, investment, etc.).

Typically, international financial institutions coming into the financial market of Ukraine used to invest in 100% of the shares of the selected bank or insurance company. Thus, we can conclude that the most common model of foreign ownership is based on the majority control, which is reasonable due to significant opportunities of supervision and control over the activities of subsidiaries.

It should be noted that during the period of a high investment activity of foreign financial institutions in Ukraine the price of domestic banks was one of the highest in the world. Mergers and acquisitions in the bank sector were carried out mostly at a price 5–6 times higher than the capitalization of these banks. This interest in buying Ukrainian banks was caused by the following reasons:

- high rates of GDP growth;
- underdevelopment of the bank sector and a low penetration of bank services;
- prospects of the retail segment;
- the much higher growth potential as compared with the European and American markets;
- some surplus of capital in the bank sector in Western countries;
- not very favourable conditions in the financial markets of other CIS countries, which were typically protected from competition with high price of access to the market (Lyutiy, 2011).

Therefore, despite the low capitalization of the bank system of Ukraine, Ukrainian banks before the crisis were very attractive to foreign investors.

The crisis, which caused a recession in the country, made adjustments in the value of bank mergers and acquisitions. Foreign financial groups have partially lost interest in bank institutions in Ukraine, first of all, avoiding taking over the bank assets of doubtful quality. During the mass access to the domestic market in 2005–2008, foreign institutions overestimated the realities of the bank sector in Ukraine. The main mistake of most foreign investors who bought Ukrainian banks was that they did not want to notice a huge part of the “shadow economy” and evaluated inadequately the banking market of Ukraine as a market that would only grow upwards.

So, today a running domestic bank can be bought at a relatively small price. Thus, the Dutch financial Home Credit Group in early 2011 made an agreement to sell its Ukrainian subsidiary Home Credit Bank for about \$US 25 million that was equal to 100% of its equity. Another example of foreign investors willing to exit the bank business in Ukraine, even losing a large part of invested capital, is Commerzbank (Germany) who at the end of July 2012 announced the intention to sell its Ukrainian subsidiary, the Forum bank, to another group of Smart Holding companies.

The process of expansion of foreign capital does not evade other segments of the financial market of Ukraine. Insurance companies are becoming more and more attractive to foreign investors. As of January 1, 2012, there were 445 insurance companies registered in Ukraine, of them 79 with foreign capital. The share of foreign capital in the total capital of insurance companies is about 26%.

The features of the development of the insurance sector give reasons to believe that the increase of foreign investment in Ukraine’s insurance market will continue, although agreements for the purchase of domestic insurance companies probably will not be

so significant in volumes, mainly because of the small size of the insurance market of Ukraine: in 2011, the assets of insurers were \$US 5 657 mln, or 4% of GDP.

The experience of CEE shows that the presence of foreign insurers at the initial stage of expansion leads to positive consequences for the financial sector, although, when a certain limit of market saturation is reached, there is no such effect any more. Instead, following the interests of parent institutions is observed only.

Analysis of the role of FDI in the development of the financial sector in Ukraine shows that there are several financial institutions with foreign capital in the domestic financial market, which belong to the following international financial groups: world leaders – Citigroup, BNP Paribas, ING Group, AIG; leaders of the European financial market Société Générale, Credit Agricole, Raiffeisen Bank International and candidates for leadership OTP Group, Intesa Sanpaolo SPA, RZB-UNIQA, SEB, GRAWE and others. Thus, the financial group ING Group runs business in the banking and insurance sectors of the financial market of Ukraine, OTP Group and Raiffeisen Bank International function in the banking and investment, BNP Paribas and SEB operate in the three sectors – banking, investment, and insurance. Currently, international financial groups in Ukraine own more than 41.9% of the bank capital and 26% of the insurance capital. This is a clear evidence of their power and influence as financial intermediaries in the financial market of Ukraine.

### **Influence of FDI on the stabilization and development of the domestic financial market**

The impact of globalization, the inflow of foreign bank and insurance capital on the financial market of Ukraine, despite the possible dangers and threats, should be considered from the point of increasing the financial capacity of the investment market and enhancing the competitive environment in the banking and insurance sectors. Over the past two decades, as a result of financial liberalization and the elimination of barriers, international financial groups showed a high activity in the financial markets of the developing countries. In countries such as Estonia, Bulgaria, Czech Republic, Slovakia, foreign financial institutions control 75–85% of banking and insurance services.

The views of the scholars on the foreign capital inflow on the financial market of Ukraine are very controversial, mainly because of both positive and negative effects of this process (Fig. 4). The global financial crisis and recession have helped to estimate the significance of foreign banks for domestic economy, particularly the real motives of their expansion, the impact on the development of the financial market of the country, and the level of risk for the economic security of the state.

It is important to note that the expanding access of the domestic banking system to foreign investment has largely provided for the solution to such hot economic contradiction as the discrepancy between the amount of savings and the demand for



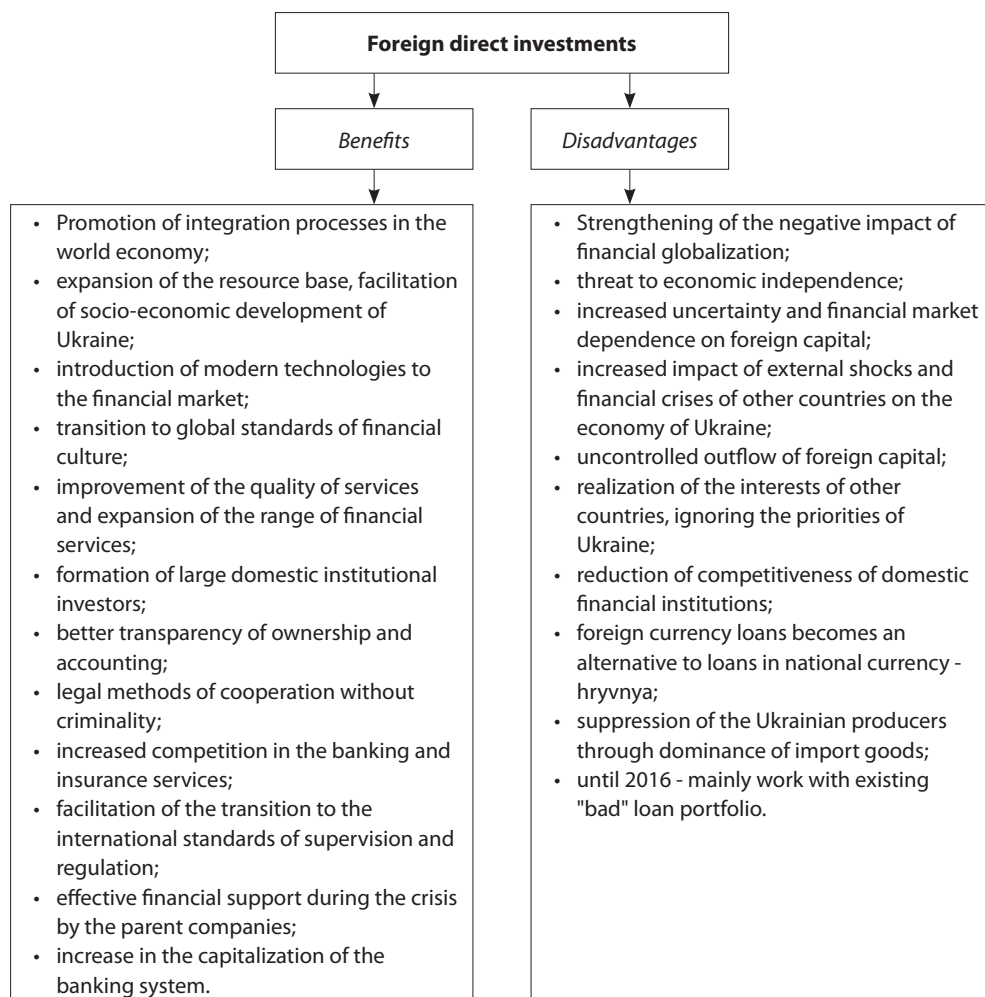


FIG. 4. **Influence of FDI on the financial market of Ukraine**

Source: composed by authors based on Geyets, (2010).

investment. In the pre-crisis period of 2005–2008, domestic savings of Ukraine were respectively 10%, 8%, 6%, 7% of GDP, whereas the volumes of FDI were 21%, 23%, 26%, 14% of GDP. Such differences in savings and investment indicate that the banking sector was able to lend to the economy much faster than the population accumulated savings. The rate of growth of loans in 2007 was the highest since independence, which positively affected the dynamics of the economic growth in Ukraine (National Institute of Strategic Research, 2011).

Thus, before the crisis, the domestic banking system had been able to satisfy the financial needs of the economic entities of the country. However, the global financial crisis had a negative impact on the economy and investment potential of the financial

market of Ukraine and has proved that the presence of foreign capital is associated not only with the benefits, but also with the risks and negative factors.

Firstly, lending in foreign currency increased the dollarization of the Ukrainian economy. The share of retail long-term loans in foreign currency in early 2008 exceeded 60%, whereas its coverage with long-term deposits decreased to 40%. At the same time, foreign banks provided credits to households more actively than to the Ukrainian economic entities. This was the reason why the banking system had no such positive impact on the economy of Ukraine as it seemed, and the fast pace of the development of the financial sector contributed to a deeper gap between it and the real sector of economy.

Second, foreign banks focused on achieving their own goals which did not always coincide with the priorities of the economic development of Ukraine, and the growing capitalization of banks from the external sources violated the balance of payments of the country.

Third, despite the increase in credit operations and the growth of the capitalization of the banking system, there were virtually no cheap credits and extension in their terms; the profitability indicators of banking activities were low. In authors' opinion, the main reasons were the relatively high inflation rate, discount rate and the riskiness of bank lending to the real sector of the national economy.

Also, during the financial crisis, there is a tendency when most international financial institutions are getting under the indirect control of their governments, and therefore the policy of Ukrainian banks with foreign capital in the near future may not only reflect the interests of mother banks, but also the governments of certain countries. Furthermore, the total assets of international financial groups are almost 350 times higher than the official reserves of the National Bank and 1300 times higher than the total assets of domestic insurers. The barriers for the entry of international financial groups into the Ukrainian financial market are considered to be minimal (about 12 million euro for banks, 1 million euro for insurance companies and 1.5 million euro for life insurers). With this position, it is clear that during the crisis periods the financial regulation of financial intermediaries in Ukraine, including banking and insurance institutions, might become much more complicated.

As regards FDI in the domestic insurance market, it should be noted that it poses some threat to the competitive position of the domestic insurers on the one hand, but on the other stimulates and requires from them the implementation of significant steps towards improving the competitiveness of their own product. However, from the point of view of the recipients of insurance services, the expansion of foreign capital has its benefits, such as the diversification of the insurance services in the domestic market, improvement of the standards of insurance and accessibility to insurance products for a wider range of potential clients much of whom do not want to use services of Ukrainian insurers due to high prices or low quality.

The positive impact of financial globalization is noticeable for those participants of the insurance market who work in the field of reinsurance. With the increasing integration processes and strengthening the competitive position of the domestic insurance market, a rapid development of the reinsurance market in Ukraine should be expected due to the inflow of the capital of foreign insurance institutions. Now this is happening in Russia; its reinsurance market is attractive to insurance companies of Hungary, Lithuania and some other Eastern European countries. The increased financial inflow of foreign reinsurers in Russia exceeds significantly (by half) the growth of capitalization of the insurance market as a whole, so there is a transformation of the country from the donor of risks that leads to capital outflow abroad into the country of the reinsurance input stream with the corresponding positive consequence – inflow of foreign capital into the domestic reinsurance market. The formation of such tendencies can be noticed in Ukraine today.

Therefore, today the presence of foreign capital in banking as well as in the insurance segment of the financial market of Ukraine is controversial. In particular, the size and capacity of the international financial institutions, which are the main suppliers of FDI in the financial sector, constitute a danger to the domestic financial market and the economy in general. The main reason for this is the insufficient capitalization of the financial market and the uneven development of its segments.

To summarize, we should note that the impact of financial globalization on the financial market and national economy of Ukraine determines the development of a balanced approach to the regulation of the monetary and financial sector and improving the mechanisms to attract FDI in the financial sector of Ukraine.

### **Investment attractiveness of the financial sector of the Ukrainian economy**

An important role in raising foreign financial capital belongs to investment attractiveness factors according to which international rating agencies form an independent rating of a country. Thus, according to the created investment picture, it is possible to evaluate the risks and benefits of each investment project. It is clear that in order to attract foreign funding, especially in the form of direct investment, a country should have a high rating. The research shows that the lower a country's independent rating, the higher the interest rate on foreign financial resources for this country. For instance, Estonia or the Czech Republic, whose rating is within AA-A, attract funding nearly 7 times cheaper than Ukraine, Libya or Ecuador with the rating within B-CCC. Thus, for many developing countries, the problem of the low ranking causes a high cost of foreign capital which respectively comes in limited volumes and cannot improve significantly the socio-economic situation of the recipient country.

Now, Ukraine has a comparatively low rating of the investment attractiveness (level B+/B according to the scale of the Standard & Poor's rating agency). Moreover,

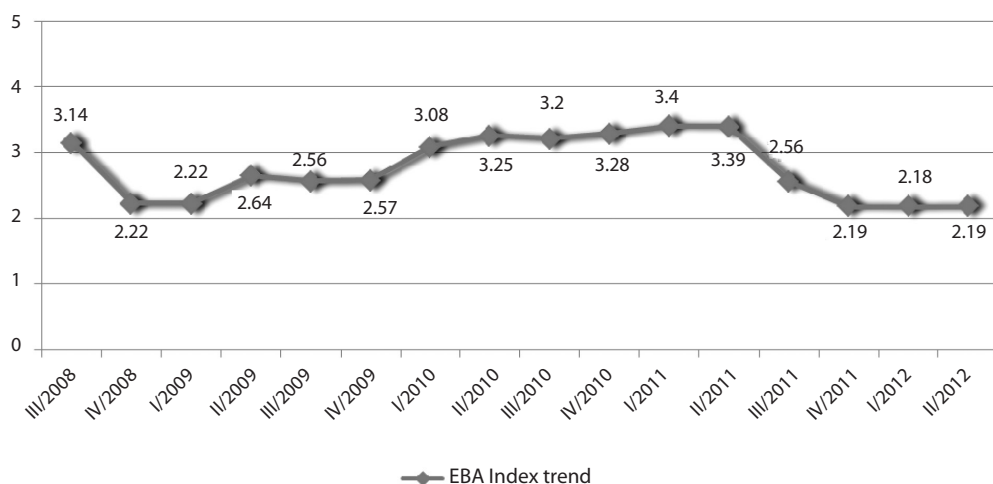


FIG. 5. Dynamics of Investment Attractiveness Index in Ukraine (EBA Investment Attractiveness Index)

according to another scale of the same agency Banking Industry Country Risk Assessment (BICRA), which provides the estimation of the risks in the banking sector on a scale from 1 to 10, Ukraine has 9 points like countries such as Azerbaijan, Venezuela, Jamaica, Paraguay, and Cambodia (Standard & Poor's, 2012). This estimation reflects the opinion of foreign investors that Ukraine undergoes very high risks of economic imbalances, politic instability, and an extremely high credit risk.

Also, not in favor of investing in Ukraine says EBA Investment Attractiveness Index which is calculated quarterly by the European Business Association (EBA) in many countries of the world (Fig. 5). It shows that on the 5-point scale Ukraine's rating never rose above 3.39 during the crisis and post-crisis periods and in the first quarter of 2012 fell to 2.18. The main reasons for this assessment are the concern of the EBA members in the increased pressure from regulatory authorities, the increasing tax pressure, high levels of corruption, instability and uncertainty in the country (European Business Association, 2012).

Such assessment of the investment climate is not conducive to attracting foreign capital into the domestic financial sector and into the economy of Ukraine in general. On the other hand, although the new foreign investors are hardly expected, the share of financial institutions with foreign capital has not changed significantly and even continues growing, indicating that the existing investors continue to finance their subsidiaries in Ukraine, although the volumes of financing are far below their potential. This means that a partial reorientation of the main reasons for investment has happened: keeping the existing market share rather than increasing it.

## Conclusions

To sum up, the most active participants of the financial market in Ukraine are commercial banks. Specialized NBFIs, unlike in most European countries, are poorly developed. The crucial volumes of assets of NBFIs in Ukraine belong to insurance companies. Private pension funds, investment companies and other financial and credit institutions are still at an early stage of their development and have no significant resources to fully deploy the investment activity in the country.

It should be noted that the presence and activity of international financial groups in the financial market of Ukraine has led to the formation of a certain dependence of the national financial system on their business. Thus, the influence of foreign investment on the insurance market of Ukraine is less critical than on the banking sector because of its much smaller volumes and more numerous participants. Foreign financial institutions present in Ukraine are superpowerful financial intermediaries as compared to the size of the domestic financial market.

However, the situation may change slightly due to the financial crisis, one of the consequences of which is a partial loss of investment attractiveness of the domestic financial market to foreign financial institutions. Therefore, this situation may lead to a significant reduction of the FDI impact on the development of the financial sector in Ukraine.

Assuming that foreign investment has become an integral part of the process of financial globalization and plays a significant role in the domestic financial market, the integration of Ukraine into the system of international monetary and financial relations could potentially generate a lot of positive results. The expansion of creditors and investors, the inflow of the middle- and long-term financial funding, lower interest rates, the increased liquidity of financial instruments create favourable conditions for the development of the financial market.

However, according to empirical studies, the impact of foreign investment on economic indicators is quite controversial. In order to minimize the potentially negative consequences and to get the benefits of international funding, it is necessary to develop an effective market infrastructure, the adequate regulatory policy and a favourable macroeconomic environment. In addition, the involvement of developing countries into the globalization process puts them at risk of financial stress due to various external shocks and requires a special regulatory control according to the interests of the country.

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