

## Ukraine: the economy that defied logic

BY NIELS SVANE  
MAFCON

Sustained political turmoil under Yushchenko's leadership has caused several international experts to question the effects of the October revolution and deem Ukraine in a state of 'business as usual'. However, business in Ukraine has been far from usual. In fact, in spite of the political developments, the economy has defied all logic and been in a league of its own. Investor interest has never been greater, and the retail sector continues to record an impressive growth driven by the rise in public demand. Rather than creating a political framework to define the rules of future economic development, the new Ukrainian government now faces the task of adjusting existing regulations to comply with an economy that simply does not stop growing.

From a historical perspective, Ukraine's vast natural resources have provided some excellent economic conditions and given the country a special status compared to its Eastern European neighbours. Forming the most important economic component of the Soviet Empire, superseded only by Russia, Ukraine's many farms and fertile black soil generated one-fourth of Soviet agricultural output and enabled the country to export large quantities of meat, milk, grain and vegetables to the other republics. Likewise, the diversified heavy industry, which is still a major player in the Ukrainian economy today, supported much of the specialised equipment and raw materials to industry and mining sites throughout the USSR.

Following the break-away from the Soviet Union on August 24 1991, Ukraine began its transition towards a modern market economy. However, with only a handful of reforms being implemented throughout the 1990s, the task of rebuilding the country's financial and political systems was not an easy one. Government focus was primarily on maintaining macroeconomic stability, and as a result private sector development suffered heavily. In 1999, Ukrainian GDP was 40 percent lower than the 1990-level, with 30 percent of the population living below the poverty line.

However, the beginning of the new millennium proved a turning point for the Ukrainian economy - a fact that is exemplified by significant GDP-increases from 1999-2004. Rising world commodity prices and a strong export growth resulted in a record-high current account surplus of ten percent of GDP in 2004, followed by a significant decline in poverty rates.

### Recent economic performance

From 2004 to 2005, Ukraine's economy experienced a setback once again. Higher

gas prices and lower world market prices for metals, the country's main export, caused the annual growth rate to drop from an impressive 12,1 percent in 2004 to a modest 2,6 percent in 2005. Although it was hoped that Yushchenko's rise to power would lead to further reforms and a new boost to the economy, so far his presidential period has largely been characterised by personal rivalry and internal mudslinging in parliament, culminating in recurring allegations of corruption and fraud. Therefore, contrary to what was initially expected, the political developments ultimately left Ukraine without a functioning governing body from March 2006 until August 2006. Subsequently, numerous international experts expressed their concern regarding the situation in Ukraine, particularly in terms of future economic development.

However, the negative perceptions of the economic and political trends are to some extent misleading, as these trends fail to show the whole picture. Sure, Ukraine's dependency on energy imports has proven a costly affair, with three or four percentage points of the decline in GDP-growth being ascribed to the unfavorable gas agreement with Russia; however, efforts are being made to improve the energy efficiency in the industrial sector. At the same time, there are positive signs of change in the economy, and these appear to be setting the stage for an improved quality of growth in terms of economic diversity and orientation. These signs of change include a dramatically heightened interest from investors, a surge in FDI, sale by financial industrial groups of subsidiaries and banks, and a retail sector that continues to grow. And contrary to logic, this has happened not because of - but in spite of - political developments. Overall growth in Ukraine has declined, yes, but it is still on a level that can only be described as impressive

compared to the levels of other former Soviet republics. Furthermore, it must be kept in mind that the annual GDP growth has been over seven percent on average since 2000. In other words, growth in Ukraine has proven to be both sustainable, and perhaps more importantly, it has become politically independent. As a result, the new Ukrainian government now faces a situation where the main task is not the establishment of a new political framework to secure future economic development - but ensuring that the existing one is not in the way of it.

### Future forecasts and prospects

The Calyon Bank of France, which in 1994 became the first Western European bank to enter the Ukrainian market, expects an increase in GDP growth from six percent in 2006 to 6,5 percent in 2007. These expectations are mainly based on the growth in the retail and service sectors as well as new increases in the industrial output. Significant increases in Ukrainian exports are also expected, however, these are cancelled out by a similar surge in imports directly related to the higher energy prices. As a result, any surplus in the external current account will be of a limited size, with only little funds available to pay off government debts.

In terms of potential prospects for investors, Calyon Bank regards Ukraine as "A worthwhile gamble on the future", and elaborates on this notion with the following statement:

"Ukraine is a country with high annual growth (more than seven percent p.a. GDP growth on average since 2000), with more than 45 million inhabitants (an educated population) and fertile lands: it cannot fail to attract businesses in search of fresh outlets, and/or advantageous manufacturing costs."



## FDI: human capital one of Ukraine's greatest assets

BY NIELS SVANE  
MAFCON

**For new EU member states such as Poland and the Baltic countries, joining the European Union was seen as an important step towards economic prosperity. However, as an increasing number of workers have since chosen to seek their fortunes in Western Europe, these countries now face one of the major deterrents of economic development: a lack of skilled labour. As wage pressures are building up, investors are likely to look further east, many of them with their sights set firmly on Ukraine.**

### The downside of EU-membership

In what could be described as the economic dilemma of EU integration, Poland and the Baltic states are currently experiencing the downsides of EU-membership. As large parts of the workforce in these respective countries have celebrated their newly

found freedom of movement by taking up jobs in Western Europe, bottlenecks and wage pressures have become new and unexpected players on the Eastern European labour markets. Although countries such as England and Ireland have benefited greatly from the inflow of foreign labour, this development is now a real threat to economic growth in the workers' home countries. For Poland and the Baltic states, this could ultimately result in possible investors being forced to look elsewhere for more profitable investment opportunities, as available workers are either too expensive or insufficient in numbers.

### Why Ukraine?

On that account, Ukraine is very likely to become the target of increased foreign direct investments, as the prospect of EU membership is still far in the future. As a consequence, the Ukrainian workforce will be subject to strict EU visa regulation for years to come, and thus available to aid the economic development on the domestic level. Add to

that the favorable structural conditions such as a low wage level, low establishment and overhead costs as well as proximity to both the Western and Eastern European markets, and the investment potential of Ukraine becomes evident. Keep in mind also that the country's population constitutes the second-largest population in Europe, and that it is also a well-educated one. The total labour force amounts to almost 23 million people of which 24 percent holds jobs in agriculture, 32 percent in the industrial sector, and 44 percent in services.

Compared to other Eastern European countries, Ukraine thus possesses some very interesting investment perspectives and the country has already caught the attention of the international business world. With recent labour market developments in mind, the country's extensive human capital has suddenly become one of its greatest assets and has given rise to expectations of further increases in future FDI rates.