Ukraine's economic challenges

From ailing to failing?
This publication aims to provide an overview of the Ukrainian economy, explaining the current situation against the backdrop of historical developments and long-standing structural challenges. It also discusses the prospects for the medium and long term.

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EXECUTIVE SUMMARY

The February 2015 Minsk II ceasefire is crumbling, and recent significantly increased levels of violence in eastern Ukraine risk the final collapse of the truce. At the same time, Kyiv is fighting another intense battle on the financial and economic front. Despite recent macro-financial assistance from the EU and a March 2015 IMF aid package, the prospects of Ukraine fully servicing its foreign debt are extremely weak. Kyiv needs to reach an agreement with its foreign creditors by 15 June to receive the IMF loan, and a possible collapse of the truce could jeopardise this process.

Ukraine's economy has been struggling for decades, undermined by corruption and bad governance. The current conflict has exacerbated the situation, and Russia has effectively used the opportunity to try to tip Ukraine over the edge. Moscow's hybrid warfare against Ukraine is extremely costly for Kyiv. Lasting peace in Donbas is a precondition for foreign investments. Moreover, Russia is a key creditor and can obstruct the necessary debt restructuring process.

Ukraine has chosen to move closer to the EU in political terms, and Kyiv has taken important steps in its urgent reform process. However, further delays in international aid could hamper this development, one necessary for Ukraine to combat its endemic corruption and curb oligarchic influence, attract foreign investors, secure future assistance from international donors and mend the growing political rifts in Kyiv.

The free trade deal between the EU and Ukraine – which is at the heart of the conflict with Russia – will be applied provisionally from January 2016, despite Moscow's strong opposition. However, Ukraine's increasing economic woes are likely to further weaken the government and boost tensions, not only between Kyiv and the country's shadow elite, but also within the government, contributing to further destabilisation.

Given growing public impatience with the lack of progress, economic collapse could increase the likelihood of a new Maidan; this time with the risk of radical forces playing a more significant role. Will Kyiv be able to break the vicious circle and move towards a functioning market economy?
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List of main acronyms

- **EBRD**: European Bank for Reconstruction and Development
- **EEU**: Eurasian Economic Union
- **GDP**: Gross domestic product
- **IDP**: Internally displaced person
- **IMF**: International Monetary Fund
- **MFA**: Macro-financial Assistance
- **MFF**: Multiannual Financial Framework
- **SAA**: Stabilisation and Association Agreement
- **UAH**: Ukrainian hryvnia
- **WTO**: World Trade Organization

Key political data

- **Next presidential elections**: May 2019
- **Next general elections**: October 2019
- **Head of State**: Petro Poroshenko (since 7 June 2014)
- **Prime Minister**: Arseniy Yatsenyuk (since 27 February 2014)
- **Deputy Prime Ministers**: Valeriy Voshchevsky, Vyacheslav Kirilenko, Yuriy Zubko (since 2 December 2014)
- **Finance Minister**: Natalie Jaresko (since 2 December 2014)
- **Foreign Affairs Minister**: Pavlo Klimkin (since 19 June 2014)
- **Defence/Security Minister**: Colonel-General Stepan Poltorak (since 14 October 2014)

Ukraine has been a member of the WTO since 16 May 2008.

Source: [IHS Connect](https://www.ihs.com)
1. Ukraine's economy: ailing since independence

Ukraine – the largest economy of the six countries under the Eastern Partnership programme (EaP)\(^1\) – has been ailing economically and financially since the country gained independence in 1991. The country was unable to reach a sustainable growth pattern, and has instead stumbled from one crisis to another. Kyiv has never had a strong constituency for reforms and has been chronically dependent on IMF aid for more than 20 years.\(^2\)

The political problems that emerged in 2013 were merely a trigger for vulnerabilities that had been growing since 1991. Kindled by continued mismanagement and fuelled by political instability, Ukraine's downward trend has reached a new low point, despite the country's undisputed potential for prosperity.

1.1. The importance of east Ukraine as an industry hub

Ukraine has a diverse economic base. The soil and climate are ideal for agricultural production, and the country served as the 'granary of the Russian Empire'.\(^3\) As Ukraine has access to good quality iron ore and hard coal, close to large ports with steelworks, steel has been a major export staple, accounting for approximately 40% of the country's exports. Metallurgy is Ukraine's most important traditional industry\(^4\) and is mainly concentrated in the eastern part of the country, particularly the Donbas.

Ukraine also hosts several important Black Sea ports, some of which – for example, Sevastopol – are located on the Crimean peninsula.\(^5\) North of Crimea, the port of Mariupol is a vital transport hub for the industrially developed region of Donbas, hitherto the centre of fighting in the east of the country.

Ukraine's three largest cities – Kyiv in the central part of the country; Donetsk and Dnipropetrovsk in the east – took the lead in economic development after the collapse of the Soviet Union. While the western regions are traditionally more rural, Ukraine's important machine-building industry is mainly concentrated in the eastern cities of Kharkiv and Dnipropetrovsk. Ukraine is a major importer of Russian oil and natural gas and has an important oil-refining sector.

1.2. Undeveloped natural gas resources in Donbas and Crimea

In addition, Ukraine has large undeveloped conventional and unconventional natural gas reserves of its own. The prospects of unconventional and conventional natural gas extraction that could significantly alter Ukraine's energy dependence on Russia led to optimism and significant foreign investment in Ukraine in 2013. However, the conflict in the Donbas and Russia's March 2014 annexation of Crimea\(^6\) abruptly halted this

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\(^1\) De Micco, P.: *When choosing means losing – The Eastern partners, the EU and the Eurasian Economic Union*, European Parliament, Policy Department, DG EXPO, March 2015.

\(^2\) Reuters: *Ukraine stuck on an IMF dripfeed a year after Crimea seizure*, 19 March 2015.


\(^4\) Metallurgy is an energy-intensive industry and has contributed significantly to Ukraine's energy dependency.


\(^6\) European Parliament resolution of 15 January 2015 on the situation in Ukraine (2014/2965(RSP)).
development. Separatism in the country's eastern regions undermines Kyiv's plan to switch from gas to coal, as the region holds almost half of the country's coal reserves.

**Figure 1: Ukraine**

Source: Ministry of Defence of Ukraine/Giulio Sabbati, EPRS.

1.2.1. Ukraine is losing energy resources

Ukraine holds Europe's third largest shale gas reserves. However, the most important shale gas reserves are located in the disputed eastern regions of the country, now largely in the hands of pro-Russian separatists. At the same time, Ukraine is concerned about losing one of the two largest shale gas fields (Yuzivska Field) in the Donetsk and Kharkiv regions. In addition, Crimea – annexed by Russia in March 2014 – has major conventional offshore gas reserves in the Black Sea. Russia's gas company, Gazprom, has taken control of the Crimean branch of Naftohaz Ukrainy, Chornomor Naftohaz, and is now de facto managing the energy resources of the Crimean peninsula. Russia is expected to claim large parts not just of Crimea's, but also of Ukraine's continental shelf and Exclusive Economic Zone (EEZ), which is likely to complicate the division of the Black Sea continental shelf and EEZs with Romania and Turkey.

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9 Ibid.
How the current crisis developed

At the Eastern Partnership summit in Vilnius on 28-29 November 2013, Ukraine's then President Viktor Yanukovich decided against signing the Association Agreement (AA) with the EU, including the Deep and Comprehensive Free Trade Agreement (DCFTA).

Instead, President Yanukovich received a US$15 billion loan and a beneficial gas deal from Moscow. Following major pro-European popular protests in Ukraine, the Parliament voted to impeach President Yanukovich in February 2014, who then fled Kyiv.

Russia saw the power shift as a coup d'état and responded by annexing the Crimean peninsula in March 2014 to protect 'Russian speakers' and launching a 'hybrid war' against Ukraine.

2. Ongoing tensions exacerbate the recession

The current deep recession is the country's second major economic crisis in six years. Ukraine was severely affected by the global financial crisis in 2008, with its economy contracting by 15% in 2009. The economy remained weak in the aftermath, as the business climate worsened under former President Viktor Yanukovich. The lack of reforms limited growth to just 0.3% in 2012 and remained static in 2013. By the end of 2013, Ukraine was already on the brink of collapse. The conflict in the eastern part of the country has further exacerbated the recession.

2.1. The impact of the war on Ukraine's GDP

As of April 2015, war-related damages in Donbas have been evaluated at some 8% of Ukraine's GDP, or US$10 billion. The loss of productive capacity in the industrial hub of Donbas accelerated GDP contraction by an estimated 7.1% in 2014. In the fourth quarter of 2014, Ukraine's GDP contracted by 15.2%, this being the first GDP figure to exclude the eastern areas of the Donbas region, where production and transport infrastructure has been severely damaged by fighting.

Ukraine's national statistics agency reported that gross domestic product (GDP) contracted by 17.6% in the first quarter of 2015, compared to one year ago, on 15 May 2015. Compared to the previous quarter, the economy contracted by 6.5%. 'The conflict in the east has become the main driving force behind the fall [of the Ukrainian economy]', a World Bank report noted, adding that 'Ukraine has considerable potential, but its implementation is possible only if the situation in the east is stabilised and the banking system recovers'.

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10 Mankoff, Jeffrey: Russia’s Latest Land Grab, Foreign Affairs, May/June 2014.
11 Hybrid war - hybrid response?, NATO review, 2014.
15 War-torn Ukraine’s economy contracts sharply, Deutsche Welle, 15 May 2015.
16 World Bank forecasts massive Ukraine economy contraction, Deutsche Welle, 29 April 2015.
2.2. Diminishing revenues from Donbas and Crimea

According to statistics from the Vienna Institute for International Economic Studies, industrial production declined by more than 30% in Donetsk and over 40% in Luhansk in 2014, accounting for the larger part of Ukraine's 11% overall GDP contraction. The coal mining and metal sectors, which are concentrated in the same area, were heavily affected and declined by 31% and 15% respectively. The machine-building industry, which mainly exports to Russia, saw a 21% decrease in 2014. Overall exports to Russia decreased by 35% in US$ in 2014. The 12% increase in exports to the EU over the same period was not enough to compensate for this steep decline. According to the February 2015 Minsk II accord, Kyiv must restore banking services, as well as pay pensions and state-sector salaries that were cut in November 2014. Therefore, despite losing considerable revenues from the rebel-held areas, Ukraine's government will nevertheless be obliged to pay subsidies to these regions.

The loss of Crimea has further decreased Ukraine's economic potential, although the exact extent is yet unknown. In addition to the southern Black Sea Riviera — formerly a popular tourist destination among Russian tourists — the region features industrial assets and port facilities, 40% of Ukraine's shipbuilding exports, as well as 6% of gas and 16% of offshore oil deposits. Russia 'nationalised' more than 400 Ukrainian companies following the illegal annexation of the peninsula in March 2014. In addition to this, Russia is extracting gas from the peninsula's 18 gas fields. Ukraine has also lost numerous military facilities (ports, airfields, barracks, warehouses) and about 200 spas and camps on the peninsula, according to Ukraine's Deputy Minister of Justice, Natalia Sevostyanova. To compensate for the losses, Kyiv intends to demand the arrest of Russian property abroad, reportedly pending a decision by the European Court of Human Rights.

2.3. Increased defence spending to hamper budget consolidation

Despite the acute financial crisis, Kyiv has stated that it intends to spend six times as much on defence in 2015 as it did in 2014, when the military budget amounted to

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18 Oliphant, R.: Ukraine peace deal: what was agreed in Minsk, The Telegraph, 12 February 2015.

19 Adarov, A., op. cit., p. 15

20 Ukraine may be able to arrest Russia’s assets abroad, ZIK, 2 June 2015.
US$1.6 billion. Some 15% of these funds will be used to purchase arms abroad. Ukraine’s parliament passed a bill on 9 March 2015 to increase the country’s armed forces to 250,000 soldiers, adding 40,000 men. The increased defence spending will make budget consolidation unlikely in the short and medium term. At the same time, the amended budget adopted by the Ukrainian parliament on 2 March 2015 cut pensions and substantially raised gas prices.

2.4. Capital flight sends the hryvnia into freefall

Fixed investments declined by an estimated 25% in 2014. Significant capital flight triggered a freefall of the Ukrainian currency, the hryvnia, in February 2015. The world’s ‘worst performing’ currency in 2015 depreciated against the US$ by 72% in February, hitting a record low of UAH 33.75 to the US$ before regaining value (to UAH 23 to the US$). People began hoarding basic foodstuffs, and the demand for foreign currency further increased the pressure on the hryvnia. However, the hryvnia has stabilised to a certain extent after the central bank raised interest rates. The official hryvnia rate stood at about 21.07 to the US$ at the beginning of June, compared with February’s record low of over 30, but still over 20% weaker than at the start of the year. The recent stability of the hryvnia could allow the central bank to ease monetary policy in the near future, a central bank official said in a statement on 2 June.

As a result of higher energy prices and the weakened currency, the consumer price index rose by 14.0% month-on-month in April 2015, bringing the year-on-year figure to 60.9%. The cost of housing and utilities grew by 88.2% in April 2015, compared to the previous year. In May 2015, the IMF revised down growth projections for 2015 to -9%, projecting end-year inflation at 46% (see chapter 3.3.1).

2.5. Ukraine’s banking system is under severe pressure

The severe currency crisis is increasing the pressure on Ukraine’s already fragile banking system. Since the government of President Yanukovich collapsed and Russia annexed Crimea in March 2014, some 29 Ukrainian banks – 17 in 2014 and 12 in the first quarter of 2015 – have lost their licences, and several other banks have been placed under temporary administration. While Ukrainian bank revenues are overwhelmingly in local currency – which continues to lose value at a fast pace – the main part of their debt is denominated in foreign currency. The gap between debt servicing costs and revenue is likely to continue to grow if the hryvnia depreciates, thus further eroding the banks’ resilience. In February 2015, the capital adequacy ‘buffer’ (reserves protecting against unexpected losses) fell below the 10% regulatory minimum.
stipulated by the Basel accords, prompting plans to agree a relaxation of the capital adequacy rules.

On 26 March, Moody’s Investors Service downgraded nine Ukrainian banks following the weakening of Ukraine’s credit profile (reflected in Moody’s 24 March 2015 downgrade of the Ukrainian government bond rating to Ca (with a negative outlook) from Caa3 (negative)).

Moody's assesses that the 'material and sustained volatility in the banks' operating environment' – prompted by Ukraine's continuously weakening macroeconomic conditions – will 'continue to exert acute pressure on Ukrainian banks' financial fundamentals, and thereby increase the risk of insolvency for many of the country's banks'. This development further weakens the credibility of Ukraine's banking system, effectively scaring off any potential investors.

3. Ukraine's dependence on international assistance

On 11 March 2015, the International Monetary Fund approved a loan of US$17.5 billion to Kyiv to prevent immediate economic and financial collapse, with US$5 billion paid on 13 March and another US$5 billion to be paid in the coming months. According to the agreement on this extended fund facility (EFF) programme, Ukraine’s financing gap over the next four years is US$40 billion. Combined with US$7.5 billion in loans from other international organisations, and an expected US$15.4 billion in debt relief that Kyiv is to negotiate with bondholders, Prime Minister Arseniy Yatsenyuk said the programme would help Kyiv to stabilise its economy, financial sector and currency, enabling ‘the Ukrainian economy to grow from 2016’.

3.1. Past performance as a guide to future behaviour?

Ukraine has been the recipient of eight IMF programmes since 1991. However, only one of them has been completed successfully, as Kyiv failed to implement the policies agreed in the remaining programmes. Some experts say that it is 'an exception' for the IMF to get involved in a conflict-ridden country like Ukraine, as it can be argued that the on-going conflict itself is dragging the economy down.

3.2. Are there potential negative consequences of the IMF package?

Short-term stabilisation comes at a price, as the four-year EFF programme involves obligations for substantial internal reforms, thus increasing the challenges for Ukraine in the short term. In addition to anti-corruption and judicial reform measures, Kyiv has agreed to increase government revenues through a 5-10% surcharge on all imports until the end of 2015. Moreover, Kyiv's austerity measures include downsizing public employment by 3%, including reducing the civil service workforce by 20% through closure of redundant regulatory agencies. A healthcare reform is to 'open up the sector

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30 Moody's takes rating actions on 9 Ukrainian banks and one leasing company, Moody's, 26 March 2015.
to private financing and gradually move to a medical insurance system. These measures could further erode already declining public support for the government.

3.2.1. Significant gas price hikes likely to prompt discontent

The reform programme aims to eliminate the deficit of state-owned energy company Naftogaz and bring gas tariffs to 'cost recovery' levels – reflecting market prices – by 2017. This means a five-fold increase in the artificially low tariffs. Retail gas prices have increased sharply over the past year. They rose by 50% as of 1 May 2014, and by another 50%, effective 1 April 2015. In line with the IMF agreement, gas prices are set to increase gradually until 2018. Experts point out that these hikes will add approximately nine percentage points to consumer price inflation in 2015. The move is bound to be unpopular, not only with cash-strapped end-users, but also with the influential energy business elite.

3.3. As key creditor, Russia could force Ukraine into default

Debt restructuring is a key part of the IMF’s EFF programme. Russia is one of Ukraine's most important creditors and therefore plays a central role in this process. With Ukraine’s debt at 71.5% of GDP, Russia is entitled to request early repayment of a US$3 billion two-year Eurobond, which is formally due in December 2015. This so-called 'Yanukovich bond' was the first and only tranche of a US$15 billion loan package proposed by Moscow before former President Viktor Yanukovich was ousted. The main condition of the loan was that Russia can demand early repayment of the loan, should Ukraine’s national debt exceed 60% of GDP.

3.3.1. IMF review hinges on debt restructuring deal

An International Monetary Fund (IMF) mission visited Kyiv in May 2015 to hold discussions on the first review under the Extended Fund Facility Arrangement (EFF). Following the visit, the IMF downgraded its 2015 real GDP forecast for Ukraine to -9.0% year-on-year from -5.5% while its inflation projection worsened to 46% year-on-year, but it noted that signs of economic stabilisation emerged in April. The IMF stated that discussions with Ukrainian authorities would continue with the aim of finalising a staff-level agreement based on the first review of the March 2015 US$17.5 billion EFF programme. The process includes assessing Kyiv’s fiscal and reform performance before it allows the release of the next tranche of funds. Completion of the review requires that Ukraine reach a deal with its creditors by 15 June 2015 to achieve US$15 billion in savings on debt service in order to get fiscal space to proceed with reforms. In March 2015, a group of private creditors formed a bloc and hired

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34. Support for Ukrainian government plummets, BNE IntelliNews, 26 March 2015.
36. Ukraine to hike domestic gas prices by 50 percent to meet IMF demands, Reuters, 26 March 2015.
38. Oxford Analytica Daily Brief: Ukraine debt restructuring will be very problematic, 27 March 2015.
41. IMF says Ukraine debt deal needed soon, The Daily Star/Agence France Presse, 30 April 2015.
42. Schadler, Susan: The IMF's Ukraine Burden, Center for international governance innovation, Policy Brief 58, April 2015.
experienced advisers in preparation of the debt restructuring negotiations, which are expected to be difficult.\textsuperscript{43} So far, Kyiv and the informal committee representing its international creditors have failed to agree on a debt restructuring proposal, as creditors object to any proposed 'haircut'.\textsuperscript{44} The likely collapse of the Minsk II ceasefire agreement would further complicate the talks.\textsuperscript{45}

Some analysts argue that Moscow may eventually join the debt talks because it is not interested in a full-blown confrontation with the West.\textsuperscript{46} IMF Managing Director, Christine Lagarde, has pointed out that a collapse of Ukraine's economy would not be in Russia's interest, 'because it is a supplier, because it is a creditor and because it wants to get paid and reimbursed at the end of the day'.\textsuperscript{47}

Indeed, despite its ability to force Ukraine into default by demanding early payment, Russia has thus far refrained from doing so. Analysts widely agree that Russia's reluctance to cooperate is the biggest risk of a disorderly default, where no agreement with creditors is reached. Russian Deputy Finance Minister Sergei Storchak stated on 14 May 2015, that Moscow does not intend to participate in restructuring Ukraine's debt, adding that Russia is expecting Ukraine to service its debt.\textsuperscript{48}

3.3.2. Minsk II as a precondition for disbursement of further IMF tranches

Apart from its role as creditor, Russia also has considerable influence over the situation in eastern Ukraine, although it still denies supplying troops to pro-Kremlin separatists. Lagarde has made it clear that the success of financial support for Kyiv depends on the stability of eastern Ukraine. If the truce breaks, investors will pull out. This means that Russia can control the fate of the aid package by directly or indirectly undermining the stability of the pro-Moscow territory in Donbas.

In addition to the problematic debt restructuring and the severely strained ceasefire, difficult border demarcation disputes with the Donetsk and Luhansk regions (including around Mariupol), as well as Ukraine's pledge under Minsk II to grant these regions autonomy could obstruct or delay the process, as fulfilment of Minsk II is a precondition for disbursement of the remaining two IMF tranches.\textsuperscript{49}

3.4. Is there a positive alternative to disorderly or orderly default?

Ukraine's bleak economic future is reflected in the consistent negative trend of the country's credit rating. For example, Moody's rating has continuously decreased; from B1 (with a positive outlook) in 2008 through Caa2 in January 2014, and then from Caa3 to Ca (with negative outlook) in March 2015, as noted above.\textsuperscript{50} Against the backdrop of the growing uncertainty over Ukraine's shock resilience and the country's sinking

\textsuperscript{43} Wigglesworth, R.: Ukraine creditors form bloc to negotiate bond restructuring, Financial Times, 15 March 2015.
\textsuperscript{44} Battle lines draw for Ukraine's debt showdown, Oxford Analytica, 13 May 2015.
\textsuperscript{45} Pointing fingers, spilling blood, The Economist, 4 June 2015
\textsuperscript{46} Ukraine Facing 30% Risk of Messy Default as Creditor Talks Begin, Bloomberg, 30 March 2015.
\textsuperscript{47} Ukraine security crisis weighs down economic reforms -IMF's Lagarde, Reuters, 4 March 2015.
\textsuperscript{48} Russia not intending to participate in restructuring Ukraine's debt, Interfax, 14 May 2015.
\textsuperscript{49} Kiev's Reluctance to Discuss Donbas Elections Violates Minsk Truce – LPR, Sputnik, 10 March 2015.
\textsuperscript{50} Ukraine credit rating, CountryEconomy.com, accessed on 4 May 2015.
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economy, a positive alternative to default – orderly or disorderly – seems increasingly unlikely to many analysts.\(^{51}\)

**Figure 3: International reserves/foreign currency liquidity in US$ billion**

![Graph showing international reserves/foreign currency liquidity in US$ billion from February 2014 to March 2015.](image)

Source: IMF

3.4.1. Scenario 1: Orderly default

Reacting to Kyiv's declared plans to seek restructuring of its privately held external public-sector debt\(^{52}\) on 10 April 2015, Standard & Poor's (S&P) announced yet another downgrade of Ukraine's creditworthiness, this time from CCC- to CC, with a negative outlook on the rating.\(^{53}\) The move reflected S&P's 'expectation that a default on foreign currency central government debt is a virtual certainty'. The next step downwards, C, is used when a debtor is in the process of filing for bankruptcy protection.

Ukraine's Central Bank reserves shrank to US$5.6 billion in February 2015.\(^{54}\) S&P states that the decision to downgrade Ukraine's rating is based on the 'deteriorating macroeconomic environment and growing pressure on the financial sector, as well as our view that default on Ukraine's foreign currency debt is virtually inevitable'. S&P describes an 'orderly' default scenario.

In contrast, a BNP Paribas report, 'Ukraine: the spectre of default' (January 2015) has identified two possible alternative scenarios as regards Ukraine's default prospects.

3.4.2. Scenario 2: Disorderly default

The next alternative is a 'disorderly' default, which cannot be ruled out given the differing interests of creditors and Ukrainian authorities, including Moscow's interest in keeping its leverage over Ukraine. In addition, the continued prospect of the failure of the Minsk II ceasefire reduces the chances of reaching an agreement with bondholders,
thus hindering debt-restructuring efforts. As of March 2015, analysts interviewed by Bloomberg foresaw a 30% risk of a 'messy' default.\footnote{Ukraine Facing 30% Risk of Messy Default as Creditor Talks Begin, Bloomberg, 30 March 2015.}

3.4.3. **Scenario 3: Immediate extreme austerity measures**

The third possible, and very optimistic, scenario, would require Kyiv to adopt and immediately implement extreme austerity measures, reaching a primary budget surplus of approximately 2-3% GDP in the short to medium term. According to some analysts, Ukraine could avoid debt restructuring with regular monitoring from the IMF, and with international creditors refinancing maturing debt over the next one to two years. However, it may prove difficult to convince creditors that such substantial austerity measures would be likely to be implemented. Moreover, these could carry socio-political risks, which have prevented such measures in the past.

The most positive of these scenarios – scenario 3 – therefore currently seems to be the least realistic.

### 4. The Russia factor: Moscow’s economic levers over Ukraine

As noted above, Ukraine's economy has been ailing for years. Unsustainable developments over several decades have provided Russia with a window of opportunity to widen its leverage over Ukraine's economy.

#### 4.1. A weighty, but unsustainable trade partner

Historically, Ukraine's economy has depended heavily on external demand.\footnote{Åslund, A.: What will happen to Russian-Ukrainian trade after the war in Donbass, Kyiv Post, 3 October 2014} Both the EU and Russia/the Eurasian Economic Union (EEU) have been, and still are, key markets for Ukraine. In 2013, despite a number of trade restrictions, mentioned below, Russia was still Ukraine's single most important trade partner, accounting for 27.3% of Ukraine's trade. In comparison, the EU 28 share amounted to 31.2%.

Russia clearly plays a substantial role in terms of trade volume. However, this comes at a price. Firstly, trade with Russia – especially in the energy sector – often benefits the oligarchs rather than Ukraine's overall economy,\footnote{Åslund, A.: Why Gazprom Resembles a Crime Syndicate, The Moscow Times, 28 February 2012. In his essay Oligarchs, Corruption, and European Integration (Journal of Democracy, 25:3, 64-73), Åslund explains how 'a few Russian officials and a few Ukrainian businessmen' shared several billion US$ by involving intermediary companies in the gas trade between the two countries, despite the fact that the gas flowed straight from Russia into Ukraine via direct pipelines.} thus feeding corruption (see chapter 5 on corruption, below).\footnote{The term 'oligarch', defined as a businessman with political influence used for his own benefit due to his financial wealth, was first used in Russia in the 1990s, and popularised by Russian sociologist Olga Kryshtanovskaya. See also Matuszak, S.: The oligarchic democracy – the influence of business groups on Ukrainian politics, Centre for Eastern Studies, September 2012.} Secondly, comparative studies of the potential long term effects of the DCFTA versus the Customs Union with Russia (an antecedent to the
Eurasian Economic Union), suggest that the DCFTA would add 11.8% to Ukraine's GDP, while the Customs Union would reduce it by 3.7%.\(^{59}\)

As indicated below, the short-term effects of Russia's trade restrictions against Ukraine have indeed forced Kyiv to divert its trade increasingly towards the EU. Trade with Russia is set to further reduce in the years to come, as Russia seeks to construct an alternative gas pipeline to Turkey – bypassing Ukraine – after the South Stream project was abandoned in December 2014.\(^ {60}\)

### 4.2. Mounting Russian trade restrictions

Since 2013, prior to the planned signing of the AA/DCFTA, the Russian government and state-owned companies continuously increased economic pressure on Kyiv,\(^ {61}\) for example by imposing bans on Ukrainian foodstuffs,\(^ {62}\) withholding clearance for trucks carrying goods of Ukrainian origin, and raising the price of natural gas:

- **July 2013**: Ban on imports from Ukrainian confectionary producer Roshen (owned by current President Poroshenko). Justification: Failure to satisfy food safety checks and violation of labelling requirements.
- **August 2013**: Enhanced border controls for imports from Ukraine. Justification: The Russian customs office classified all Ukrainian exports as 'high risk', prompting extensive border control. The exports later resumed, but ad hoc enhanced controls have been reported.
- **September-October 2013**: Ban on imports of Ukrainian railcars. Justification: Non-recognition of certificates, defective steel casting.
- **February 2014**: Ban on imports from a major Ukrainian poultry producer, MHP, following the company receiving permission to export to the EU market, in 2013. The Russian authorities suspended MHP's certificate, which subsequently redirected its products to other markets.
- **April 2014**: Ban on imports of selected cheeses from Ukraine. Justification: Food safety concerns.
- **June 2014**: Stoppage of gas supplies to Ukraine. Disputes over prices and payments (including debt) for gas.
- **August 2014**: Ban on imports of alcohol products from three Ukrainian companies. Justification: Violation of labelling requirements.\(^ {63}\)

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\(^{59}\) Movchan, V. and Giucci, R.: *Quantitative Assessment of Ukraine's Regional Integration Options*: DCFTA with European Union vs. Customs Union with Russia, Belarus and Kazakhstan, German Advisory Group, November 2011.

\(^{60}\) Geropoulos, K.: *Russia's Turkish Stream to bypass Ukraine, European laws*, 17 April 2015.


\(^{62}\) Russia bans Ukraine candy imports, Deutsche Welle, 5 September 2014.

\(^{63}\) Russia’s Punitive Trade Policy Measures towards Ukraine, Moldova, and Georgia, CEPS working document no. 400, September 2014. An updated list of Russia-related sanctions can be found at Baker & McKenzie’s [Sanctions Update](https://www.bakermckenzie.com/en/services/services-sections/international-law/sanctions-update) blog.
4.3. Energy: Russian carrots and sticks

Ukraine’s energy consumption is enormous, and its addiction to Russian gas notorious. Although Ukraine's natural gas market is likely to continue shrinking due to economic recession, it was still the fourth biggest European market in 2014, consuming 42.6 billion cubic metres, behind Germany (86.2), the UK (78.7) and Italy (68.7). Comparing the energy intensity – the ratio of primary energy consumption over gross domestic product (GDP/US$ in 2013) – in Ukraine (0.395), Germany (0.113), Italy (0.099) and the UK (0.091), Ukraine's significant energy-saving potential becomes obvious.

Energy dependence is a widely recognised Russian foreign policy tool, and Moscow has alternately used fluctuating gas prices as a carrot and – especially since the February 2014 revolution – a stick to force Kyiv to concede ground. Gazprom stopped deliveries to Ukraine in June 2014, resuming only after negotiations with Kyiv led to a new EU-mediated deal at the end of that year. Ukraine now pays US$247 per thousand cubic meters (tcm) of gas, around US$100 less than Gazprom originally demanded.

4.3.1. Trilateral talks on new gas deal

At an April 2015 meeting, European Commission Vice-President for Energy Union, Maros Sefcovic, and Ukraine's Minister for Energy, Volodymyr Demchyshyn discussed a draft memorandum of understanding for the provision of Russian gas to Ukraine for 2015-16. The agenda for trilateral talks on a new arrangement includes: Russia examining the possibility of a discount on its gas deliveries to Ukraine; Ukraine committing to secure sufficient reserves to enable the transit of Russian gas intended for the EU market; and the Commission considering how to help Ukraine find adequate financial support for gas purchases.

On 7 May 2015, Vice-President Sefcovic announced that the EU aims for a new gas agreement between Russia and Ukraine by June 2015, to secure gas supplies for next winter. The EU goal is to reach an interim agreement until the arbitration court makes a ruling on the long-standing dispute on prices and debt between Ukrainian gas company Naftogaz and Gazprom. Following the ruling, which is expected in late 2016, the aim is to conclude a longer term agreement by the end of 2016. A new gas agreement between Russia and Ukraine would lower the risk of disruption of gas supplies to the EU. Russian gas flows via Ukraine account for more than 10% of

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65 TrendEconomy, Energy intensity, accessed on 20 May 2015. The website defines energy intensity as 'the ratio of primary energy consumption over Gross Domestic Product (GDP) measured in constant US$ at purchasing power parities. It measures the total amount of energy necessary to generate one unit of GDP'.
66 Experts argue that Ukraine's energy-saving potential could be as much as 50% of its current energy consumption. See for example Bochkarev, D.: Ukraine should prioritise energy efficiency, Euractiv, 24 November 2014.
68 Gazprom profits slump on weak rubel, Ukraine crisis, Deutsche Welle, 29 April 2015.
69 Sefcovic, Demchyshyn discuss draft protocol on gas supplies from Russia for 2015-2016, Kyiv Post, 28 April 2015.
70 EU Energy Chief Sefcovic Eyes Russia-Ukraine Gas Deal by June, Bloomberg, 7 May 2015.
71 Gazprom says Naftogaz demanding $6.2 bln in court, UNIAN news, 29 January 2015.
European demand. Payment disputes between Russia and Ukraine disrupted transit flows to Europe in 2006 and 2009. The agreement on a winter package, which was reached in trilateral talks last year, expired at the end of March 2015. On 9 June 2015, Gazprom reiterated that it would cut off gas flows to Europe via Ukraine in 2019 and instead deliver gas to Europe via a new hub on the Turkey-Greece border.72

4.3.2. 'De-oligarchising' and de-monopolising the gas market
As outlined in more detail in the following chapter, Russia's monopoly on Ukraine's gas market has historically enabled the evolution of the country's energy oligarchy and boosted their economic and political influence. However, Kyiv has recently taken steps to reverse this development. Ukraine is planning to reduce its gas imports from Russia, which previously covered 100% of Ukraine's need, to 40% in 2015. The rest will be imported from the EU (including re-exported Russian gas),73 and other countries such as Norway.74 On 9 April 2015, Kyiv adopted a Gas Market Law which addresses key issues in the sector, complying with the EU's Third Energy Package and aiming to end Ukraine's energy dependency on Russia. As Prime Minister Yatsenyuk commented: 'for 10 years we couldn't get the vote through, but finally today we de-oligarchised and de-monopolised our country's gas market'.75

The main aim of the law, which still needs to be signed by President Poroshenko, is to boost competition in the natural gas market by opening the market to investors and unbundling state gas conglomerate Naftogaz into separate production, transit, storage and supply businesses, as well as securing non-discriminatory access to gas infrastructure.

5. Corruption: the 'main threat to the nation'

A key to understanding any society is its informal institutions, which influence both its economy and its politics. In Ukraine, the most important such institution is endemic corruption. Aside from Russia's campaign against Ukraine's territorial integrity and sovereignty, corruption is the main threat to the nation.76

Ukraine is the most corrupt country in Europe, ranking 142 out of 174 countries in Transparency International's Corruption Perceptions Index 2014,77 alongside Uganda. In comparison, Russia is ranked 136, Belarus 119, and Kosovo 110. The widespread corruption undermines not only the state budget, but also the investment climate and citizens' confidence in state institutions. There is concern that a substantial share of any international and/or EU funds could be misappropriated or stolen.78

Current Prime Minister, Arseniy Yatsenyuk has accused the Yanukovich regime of stealing US$37 billion – more than one fifth of the country's 2013 GDP – from the state

73 Ukraine sees imports of European gas overtaking Russian gas this year, Reuters, 22 January 2015.
74 Norway's Statoil sells gas to Ukraine's Naftogaz, Reuters, 3 October 2014.
77 Transparency International: Corruption Perceptions Index 2014.
during its four years in power. This was enabled partly through large infrastructure projects (many of them linked to the Euro 2012 football tournament), where the government paid twice as much as necessary, providing an estimated US$2 billion a year to the Yanukovich family, partly through direct theft from the government, and partly through the natural gas sector.  

5.1. A conglomerate of interests: Ukraine's informal elite

Ukrainian politics have been described as an increasingly 'behind-the-scenes duopoly', where high-ranking political leaders depend on support from the informal elite to gain or retain power. In order to secure international aid, Kyiv needs to combat corruption and decrease the influence of Ukraine's oligarchs. At the same time, both the government and the president rose to power with – and with the help of – the same shadow elite whose influence they are now committed to curbing. Ending this conglomerate of interests could prompt the oligarchs to shift their loyalties to other political leaders.

5.1.1. 'Gas kings' influence politics and media beyond Ukraine

Just as in Russia, the collapse of the Soviet Union sparked the rise of a number of business entrepreneurs who were able to benefit from the opaque privatisation process and use it to their economic advantage. In Ukraine, such oligarchs control various important sectors of the country's economy, including metallurgy, mining, the chemical industry, and – most importantly – the energy sector.

One of the most lucrative sectors in Ukraine was, and still is, natural gas distribution. Russian gas was imported by the Ukrainian State company at an artificially low state-regulated price from Gazprom, and then sold at a high monopoly-shielded price. Although direct pipelines – owned by Gazprom and Naftogaz – from Russia to Ukraine transported all gas imports, intermediary companies became involved and benefited from the trade by buying cheap gas – both Russian and subsidised domestically produced gas – and reselling it at a high price. These rent-seeking practices also took place in other energy sectors, such as the coal and nuclear sectors. The IMF estimates that 7.5% of Ukraine's GDP was spent on energy subsidies that benefited the 'gas kings'.

The spending power of the privileged businessmen is translated into political influence through their close ties to the country's political parties, secured by their control over Ukraine's mass media, and not least by their support for extremely costly election campaigns. As the key businessmen in the gas industry often change according to election results, political affiliations can make or break their future, and they invest accordingly.

The Maidan revolution was mainly driven by the Ukrainian citizens' wish to end the unpopular Yanukovich regime – including its kleptocratic traditions – and move closer towards Europe. Despite this, many oligarchs supported the movement to secure their

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82 According to Åslund (2014), businessmen in some industries – for example, the nuclear industry – tend to survive changing governments by changing their own political affiliations.
own interests by funding important resistance groups, influencing news coverage of the events, and engaging in the election campaigns that followed Yanukovich's ousting.

5.1.2. Competing power structures
The change of power following the revolution not only affected formal political power structures; the October 2014 parliamentary elections were also seen as a contest between Ukraine’s biggest oligarchic groups, who were keen, and had the means, to protect their own interests. Oleksandr Borodai, the former Prime Minister of the self-proclaimed People's Republic of Donets (DPR), explained that the separatists had the opportunity to take the port city of Mariupol in September 2014. However, they refrained from doing so in order to facilitate the business of Rinat Akhmetov, as Mariupol is the only port available for Akhmetov, whose assets are concentrated in the east of the country. He added that Odessa was not available to Akhmetov’s businesses, as the Odessa ports were controlled by the then governor of Dnipropetovsk, Ihor Kolomoisky, ‘and he would never let Akhmetov in’.

While the direct political influence of Rinat Akhmetov – who is still the wealthiest man in Ukraine – was significantly reduced after the October 2014 elections, businessman Dmytro Firtash and his ally Serhiy Lyovochkin – the head of ex-President Yanukovich’s administration until January 2014 – supported current President Petro Poroshenko during the presidential campaign. In this way, President Poroshenko was able to secure favourable coverage on the major TV channel, Inter, owned by Firtash and Lyovochkin. Nevertheless, the Firtash-Lyovochki partnership does not limit its financial support to pro-Western forces, but also backs the populist Radical Party, led by Oleh Lyashko, as well as the pro-Russian Opposition Bloc.

Dmytro Firtash was arrested in Vienna on 12 March 2014, at the FBI’s request, and has been under house arrest in the Austrian capital ever since, pending US extradition on bribery charges. However, an Austrian court refused his extradition, ruling that the US charges were ‘politically motivated’. Although Firtash’s political influence in Ukraine may have decreased, he has remained active while in Vienna. He helped create the deal between the political parties led by Petro Poroshenko and current Kyiv Mayor Vitali Klitschko, respectively, ahead of the May 2014 presidential election, thus helping ensure Petro Poroshenko’s victory. In March 2015, Dmytro Firtash launched a new initiative, the 'Agency for the Modernisation of Ukraine', in Vienna – with high-ranking European politicians as advisors, including former Austrian Finance Minister

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84 Åslund, A. (2014), op. cit.
85 Separatist leader hails relationship between Akhmetov and self-proclaimed republic, Kyiv Post, 2 April 2015.
89 Ukrainischer Top-Oligarch Firtasch in Wien verhaftet, Die Presse, 13 March 2014.
90 Firtasch wird nicht an USA ausgeliefert, Der Standard, 30 April 2015.
Michael Spindelegger. Critics in Ukraine saw the initiative as an attempt by Firtash to restore his reputation ahead of the court's decision on the US extradition request.

5.1.3. Ihor Kolomoisky and Kyiv's 'de-oligarchisation' efforts

While the Firtash-Lyovochki partnership took President Poroshenko under their wing during the election campaign, current Prime Minister Arseniy Yatsenyuk's People's Front was backed by the TV channel TV 1+1, owned by Ihor Kolomoisky, head of the banking and industrial conglomerate Privat group, and the fourth richest man in Ukraine.

Kolomoisky became Governor of his home region of Dnipropetovsk in March 2014. The region – often referred to as 'Dniprokolomoisk' – is claimed to be a state within the state. Kolomoisky controls important industrial assets in the east of the country and has funded Ukrainian volunteer battalions in Donbas. His troops include Dnipro-1, a battalion of 2 000 heavily armed fighters. Kolomoisky was forced to resign from his post as Governor after masked, armed men, allegedly belonging to his private army, stormed the headquarters of state-owned oil company UkrTransNafta in Kyiv, following the dismissal of the company's Director Oleksander Lazorko, a key ally of Kolomoisky.

5.1.4. 'De-oligarchisation' – or redistribution of spheres of influence?

Following the widely reported Kolomoisky incident, efforts towards 'de-oligarchisation' have been visibly stepped up. President Poroshenko launched an anti-oligarch campaign, announcing an end not only to private individuals' 'pocket armies' (a hint to Kolomoisky), but also what he referred to as a 'governmental umbrella' that has always protected 'corrupt officials' and allowed them to continue their criminal activity. 'Is there corruption in Ukraine now? Yes, there is. But there is no more "umbrella". I have ruined it and will continue to do so,' President Poroshenko stated on 2 April 2015.

5.1.5. Can infighting undermine Ukraine's stability?

Formally, President Poroshenko's anti-corruption efforts are perfectly in line with international demands. However, some observers followed the confrontation between the President and Kolomoisky with unease. One analyst referred to the current situation as 'reminiscent' of the conflict of 2005 between the two pro-Western leaders (Viktor Yushchenko and Yulia Tymoshenko) that eventually led to the victory of the pro-Russian President Yanukovich in the 2010 election, warning that the Poroshenko-Kolomoisky conflict has the potential to undermine Ukrainian statehood.

92 Spindelegger soll Ukraine auf die Beine helfen, Kurier, 13 May 2015.
93 Skepsis gegenüber Firtsch-Projekt, Der Standard, 5 March 2015.
95 In Ukraine, Governors are appointed by the President.
97 Hirst, T.: Meet the private army controlled by sacked Ukrainian billionaire Igor Kolomoisky, Business Insider, 25 March 2015.
98 President: Finding and punishing killers of Security Service officer Viktor Mandzyk is a matter of honor, Press office of President Poroshenko, 23 March 2015.
99 President: Corruption in Ukraine will be no more covered, Press office of President Poroshenko, 2 April 2015.
100 Ukraine Business Online: Conflict between Poroshenko and Kolomoisky intensifies, 24 March 2015.
According to Oxford Analytica, Kolomoisky may prove a greater problem for President Poroshenko now that he is not 'burdened by public office'. It is unclear how Governor Kolomoisky's dismissal will affect his pivotal support for volunteer battalions that have fought alongside the official army in the east against pro-Russia separatists. Moreover, infighting between Kyiv and the influential oligarchs could derail economic reform and therefore financial aid for Ukraine, thus posing an increasing risk to Ukraine's long term stability.\(^{101}\) It remains to be seen whether the confrontation with Kolomoisky marks the start of a thorough 'de-oligarchisation' process, or whether it will merely lead to a redistribution of spheres of influence.

5.2. First steps to counter corruption

A specific challenge to the fight against corruption is Ukraine's 'notoriously corrupt' courts, still dominated by Yanukovich-appointed judges who allegedly continue to favour the former President's clan.\(^{102}\) However, Kyiv is taking visible steps towards combatting the problems. In October 2014, the parliament passed an Anti-Corruption Package\(^{103}\) — corresponding with the demands of both the Maidan revolution and the terms and conditions of the IMF and the EU-Ukraine Association Agreement.\(^{104}\)

**Figure 4: Corruption perception in Ukraine by institution (2013)**

![Corruption perception in Ukraine by institution (2013)](image)

Source: Transparency International.

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\(^{101}\) Oxford Analytica Daily Brief, 25 March 2015, op. cit.

\(^{102}\) Ibid.


On 16 April 2015, President Poroshenko appointed Artem Sytnyk – former investigation Chief for Kyiv's Prosecutor's Office – Head of Ukraine's first anti-corruption bureau, established with EU support to investigate high-level corruption cases. Sytnyk said he would combine Ukrainian and foreign anti-corruption experience to build the first new law enforcement agency in Ukraine since Soviet days.¹⁰⁵

According to Enlargement Commissioner, Johannes Hahn, the EU could help Ukraine establish electronic databases for a 'truly transparent asset disclosure and verification system'. He also emphasised the importance of privatisation and procurement in the fight against corruption, and in the latter field recommended combining e-procurement – 'simple, open and transparent procedures online' – with 'effective oversight'.¹⁰⁶

5.2.1. Curbing the oligarchs' political influence
Some experts recommend that political financing should be limited to public financing and party-membership dues. Full transparency should curb foreign political money to influence future campaigns.¹⁰⁷ The parties' practice of using so-called 'grey cardinals' – persons responsible for the party's secret funds, financed by auctioning off high offices – should end. Regional Governors should be elected, rather than appointed by the President.

6. An impending demographic meltdown

In addition to the numerous acute challenges already mentioned, the demographic situation in the country is alarming, despite the country's current large, trained, and educated workforce.¹⁰⁸ In addition, the population is also worryingly unhealthy.

6.1. An ageing and shrinking population

Ukraine's population has declined steadily since the collapse of the Soviet Union, shrinking by 12% (6.4 million people) between 1990 and 2013. According to the UN Population Division, this trend will continue, with a population of less than 34 million by 2050,¹⁰⁹ down from around 44 million in 2015.¹¹⁰

By 2020, the 65+ age group is predicted to rise to 7.6 million – from 7.0 million in 2011. At the same time, the working age population (15-64 age group) will decrease by 9.5% from 2011 to 2020. A shrinking labour force (and the resulting drop in tax revenues), combined with an ageing population, will curb consumption and production in the future and adversely affect public finances. In July 2011, Kyiv raised the female retirement age from 55 to 60 and the male retirement age from 60 to 62. However, this will not be enough to resolve the problem of labour shortages and falling economic output in the medium and long term.¹¹¹

¹⁰⁵ President appointed Artem Sytnyk Director of the National Anti-Corruption Bureau, Press office of President Poroshenko, 16 April 2015.
¹⁰⁶ Johannes Hahn, Speech at Bertelsmann Stiftung event, Brussels, 15 April 2015.
¹⁰⁹ United Nations, Department on Economic and Social Affairs, accessed on 30 April 2015.
¹¹¹ Ukraine’s Population In Rapid Decline, Euromonitor, 11 May 2012.
6.2. Health factors and life expectancy

Ukraine's fertility rate lies well below the level of around 2.1 needed for stable population replacement. Life expectancy is the lowest in Europe – even lower than Russia – with 63.8 for men and 74.9 for women (2013 figures). Premature mortality for working-age men and increasingly for younger males has reached crisis levels, caused mainly by lifestyle issues such as excessive alcohol consumption, smoking, poor diet and exercise, poor access to healthcare, and stress due to people's perceptions that they have little control over their lives and future. In the 18-29 age group, 20% are hypertensive. In addition, Ukraine has the highest mortality rate from infectious diseases (mainly HIV and tuberculosis) in Europe, surpassing Russia. These evolving epidemics could have considerable, albeit not yet quantifiable, economic consequences in the medium and long term. Generally, the population in the east of Ukraine is more severely affected by the above-mentioned problems than that in western parts of the country.

6.3. Decreasing remittances from labour migrants in Russia

With the unemployment rate approaching double digits and a war in the eastern part of the country, Ukraine is a net exporter of labour, and does not attract labour migrants. According to a survey conducted by the International Labour Organization, 1.2 million, or 3.4% of the Ukrainian population aged 15-70 were identified as labour migrants from January 2010 until June 2012. Ukrainian labour migrants earned US$ 930 per month on average, almost three times higher than their counterparts remaining in the country. The main destinations for Ukrainian labour migrants between 2010 and 2012 were Russia (43.2%), Poland (14.3%), Italy (13.2%), and the Czech Republic (12.9%).

While labour migration to Russia is decreasing, more are leaving to work in the EU, a trend that will likely continue given the ongoing conflict in the east of the country and

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economic recession in Russia. Russia is the largest source of remittances to countries in Europe and Central Asia, and Ukraine is the largest recipient of remittances in the same region. In 2012, private remittances to Ukraine equalled 4% of GDP in Ukraine, more than net foreign direct investment. The trend towards decreasing remittances from Russia will continue to add pressure to Ukraine's financial situation.

7. Humanitarian and environmental aspects of the war

7.1. An unfolding humanitarian crisis

The military conflict has sparked a humanitarian crisis. The death toll rose to more than 6 100 people in mid-April 2014. Some 15 491 people have been wounded in the conflict zone of eastern Ukraine. The Internal Displacement Monitoring Centre (IDMC) estimated that there were at least 1.2 million registered IDPs in Ukraine as of 15 April 2015, an increase of 15 000 people within just one week. The unfolding humanitarian crisis is placing further strains on the economy, both in the short and in the long term, despite assistance from international donors, including the European Investment Bank (EIB). An estimated 5 million people need life-saving assistance.

Some schools have been damaged or destroyed by fighting; a lack of school transport also hampers access to education. Many IDPs are unable to enrol their children due to overcrowding in schools, while others are keeping them at home in the hope that they can return to their areas of origin before the beginning of the next school year. The long-term consequences of these developments are, although potentially significant, difficult to measure.

7.2. A looming environmental disaster

Posing a more acute problem, drinking water supplies have been damaged and disrupted, affecting some 700 000 people in Donetsk and Luhansk oblasts. Chlorine for water disinfection is unavailable in the conflict zone, and the lack of personal hygiene poses a potential risk of water-borne diseases. The deteriorating humanitarian crisis is likely to be exacerbated by growing environmental problems, as drinking water

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117 IDMC: Ukraine IDP Figures Analysis, April 2015.
118 The EIB will provide a €200 million loan to Ukraine for the implementation of a series of measures in 2015-2020, provided in tranches, aimed at 'overcoming negative consequences of geopolitical events in eastern regions of the country', including support for IDPs, and restoration of main infrastructure facilities in the territory of Donetsk and Luhansk regions controlled by the Ukrainian authorities (press release, Petro Poroshenko's official website, 12 May 2015).
119 Aid worker diary: “A year ago, no one was displaced…”, United Nations Office for the Coordination of Humanitarian Affairs, 19 March 2015.
121 UNICEF: Wash. situation update, 3 March 2015.
supplies could be further affected by the uncontrolled flooding of coal mines in the areas, where toxic water leaks into ground water and surface waters.122

8. Future prospects: Can Kyiv break the vicious circle?

Ukraine has clearly chosen to move closer to the EU in political terms. However, Russia will – for better or worse – remain its next-door neighbour. In the light of Moscow's manifold levers over Kyiv, economic stability in Ukraine hinges not only on Kyiv's will for reform and actual efforts, but also on Russia's goodwill, which currently is non-existent.

Ukraine is likely to remain a split country, possibly involving a 'frozen conflict' (where neither party to the conflict is willing or able to break the deadlock) with parts of eastern Ukraine forming closer ties to Russia, while the rest of Ukraine continues its orientation towards the EU. A resolution to the military conflict in Ukraine is the key precondition for macroeconomic stabilisation, investment in restructuring and growth, and implementation of institutional reforms. However, in light of Russia's crucial role in the conflict, Kyiv cannot resolve the conflict alone. A lack of progress could likely further erode the government's credibility both domestically and internationally, thus jeopardising the country's stability in both the short and medium term.

On the one hand, government efforts to stabilise the economy may be unpopular, as the short-term effect of spending cuts and higher gas prices on the average citizen will be painful. On the other hand, however, a failure to implement reforms would not only jeopardise ties to, and funding from, the EU, but could lead to economic and political collapse. This in turn would increase the risk of a more radical Maidan, paving the way for yet another power shift, thus further polarising and destabilising the country.

Ukraine's corruption issues have an immense negative effect on the economy, but curbing them requires significant political efforts. The Maidan revolution represented the public wish to move beyond kleptocratic structures, and Kyiv needs to translate its commitments into results. The transition towards a liberal economy in accordance with European standards has started, but it will take years of hard work before results are evident and Ukraine achieves stability.

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122 As essential care and maintenance is no longer possible, a number of coal mines in the east of the country have been flooded. Out of 128 operational coal mines operational in 2014, 60 are reportedly flooded. International Coal Dialogue: Quo vadis Ukraine? Conference report, European Economic and Social Committee, 18 November 2014.
9. Annexes


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**EU Budget heading 4**

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NB Data from March 2015.

\(^{123}\) Report on the BUDG Committee mission to Ukraine, 18-20 March 2015.

\(^{124}\) The European Parliament, in March 2015, approved a third programme worth €1.8 billion, proposed by the Commission in January. The aid will be disbursed in three instalments in 2015 and 2016 and is dependent on the completion of reforms by the Ukrainian government to tackle problems that contributed to the current crisis.
9.2. The EU-Ukraine Deep and Comprehensive Free Trade Agreement (DCFTA)\textsuperscript{125}

The EU-Ukraine DCFTA was signed on 27 June 2014 as part of the broader Association Agreement (AA). The DCFTA – consisting of 900 pages, 15 chapters, 14 annexes and three protocols – aims to eliminate customs duties, reduce trade obstacles, integrate Ukraine into the EU market, harmonise laws, norms, and regulations, as well as align key sectors of Ukraine's economy to EU standards. By reducing tariffs, Ukrainian exporters are expected to save €487 million annually, while EU exporters will save an estimated €390 million annually.\textsuperscript{126}

In April 2014, in response to the unfolding security, political and economic crisis in Ukraine, the EU unilaterally granted Ukraine preferential access to the EU market until 31 December 2015. The DCFTA was originally expected to enter into force in November 2014. However, in September 2014, the EU postponed implementing the DCFTA until January 2016 to offer Moscow an incentive to stick to the ceasefire agreed in the September 2014 Minsk Protocol. The move was criticised for giving Russia 'incentives to raise the pressure because it opens a large window of opportunity to prevent the DCFTA from entering into force'.\textsuperscript{127}

In April 2015, Commissioner for European Neighbourhood Policy and Enlargement Negotiations, Johannes Hahn encouraged Ukraine to engage in a trilateral trade format, including both the EU DCFTA and the Russia-led EEU. Commissioner Hahn argued that 'at least partial restoration of links with Russia, and the ... Eurasian Economic Union will be important to Ukraine's economic recovery' and that 'Ukraine should diversify its export markets and develop trade relations in many directions.'\textsuperscript{128}

In connection with the EU-Ukraine summit in Kyiv on 27 April 2015, European Commission President, Jean-Claude Juncker called it 'important' for the DCFTA to be fully implemented from 1 January 2016, even though 'others want to postpone the entry into force'.\textsuperscript{129} On 7 May 2015, European Trade Commissioner, Cecilia Malmström confirmed that the DCFTA would be implemented from the beginning of 2016 despite Russian opposition. 'It is not for Russia to decide,' Commissioner Malmström said, adding that 'There has been a very clear statement by the European Union, by Member States, by the Ukrainians ... that the first of January 2016 is the date'.\textsuperscript{130} The decision is expected to anger Moscow and increase the chance of further escalation of tension in the Donbas region.\textsuperscript{131}

The joint declaration of the Eastern Partnership Summit in Riga on 21-22 May 2015 stated that 'Summit participants look forward to the provisional application of the Deep

\textsuperscript{125} For a detailed comparison of the Deep and Comprehensive Trade Agreements with other EU trade agreements, see De Micco, P.: \textit{When choosing means losing – The Eastern partners, the EU and the Eurasian Economic Union}, European Parliament, Policy Department, DG EXPO, March 2015.

\textsuperscript{126} EU-Ukraine Deep and Comprehensive Free Trade Area (overview).


\textsuperscript{128} EU pushing Ukraine towards trilateral free trade, with Russia, Euractiv, 15 April 2015.

\textsuperscript{129} Rettman, A.: Juncker: No more delay on Ukraine free trade, EUobserver, 28 April 2015.


\textsuperscript{131} Ukraine-EU trade deal decision will anger Russia, Oxford Analytica, 8 May 2015.
and Comprehensive Free Trade Area (DCFTA) with Ukraine starting on 1 January 2016 and the positive impact its implementation will bring about.132

**Ukraine's trade with the EU and Russia**:133

- The **EU** (28) is Ukraine's largest trading partner, accounting for more than a third of its trade. It is also its main source of foreign direct investment (FDI).
- Main Ukraine exports to the EU: raw materials (iron, steel, mining products, agricultural products), chemical products and machinery.
- Main EU exports to Ukraine: machinery and transport equipment, chemicals, and manufactured goods.
- Despite the crisis, **Russia** remained Ukraine's single largest export partner in 2014, with 17.6% of exports, down from 23.6% in 2013.
- Main Ukraine exports to Russia: machinery, steel, agriculture, chemicals.134
- Ukraine plans to reduce its gas imports from Russia, which previously covered 100% of Ukraine's needs, to 40% in 2015.

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132 Joint Declaration of the Eastern Partnership Summit (Riga, 21-22 May 2015)


134 Åslund, A.: What will happen to Russian-Ukrainian trade after the war in Donbass, Kyiv Post, 3 October 2014.
10. Main references


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Ukraine’s downward economic spiral started long before Russia annexed the Crimean peninsula in March 2014. The economy has been struggling since the country gained independence after the collapse of the Soviet Union. Kindled by continuous mismanagement and fuelled by political instability, the current economic crisis finally flared up in response to mounting pressure from Moscow.

Kyiv is dependent on foreign aid and must conduct wide-ranging reforms. However, Moscow has multiple economic levers over Ukraine and will likely continue to contribute to further destabilisation. Moreover, Ukraine’s long-standing, home-grown problems will pose significant obstacles to Kyiv’s efforts to break the vicious circle and move towards a functional market economy.