Impact of the Global Economic Crisis on the Ukrainian Economy: Regional Aspects

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Executive Summary

The report discusses the fragilities of the Ukrainian economy before the crisis, and the impact of the crisis on different sectors. Next, a regional economic outlook is provided.

The Ukrainian economic situation sharply deteriorated at the end of 2008 in the face of the global economic crisis. The country’s real GDP dropped by 8.0% year-over-year in the fourth quarter of 2008. The Institute for Economic Research and Policy Consulting forecasts a further contraction of the Ukrainian economy by 14.1% in 2009.

An analysis showed that regions with higher shares of industrial sectors that are traditionally more developed have suffered more from the crisis than agricultural regions with lower levels of economic development. The study allows concluding that regional disparities have slightly declined due to the crisis.

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1. Introduction

As a consequence of the global financial crisis in 2008 most countries in the world faced economic recession. Economic downturn has continued in 2009 though economic situation has been gradually improving. According to experts’ estimates real GDP growth will be observed in many countries in the fourth quarter of 2009 in quarter over quarter terms.

Sharp slowdown in the world economy has also affected the Ukrainian economy. In particular, demand for Ukrainian export goods has decreased significantly while the foreign capital inflow has almost ceased. The effect of negative external shocks has been reinforced by internal factors. Economic reforms that could increase the degree of the economy’s resistance to the crisis have long been hampered by political instability. Swift increase in social standards has caused disproportions in the households’ revenues structure and significantly reduced the government’s range of manoeuvre in planning and executing the state budget during economic crisis.

As a result, the country’s real GDP dropped by 8.0% year-over-year (yoy) in the fourth quarter of 2008. The Institute for Economic Research and Policy Consulting forecast further contraction in Ukraine’s economy by 14.1% in 2009. The crisis affected economic indicators of the Ukrainian regions differently. In particular, regions with larger share of industrial sectors, traditionally considered to be more developed, have suffered more than agricultural regions usually characterised by lower level of economic developed. In consequence, such indicators as regional wages, unemployment rate, and others have also changed.

This study begins with the analysis of weak points of the Ukrainian economy observed on the eve of the crisis that reinforced the negative impact of external shocks. Next sections analyse crisis impact on various sectors of economy and of the economic situation in regions. In particular, attention is paid to crisis impact on such indicators of economic situation in the regions as industrial production, agricultural production, trade, investments, unemployment, salaries, and migration. The last chapter of the report contains conclusions.

2. Economic situation in Ukraine

Global financial crisis that caused a sharp slowdown in the world’s economy had a negative impact on Ukraine’s economic development. In consequence of the crisis the demand for traditional Ukrainian export goods, especially metal and chemical products, has substantially decreased. As a result, in the fourth quarter of 2008 industrial output plunged. The output had continued at the beginning of 2009: in January real industrial output decreased by 34.1% yoy. Later on the output has slightly increased though its level remained much lower than year before. In particular, between January and August real output has dropped by 29.4% yoy.

The banking sector also faced problems in the fourth quarter of 2008. In particular, there was an outflow of deposits against the background of increased amount of bad loans and significant external loans’ redemption obligations. Due to global financial crisis banks have lost the possibility to attract syndicated credits while the capacity to refinance old debts has remained limited. As a result, banks have drastically reduced crediting both for physical persons and legal entities while credits were among major sources for investment and consumption before the crisis. The demand for motor vehicles, housing and some consumer products has decreased respectively.

At the end of 2008 and the beginning of 2009 financial account inflows reduced while payments augmented causing financial and capital accounts deficits. Hryvnia has lost almost the half of its value due to reduction of foreign currency supply in the interbank exchange market against the background high demand for foreign currency both from corporate sector and households. In order to support the national currency the National Bank had to spend a large part of its reserves as well as to resort to the IMF help.

Substantial economic decline has forced many employers to cut costs, in particular on wages. As a result, the unemployment rate has increased and reached 9.5% of economically active population aged between 15 and 70 (according to the ILO methodology) in the first quarter of 2009. At the same time wages in a number of sectors had been cut at the end of 2008 and in January 2009. Later on wages have resumed their growth although at slower rate than year ago. Therefore population incomes from wages have decreased in real terms.
The economic slowdown has caused reduction in central fiscal revenues in comparison to previous year also causing real term reduction in social transfers. Thus, already in the first quarter of 2009 households consumption decreased by 11.6% yoy in real terms. This figure for the entire year is estimated to decline further taking into account high net bank credits’ reimbursements.

Therefore, in the fourth quarter of 2008 Ukraine’s real GDP decreased by 8.0% yoy, while in the first and second quarters of 2009 it dropped by 20.3% yoy and 18.0% yoy, respectively. According to the IER forecast, the real GDP will decrease by 14.1% in 2009.

3. Reasons for Ukrainian economy weaknesses

A rapid decline in the Ukrainian economy demonstrated its non-preparedness to confront challenges of the crisis caused by several reasons at least. First, the crisis has once again demonstrated the low diversification of exports against the background of high dependence of the economy on the external demand. In particular, in 2008, more than 40% of merchandise exports accounted for metals and products thereof, mainly steel and iron products. Moreover, about 80% of domestic metal production has been exported. At the same time, the level of sector’s modernization has remained low (blast-furnace production still holds a dominant position in the sector) that resulted in relatively high production cost. Another problem has been low quality of Ukrainian metal products. As a result, these products are not traded on the world markets under long-term contracts that have significantly increased risks.

While many steel companies have started investment projects aimed at improving energy efficiency and quality and reducing costs, not all projects were completed prior to the crisis. The drop in global steel prices and increase in gas prices has become an unfavourable concatenation of circumstances that forced companies to reduce production. Lower profits or even losses pushed enterprises to suspend a number of investment projects, continuing only the most important. Similar situation has been observed also in a chemical industry. A machine building was also faced a sharp decline in both external and domestic demand. In general, the lack of strategic thinking of Ukrainian entrepreneurs who accounted for further favourable external environment resulted in non-preparedness of main economic sectors to the crisis.

Final household consumption had been a driving force of a real GDP growth during last several years. In the first quarter of 2008, real final consumption of households increased by 22.5% yoy, while real GDP grew by 6.3% yoy, indicating overheating. Large share of consumption, especially demand for durables, were satisfied through imports resulting in its faster growth as compared to exports. Therefore, in the fourth quarter of 2008, current account deficit reached USD 3.7 bn or 10% of GDP.

Consumption growth had been attributed not only to rapid increase in income stimulated by growing minimum wage and pensions but also to a bank credit expansion. The latter were primarily ensured through external loans taken by the Ukrainian banks. In the crisis external loans redemption has become a problem for banks as worsening of domestic economic situation affected the quality of loans, while the possibilities of external debt refinancing de-facto disappeared.

At the same time, populism of Ukrainian authorities resulted in distortions of households’ income structure and in public finances. In particular, wages and social transfers have constituted almost equal shares in households’ income structure naturally reducing work incentives. Besides, there has been a sharp increase in social expenditures of the budget that reduced the government’s range of manoeuvre during the crisis and limited financial resources that could be spent on highly important infrastructural projects. Instead, the government was forced to borrow from the IMF in order to finance the fiscal deficit estimated for 2009 at 6.0% of GDP. It should be said that the deficit financing with the IMF loans is an exceptional situation in the practice of this international institution.

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Ceased credits led to the burst of the “bubble” on the real estate market. As a result, construction companies have confronted with liquidity problem unable to complete even already started projects.

The crisis has affected Ukraine much stronger than other countries partly due to the lack of major structural reforms. In particular, the reform of a pension system has been initiated but not completed yet. There has been no tax reform, reform of intergovernmental relations, administrative and territorial reforms. The cross-subsidization of population by public enterprises has been preserved, resulting in additional companies’ losses. The government has also failed to implement the reform of social support system that would have ensured the real protection for low-income population during the crisis. The law on public procurement envisaging transparent procurement procedures has not been approved yet. Permit system has not been simplified hampering the development of small and medium enterprises that have been in the focus of anti-crisis policy in majority of countries. The high level of corruption has been preserved significantly worsening business environment in the country.

As a result, during the economic crisis the government has aced serious challenges with implementation of economic policies aimed at support of the economy and provision of social protection against the background of insufficiently reformed economy and limited funding.

4. Regional differences

Ukraine’s regions are specialized on different economic activities and thus differ upon the growth rates of economic development and welfare levels. In 2007 the gross regional product (GDP) per capita in the richest regions – Dnipropetrovsk and Donetsk – was on the level of UAH 20868 and UAH 20197 respectively that exceeds the average for Ukraine level by 30%. The poorest region was Chernivtsi, where GRP per capita was more than twice as low as the average country rate (UAH 7369).

The rates of regional economic growth have differed significantly in the recent years. In particular, in 2007, the most wealthy regions - Dnipropetrovsk and Donetsk – were growing slower than the GDP growth rate for Ukraine (5.3% and 4.6% respectively, comparing to the 7.9% real GDP growth rate in the country), and in 2005 real GRP in Donetsk even decreased by 2.9%. On the contrary, Chernivtsi region demonstrated growth by 8.3% in 2007. The factors that traditionally define regional development are the sectors of regions’ specialization.

In the structure of value added of the country the most important sectors are manufacturing industry, trade, transport, real estate activity and agriculture. During the last years the share of agriculture in the regional value added has decreased in all the regions and has been mostly redistributed among manufacturing industry, trade and real estate sector. In 2006 in the value added structure agriculture prevailed in eight regions, industry in fourteen, trade in four, and transport services in one region.

In general, all regions of Ukraine can be tentatively divided into regions with higher share of industrial sectors that are traditionally considered as more developed, and regions, where agriculture prevails and which are characterized with lower level of economic development. In 2008, 72.3% of the sold industrial products were produced in 12 regions mostly of the East Ukraine, with 38% of them were due to Donetsk and Dnipropetrovsk regions. On the other side, the major share of the agricultural output was produced in the 5 central regions of Ukraine. Since country’s regions have different structure of economy, the impact of macroeconomic changes on them is also different. Thus, regions with the higher share of

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3 Unemployment in Ukraine: from scale and trends to adequate policy response. Analytical note of the IER, June 26, 2009

4 A description of regional differences in Ukraine's economy provided below is largely based on materials prepared within the framework of “SWAP Scoping Study – Macroeconomic assessment and impact on regions” project. The project was conducted upon the request of Support for Sustainable Regional Development Project financed the EU

5 The Ukraine Competitiveness Report 2008, World Economic Forum

export-oriented enterprises (those that work in metallurgy, chemical industry, machine building) are highly dependent on price trends and situation on the world markets. Performance of agrarian regions is more sensitive to weather conditions and government policies.

In 2009, the economic crisis caused the GRP to drop in all the regions, but the decrease was not uniform. Differences of regions’ development in the time of economic crisis are first of all explained by differences in structure of their economies. According to our estimations, the GRP of industrial regions, specialized in production of non-metal mineral products, metals, and machinery and equipment, declined more, than the GRP of agrarian regions. Thus, the GDP in such regions as Donetsk, Lugansk, Zaporizzhya, Kirovograd and Zakarpattya declined more, than the Ukrainian average. According to IER estimates, the most moderate economic decline will be in Zhytomyr, Ternopil, Chmelnytsk, Ivano-Frankivsk regions, Kyiv city and AR Crimea.

4.1. Industrial production

Tightening domestic and external demand entailed sharp drop in industrial output in Ukraine. The peak of decline was between October 2008 and January 2009. At that period, the production had been decreasing both on monthly and yearly basis. Starting from February 2009, each month has been bringing gradual recovery of production volumes compared to January 2009 but the growth rate was significantly lower in year-over-year comparison. As a result, between January and September 2009 the industrial output shrank by 29.6% as compared to the same period of the pervious year. Machine building with 52.2% yoy drop, production of non-metal mineral products, metall and chemical industries were the sectors most severely hit by the crisis. At the same time, food industry suffered much less underpinned with more stable demand and shift of domestic consumption patterns towards the Ukrainian foodstuffs.

Figure 1
Changes in industrial production output

![Graph showing changes in industrial production output](source: Derzhkomstat)

The difference in the impact of economic crisis on various manufacturing sectors defined different level of production decline measured across regions of the country. The sharpest decline was registered for Zakarpattya, Volyn, and Zaporizzhya regions primarily due to challenges faced by machine building industry suffering from both diminishing investment programs and enhanced credit crunch.

Donetsk and Dnipropetrovsk regions suffered due to deteriorating environment in metallurgy, and the reduction of output in Rivne and Cherkasy regions was primarily caused by problems encountered by chemical plants. At the same time, the situation has been much better for Kherson and Mykolaiv regions thanks to high concentration of food industry companies that have been hit less by the crisis compared to other sectors.
4.2. Agriculture

At the end of 2008 and over the first eight months of 2009 agriculture remained the only sector of the economy with real growth. However, in August real growth slowed due to the high statistical base of the previous year attributed to previous-year record grain harvest. Overall in 2009 the IER expects the decline in the agricultural output.

Impact of the economic crisis on the agriculture in 2009 was weaker than on the industry because of several reasons. First, crisis aggravated after winter crops were seeded. Thus it didn’t impact the decisions of agricultural enterprises on areas seeded and usage of fertilizers in autumn. Second, demand for the agricultural products remained more stable than demand for industrial products and services while hryvnia depreciation supported competitiveness of the Ukrainian agricultural products on the world markets. At the same time despite some state support crisis limited availability of loans for agricultural enterprises necessary to buy fertilizers in spring that decreased crop yields. Economic crisis will likely influence agricultural output in 2010. Agrarians lack funds to buy fertilizers to seed winter crops as they didn’t receive payment for the new harvest while bank loans are very limited.

Agricultural situation in 2009 differs in Ukrainian regions. While several regions including Lugansk, Odessa and Kirovograd saw real agricultural output fall by more than 12% yoy, output in Ternopil, Lviv, Khmelnytsky and Ivano-Frankivsk regions grew by more than 12% yoy. These disparities are explained not by crisis but by differences in specialization and climate.
4.3. **Trade**

Decline in real household incomes against the background of high debt burden, worsening financial state of enterprises and low fiscal revenues negatively influenced on retail trade sector. Between January and August of 2009 retail trade turnover fell by 15.9% yoy while sales by retail trade enterprises and restaurants fell by 20.5% yoy. Both indicators worsened as compared to January when the decline was 7.1% yoy and 8.1% yoy, respectively.

Trade volumes decreased in all regions though in different degree. In particular, retail trade turnover dropped the most in Poltava region (20.9% yoy over the first seven months of the year), and the least in Kyiv region (5.9% yoy). These differences are explained by variations in wages and other components of income changes, as well by labour market situation in regions.
4.4. Investment activity

Over the previous years investments have been funded by revenues of enterprises (primary source) and loans. Immediately at the beginning of the crisis companies’ sales decreased while lending was almost stopped. As a result, a large number of companies suspended funding of existing investment projects and delayed new projects. In parallel, real estate bubble burst. Investments funded by the budget limited before crisis now have almost disappeared. Thus in the first half of 2009 fixed capital investments plunged by 43.3% yoy.

According to the Ministry of Economy of Ukraine, 75% of regional developers have frozen or delayed construction projects. In different regions construction was suspended at 30-70% of construction sites.

Fixed capital investments fell in all regions of Ukraine. Differences in speed of decline have been related to economic structure of the regions. Investment in Lugansk region reduced the most. One possible reason for the drop was the redirection of budget appropriations from mine restructuring to paying wages to the miners. Besides regional investment indicators are very sensitive to investment decisions of one or more large enterprises working in the region. For example in Lugansk region it is JSC "Alchevsk Metallurgical Plant", in Dnipropetrovsk region it is JSC "ArcelorMittal Kryviy Rih" etc.

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4.5. Unemployment

As economic activity in the fourth quarter of 2008 and in the first quarter of 2009 declined, unemployment increased significantly. In particular in the last quarter of 2009 ILO unemployment increased to 7.5% of economically active population aged from 15 to 70 from 5.5% in the third quarter. In the first quarter of 2009 unemployment reached 9.5% with largest increases in Donetsk, Kharkiv and Dnipropetrovsk regions. At the same time agriculture-dominated regions had smaller increases in unemployment.

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8 Unemployment in Ukraine: from scale and trends to adequate policy response. Analytical note of the IER, June 26, 2009
Unemployment increased as number of salaried employees dropped due to impact of crisis on enterprises, and as number of self-employed people decreased due to falling demand for their goods and services. Number of salaried employees decreased the most in Volyn, Donetsk, Dnipropetrovsk, Sumy, Cherkasy and Lugansk regions.

Registered unemployment also increased significantly in 2008 from 1.8% of working-age population at the end of September to 3.0% in December. However according to State Employment Office registered unemployment rate decreased over the first half of 2009 and reached 2.0% by end-August. In the first five months of the year number of registered unemployed has been decreasing partly due to increase in rural employment caused by the seasonal factors. Changes in legislation limiting access of rural population to unemployment benefits also contributed to decrease in registered unemployment.\textsuperscript{9} At the same time in July and August urban unemployment also started to fall. However this trend has not been accompanied by visible improvements on labour market. In particular, number of salaried employees continues to fall.

Reduction in registered unemployment could be explained by more difficult access to unemployment benefits than in the previous year. In particular, new legislative provisions became effective in the beginning of 2009. They complicated unemployment registration for certain persons, introduced stricter job search and public works rules and added reasons to remove person from the list of unemployed.\textsuperscript{10} Besides the statutory provision required the unemployed to apply for benefits at the place of registration which could differ from the actual location of the individual further complicating an access to unemployment benefits.

\textbf{4.6. Wages}

As finances of enterprises worsened wages declined substantially in November 2008 and continued to fall in January 2009. However starting February wages have begun to increase slowly as economic activity in some sectors has increased gradually. In 2009, wages for all public employees except for those earning minimum wage were frozen at the end-2008 level.

\textsuperscript{9} Macroeconomic monitoring of Ukraine(MEMU) 103, Supplement, May 2009

\textsuperscript{10} Macroeconomic monitoring of Ukraine(MEMU) 103, Supplement, May 2009
This step and small minimum wage increases over the year also limited wage growth. In particular, nominal wage growth in July slowed to 1.4% mom and average monthly wage was UAH 2008. Highest wage growth was in financial sector at 14.1% mom. Wage increases in construction and industry were moderate. Overall nominal wage growth slowed to 5.8% yoy between January and July of 2009.

Real wages decreased on average by 10.1% yoy over the first seven months of the year. In Donetsk, Dnipropetrovsk, Zaporizhya regions real wages fell by almost 14% while in Volyn, Zakarpattya, Mykolayiv, Ternopil and Kherson regions real wages fell only by 4-6% yoy. As a result wage difference between regions lessened.

### 4.7. Migration

When crisis started many politicians and experts expected a lot of emigrants to return home creating additional pressure on labour market. However, these expectations didn't turn out to be true. According to the Derzhkomstat, both inbound and outbound migration fell between January and July of 2009 as compared to a year before. In particular, internal migration reduced by 14.0% yoy.

External emigration rate remained at 0.3 per thousand persons though number of immigrants decreased by 7.5% yoy and number of emigrants dropped by 10.3% yoy. Deeper crisis in Ukraine and thus difficulties with finding job in the country may have brought down number of inward migrants. Ukrainians working abroad have been trying to wait out the crisis there agreeing to work even on worse jobs. On the other hand, number of outward migrants went down as traditional sectors employing Ukrainians such as construction suffered from crisis bringing down labour demand abroad.\(^\text{11}\) Besides, governments of countries employing large numbers of foreign workers introduced measures to curb their employment. These countries include Czech Republic, Spain and Italy.

Internal migration dropped the most in Kyiv city, AR Crimea, Zakarpattya and Kharkiv regions. While in the most of regions inbound and outbound migration changed similarly, in Kyiv inbound traffic reduced by 20.8% while outbound migrants decreased only by 0.8%. Apparently people already in Kyiv both working or unemployed have been trying to remain in the city. At the same time decision to move to Kyiv during crisis may be too expensive. \(^\text{11}\)

Lugansk, Rivne and Zakarpattya regions had negative balance of outward migration over the several previous years. While residents of the first two regions most often went to work in EU countries, Lugansk region inhabitants went mostly to Russia (in particular laid-off miners went to work in Russian mines). These regions have preserved external migration outflow in 2009. Other regions featured external inflows though migration levels changed slightly.

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\(^\text{11}\) Coping with the Effects of International Financial Crisis. Searching for Proper Policy Response. IER Analytical report, April 2009
5. Conclusions

Due to the global financial crisis the Ukrainian economy went into deep recession in the last quarter of 2008. The recession has continued in 2009. Lower disposable income of households, lower business revenues and credit crunch led to plunge in real consumption and investment. Slump in demand for Ukrainian exports negatively influenced metal and chemical industries. Falling exports, declining capital inflows and large external debt repayments have resulted to deficit in balance of payments. Consequently, hryvnia has lost much of its value.

According to the IER estimates gross regional product will fall more in industrialized regions as Donetsk, Lugansk, Zaporizhia traditionally considered to be more developed. At the same time economies of less economically developed regions with high share of agriculture and food industry will fall less than average. In particular, it concerns Zhytomyr, Ternopil, Khmelnytskyi and Ivano-Frankivk regions.

Regional labour markets mirror situation in main sectors of regional economies. In the first quarter of 2009 ILO unemployment rate increased the most in Donetsk and Dnipropetrovsk regions that feature high share of metal production, and in Zakarpatya region with its machine-building. Over the first seven months of 2009 wages declined the most in Donetsk, Dnipropetrovsk and Zaporizhia regions that felt larger impact of the crisis than other regions.

As a result we can conclude that crisis has indeed led to some decrease in regional differences. In 2009 the expectations regarding returning migrants from abroad that could worsen labour market situation in some regions didn’t turn out to be true. External migration flows decreased but their structure didn’t change much. In particular, net outflows continued in spite of crisis in Zakarpatya, Rivne and Lugansk regions.

Internal migration also fell in Ukraine. Largest decreases in migration flows were in Kyiv city, Republic of Crimea, Zakarpatya and Kharkiv regions.

In general, the crisis showed that lack of structural and institutional reforms constrained the ability of country to react to the economic shocks both on central and regional levels. Now it is obvious that economic recovery will require large-scale efforts on all levels of public governance and to the large extent will depend on world economic situation.