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# POLICY BRIEF

## *What economic model for a post-conflict Donbas? How economic measures could play a role in exiting the negative scenario*

Economic problems have marked the recent history of eastern Ukraine. The region entered a phase of prolonged economic depression and structural problems in the early 1990s and was only just starting to recover from the fallout of the 2008 financial crisis when the armed conflict broke out in Spring 2014. The armed conflict further exacerbated an already difficult situation: large-scale destruction, disposal of industrial assets, physical and economic disconnection from Ukraine, and massive loss of productive population compounded many other challenges for the regional economy.

While diplomatic efforts towards a political resolution of the conflict progress slowly and contradictorily, it is high time to start a structured reflection on the post-conflict recovery of the region. Peace in Donbas appears distant at the moment, but economic incentives could play a useful role in addressing the diverging interests of conflicting parties. A common understanding on the future economic model for Donbas could help overcome the current deadlock.

The first meeting of the High-Level Policy Dialogue (HLPD), organised by the School of Transnational Governance of the European University Institute on 15 December 2018, brought together high level policy influencers, leading economists, academics and civil society representatives working on the region. The HLPD analysed current economic dynamics in the Donbas and possible measures which could facilitate exiting the negative scenario. The discussion focused both on the transformations taking place in Ukraine and on the contours of the "end game" defined in the Minsk agreements.

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**High-Level Policy Dialogue:** "What economic model for a post-conflict Donbas?" EUI, Florence, 15 December 2018

**Policy Dialogue conveners:** Luigi Narbone and Remi Duflot

*The opinions of the authors represent personal opinions and do not represent the position or opinion of the European University Institute*



## Key take-away points from the HLPD

1. After five years of destruction and isolation, Donbas presents a highly degraded economic situation. While the region had already experienced serious socio-economic problems before 2014, the impact of the conflict on the industrial base and on the human and social capital has been devastating. There is no way to return to the pre-war situation.
2. While current prospects for immediate reintegration remain dim, any effort to reintegrate non-government controlled territories (NGCT) and government-controlled territories (GCT) must avoid creating further dividing lines, and must provide peace dividends for the entire population. The success of future reintegration is also dependent on setting up an economic alternative which is attractive to the whole region, including the populations in the occupied territories, and to the rest of Ukraine. The financial participation of external players in providing, at least in part, peace dividends to all is essential.
3. The GCT, and in the future a reintegrated Donbas, needs a long-term development plan that also accounts for the costs of reintegration. It should build on Ukraine's successful decentralisation process and on previous positive experiences. It could include, by way of example, special economic zones, areas of diversification of the production base and investment in social capital.
4. To operationalise the new development model for the region, a possible plan for reconnecting the two parts of the region should be drawn, including through rehabilitating the industrial base, while at the same time ensuring that it moves up in the value chain, and through increasing connectivity at the national and international level. International funding and public-private partnerships could be mobilised to develop the existing potential in agribusiness, light engineering and ICT. Small and medium enterprises' (SMEs) support, mechanisms for injecting microfinance, and attention to governance at the local level should be pursued.
5. Any economic solution should always be seen in the broader framework of conflict resolution.

### 1. The conflict in eastern Ukraine: political and economic realities

The Donbas was one of the most important industrial and coal producing regions of the Russian Empire and the USSR. Its economic downturn started in 1991, with the dissolution of the Soviet Union and the transition of post-Soviet states to a free market system. In the first two decades following Ukraine's independence the decline continued unabated, but the Donbas remained an important industrial engine for the Ukrainian economy, with steel and heavy metal industry playing a central role. Although yearly coal production was still 83.7 million tons in 2013, making it the third biggest coal producer in Europe after Poland and Russia, the number of functioning coal mines in the region had dropped from 250 in the mid-1990s to 100. At the same time, widespread

cross-subsidisation of the region's industries discouraged economic diversification.

The deterioration of the global economy in the aftermath of the 2008 financial crisis, coupled with an increasing fall of Russian imports of Ukrainian products, plunged Donbas into deep economic recession. Both the Donetsk's and Luhansk's export-oriented economies suffered from the heavy contraction of trade in engineering, agricultural and food products. By 2013 the region had returned to grow but the beginning of the armed conflict in Spring 2014 impacted it in a heavy manner. Gross regional products fell by 60%, with about 50% and 75% reduction in industrial productions and commodity export respectively. This contraction represented a large share of Ukraine's total GDP loss in those years (about 15% at country level) and resulted in inflation and large increase in foreign and domestic debt.



The Ukrainian economy has since partially recovered and is currently undergoing a cycle of modest positive growth. Capital investment by Ukrainian companies has been a main driver of growth and exports, but key macroeconomic imbalances remain, particularly in terms of shortage of capital, excessive pressure on trade balance and labour migration.

**1.1 Donbas' economic situation and prospects for the government-controlled and non-government controlled territories**

The demographic situation of the Donbas region is tragic. Only 10% of the population is below 20, and 37% below 40. The birth rate is 5.1 per 1000 people and the mortality rate is one of the highest in the world. As the conflict continues, the aging population is likely to increase with a considerable drop in the number of economically active people.

As mentioned, before the conflict the industrial production downturn had heavily impacted the economies of the controlled (GCT) and non-government controlled areas (NGCT) of the Donbas. The crisis that followed was also a result of lack of economic diversification. The huge economic downturn since the start of the conflict reflects the economic specificities of the two parts of the region.

**1.1.1 Government-controlled territories (GCT)**

The conflict significantly worsened the situation. The region lost competitiveness and economic ties and the industrial potential of the area was considerably reduced, particularly for coal, mining and metallurgy. In the Luhansk region, where agriculture is important, the destruction of connectivity between the two parts of the Donbas region, particularly after 2017, resulted in a considerable and rapid decrease in trade and commercial transit, despite the continuing increase in the number of individuals crossing the contact line (+20% in 2018).

More specifically the economy of the newly formed region is characterised by:

- a reduction in diversity of the industrial base compared to pre-conflict, which comprises essentially the metallurgical, chemical and coal industries;
- obstacles to the normal operations of the industrial facilities located near the line of demarcation;
- a loss of exports and changes in exports' geographical structure. Since 2013, the share of Donbas' exports (non-government-controlled part excluded) to the country's overall exports has decreased by 2.5 times. Raw materials and semi-manufactured products dominate the region's export;
- an increase in the relative weight of the agricultural sector, particularly for the Luhansk region;
- drop in the internal resource base, e.g. lack of coking coal, as it can be found mainly in the non-government controlled part of the region;
- the destruction of the region's connectivity, including the prospects for transport corridors along the Black and Azov Seas.

**1.1.2 Non-Government-controlled territories (NGCT)**

The region's industry is especially concentrated in coal mining and the metallurgic sectors, (heavily concentrated sectors themselves): two large companies represent 60% of the NGCT industrial capacity, and coal mining accounts for 60% of the activities. Despite its physical assets, the NGCT economy faces a severe industrial recession. From 2013 to 2017, the metallurgical sector decreased almost four-fold, production capacities decreased five-fold, and their share in the area's total turnover shrank by 2.5 times. The conflict has brought about physical destruction, outflow of capital, and loss of commercial and industrial connections and businesses. The degradation of economic and social capital in the NGCT has left an aging population and a devastated industrial base. The economic base is outdated, markets have disappeared and during the active phase of the armed conflict (2014-2016) many capital goods have been uninstalled and shipped to Russia or sold as scrap metal. Investments are at a historical low.

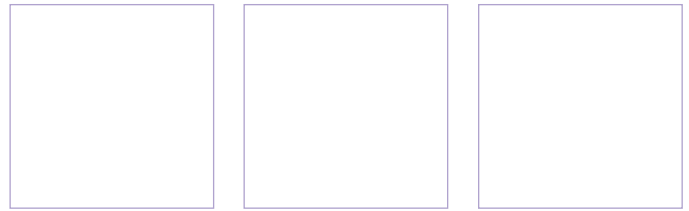


In a nutshell, several factors explain the severity of the recession:

- the unrecognised status of breakaway territories, which provides abundant opportunities for economic actors to work in the shadows<sup>1</sup>;
- the physical destruction or pillage of industrial assets;
- a huge outflow of capital at the initial stage of the conflict;
- the disruption of industrial ties;
- the need to replace traditional raw materials and energy sources from Ukraine, and attempts at organising new supply chains connected to Russia. Competing industries, based on the same raw materials, can be found in the Russian part of the Donbas, just across the border with NGCT;
- the loss of markets and a re-focus of the engineering sector on the repair of military equipment;
- the near-to-complete destruction of machine-building enterprises dependent on the Ukrainian market;
- increasing unemployment, the reduction and naturalisation of wages, and the destruction of human capital.

In addition, the establishment of new production ties with Russia was carried out on the condition that NGCT economic assets be put under the control of Russia-based businesses. The functioning of the export sector (the coal and metallurgical sectors) of the NGCTs is critically dependent on the capacity of NGCT-based companies to legalise their sales to Russia (sometimes followed by their illegal re-export to Ukraine or other countries).

Finally, organised crime groups have been a deterrent to foreign investment in NGCT, including Russian investment. While population emigration remains the main problem, the question of weak rule of law is central to the sustainability of the economy.



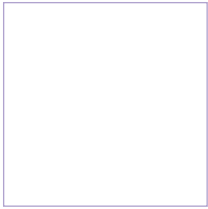
In sum, the region has lost its economic self-sufficiency, is burdened with technically obsolete enterprises, and is fragmented and structurally unbalanced. The prospects for self-sustained recovery and development are seriously undermined.

## 2. What prospects for reintegration?

Against this backdrop, the reintegration of Donetsk and Luhansk regions will necessarily be difficult and potentially problematic for the weakened Ukrainian economy and public finances. There is widespread recognition that reconstruction while military activity is still taking place, is problematic. The human factor is essential to exiting the crisis. An estimated 1.5 million people have left the occupied territories, while the bulk of residents are pensioners. As shown by the IOM National Monitoring System in Ukraine the number of people intending to go back to the Donbas region is falling each quarter<sup>2</sup>. While many parts of the region are underpopulated, the UN states that 40,000 houses were damaged during the conflict. Nearly 700 schools and many roads and bridges need to be rehabilitated or rebuilt. Many territories have mine fields, and de-mining is estimated to require up to 15 years. Furthermore, the environment suffers serious problems, including flooding of coal mines, water, land and air contamination by military activity and 150,000 hectares of forest have been impacted. The cost of addressing these issues will put a huge burden on the country's public finance; this requires a careful and timely assessment and a strategic approach that are still lacking.

Finally, the economic reintegration of the non-government-controlled areas into the Ukrainian economy appears increasingly challenging. The region is attempting to develop economic connections with Russia to the detriment of its links with Ukraine, but the Russian Federation shows little interest. The persistence of the conflict continues to exacerbate the problems highlighted above.

At the same time, the reintegration of post-conflict Donetsk and Luhansk could also present some opportunities. For instance, because of the necessity to rebuild the economy from scratch, these regions could be more receptive to enacting structural reforms, thus increasing



their potential in terms of attractiveness for investors. As other parts of Ukraine, there will also be a need to re-orient exports.

At the sub-regional level, the Donbas is quite diversified: some areas are industrialised and urbanised while others are preponderantly agricultural; some territories remain economically active, but others are totally depressed. As a consequence, the response measures are necessarily different. For instance, depressed areas require strong revitalisation efforts as well as the launching of self-employment facilities and schemes to attract investments. Ukraine has been rather successful in reforming local communities during the first phase of its decentralisation reform; a similar process could also be used to support local communities in the Donbas as well as their efforts to reload social capital. By doing so, attention would shift away from conflict dynamics to the development and organisation of local communities, territories and utilities. Central European experiences, where hundreds of heavy industry workers were reoriented to jobs in different sectors, could serve as a useful example for restructuring the region.

### 3. The economic dimension of conflict resolution

The economic dimension represents a crucial yet often overlooked dimension of conflict resolution in eastern Ukraine. For example, economic recovery, and its demonstrated positive effects, are essential elements to ending the conflict, while addressing the ecological dimension could provide incentives to tackle some underlying questions of the conflict when the conditions are ripe.

Huge economic benefits both in terms of growth and security could be delivered to the citizens if a peaceful solution is brought to Donbas. Creating a link between conflict resolution in the Donbas and Ukrainian economic development would ensure that the entire country buys into the peace-building project.

In this context, sequencing is important. The first priority should be to start reflecting on what can be done to redevelop large parts of GCT and re-connect them

with Ukraine’s domestic, as well as with Europe and the Black Sea, markets. However, setting up an economically attractive alternative also for the population in the occupied territories is crucial for reintegration.

With the trade ban and expropriation decisions of March 2017, separation between the two territories, both in economic and in structural terms, has entered a deeper phase and most of the economic links have been severed. It is therefore important that the government and the international community come up with a clear plan for reintegration of the government-controlled and the non-government controlled parts of the region with the rest of Ukraine. To avoid creating further dividing lines, peace dividends should be made available for the whole population, different constituencies and stakeholders. The role of the EU and the international donor community in supporting this process is essential; this point needs to be considered in more detail.

The case for reintegration and the improvements on quality of life and living standards should be made compelling and communicated to both sides. One of the challenges is to win back the trust and confidence of the Ukrainians on the non-government controlled side. 1.2 million citizens move across contact line every month and efforts should be made to create a narrative supporting reintegration as an enabler of a better economic future for all. Direct communication – at the crossing points and through the media – could provide an excellent opportunity to win hearts and minds. Should economic changes in GCT be successful, they could serve as a positive model of what the future could look like in terms of jobs, salaries, education, healthcare, social payments, and pensions if the NGCT embark on the reintegration pathway. A successful economic model could thus help in creating a conducive environment for the peace process.

### 4. Designing Donbas' economic model for reintegration: possible approaches and practices

What could be retained of the current Donbas’ economic model? What are the prospects for diversification? Which sectors should be targeted? What kind of policies should

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5 ■ What economic model for a post-conflict Donbas? How economic measures could play a role in exiting the negative scenario





be used? To what extent does the future of region depend on re-establishing financial relations with Russia? Several questions concerning the future economic model for the post-conflict Donbas were raised during the HLPD, including on the investment needs for the wider region and on the role of the international community.

The participants of the HLPD were more optimistic about the GCTs. Considering also the Minsk agreements, decentralisation appears as an excellent template for positive transformation in Ukraine and NGCTs in the future. Free economic zones were considered as one possible model for the territory along the contact line. However, to set up special economic zones, labour force would be needed, and the question of how to motivate return to the region is central.

More generally, investment in social and human capital, moving people into new sectors of the economy as well as rebooting human capital through the improvement of existing industrial capacities are essential. These processes can be facilitated by optimising the existing commercial and industrial connections as well and by increasing competitiveness through innovation and reintegration.

As a region, today's Donbas is clearly marginalised and needs to be reconnected to make industrial policy and economic free zones attractive to investors. Enhancing connectivity must also permit access to Turkey and other markets across the Black Sea. In this context, the current security issues in the Azov Sea are worrisome. Maintaining access to deep water ports in the Black Sea is crucial for Ukraine's survival as an export country. It is of paramount importance to avoid a further deterioration of the situation, which would impede access to the Black Sea.

The effective elements of the existing industrial base should be preserved and can constitute a springboard for the future. To be effective, though, it needs access to both the domestic and the international markets. Infrastructure investment is necessary to make economic connectivity possible (estimated within 2 to 5 year period). In particular, it should focus on the following areas

- *Transport logistics*, connecting the East with the rest of the country. Currently there is no air connection, and the road connections are poor. While there has been an explosion in air travel in Ukraine, in the East there is still no good airport. Building a regional airport, and improving transport links, will be crucial to the connectivity of the region.
- *Improving rail connectivity* between the East and the centre. In light of the threat in the Azov Sea, improving the rail link from Mariupol is essential to provide alternatives for travel in and out the region. Rail and port investment are crucial to connectivity, both for agribusiness and for metallurgy.
- *Improving regional ports capacity* and increase the maritime traffic through those.

These connectivity measures would permit that Ukrainian producers move away from commoditised products and move up the value chain for exports. This would benefit the country, through the development of knowledge and human capital, higher valued products, and better salaries.

The east of Ukraine needs to be integrated into the EU supply chain, following the example of the rest of the Ukrainian economy. Essential EU manufacturing depends on steel from Ukraine and some 40% of steel from Mariupol is shipped to the EU. Greater focus on clarifying the role of the Donbas in international supply chains could better support its industrial recovery.

In terms of investments, it has become very difficult to attract foreign direct investment (FDI), as the region is considered too distant because of the lack of good transport connections and too risky due to the conflict. Most of the capital which could be attracted is likely to be domestic, focusing on the opportunities provided by improving the existing manufacturing and industrial base. In this context, a newly created Donbas economic development agency could work with the government to develop a master plan for the development of the region. The agency should be coupled with a regional development bank for Donbas, funded by a combination of inter-



national donors, the Ukrainian government and regional government, but also other partners, if assurances were provided on the independence of the management board. With a clear governance model, property rights and respect for the rule of law, banks would be able to provide relatively low-cost loans within the Donbas.

The biggest challenge in the Donbas today is access to capital. It is important to find successful businesses that can grow quickly, and leverage private investment through public investment and solid banking. A broadly-based regional development bank would be more likely to be successful and bring in the capital necessary.

In addition to the EU, other actors could also participate, including for instance the US, Canada, Japan, China and of course Ukraine. Russia should also be invited to contribute, as part of the reset of bilateral relations. While competing global priorities limit the current international appetite to invest in the region's re-development, the recovery of the Donbas cannot be achieved by the government of Ukraine alone. The case for investment in the Donbas must be made both domestically, in relation to the benefits to the society and the economy, and explained internationally as a cost-effective way of ensuring security and safety of the Donbas and its reintegration.

There was consensus that the future of the region would lie in particular in the development of small and medium enterprise (SMEs) and shifting to an SME-driven economy as opposed to large corporations. Government and private policy should focus on SMEs as potential economic actors and as a way to accelerate economic growth and employment opportunities in the region. Being less capital intensive, and able to act faster, SMEs would be central to the future economic recovery of the Donbas.

Finally, there is no question that the primary driver of redevelopment will be people. They need to be reintegrated first and a primary goal needs to be the creation of job opportunities, which may also include self-employment. A job-creation scheme will also allow ex-combatants and all those recruited into illegal armed formations

to be given alternatives, and prevent the risk of returning to such activities. Allowing ex-combatants, after careful vetting, to become a constructive part of the social fabric that needs to be rebuilt in the region is key to its future; it will require careful consideration and communication of the rules on amnesty. Some thoughts will need to be given to how to find opportunities for those people and how to engage them in community building, in rebuilding trust within communities, as well as in broader questions of disarmament, demobilisation and reintegration (DDR) as well as in dealing with Post-Traumatic Stress Disorder. De-mining was put forward as one possible area of activity.

## 5. Next steps

The participants of the HLPD agreed that the outcome of the discussion held at EUI on 15 December 2018 should be shared externally. There was also a consensus that the next step should be to involve both donors and political actors inside Ukraine. In particular, efforts will be made to reach out to those responsible for planning policies and operationalise the plans for economic development. It was agreed among participants that the next dialogue would bring in relevant donors and international actors. This could include the donor community, the banking community, and possibly other actors from the private sector. Broadening the participants would allow space for further debate, and possibly implementing some of the ideas. Further, there was agreement that the proposals emerging from the dialogue should be brought to the attention not only of the business community but also politicians, including the newly elected government after the snap parliamentary elections in July 2019. In this context, the media could at some point in the future be used to promote the result of the dialogue and share it with the political powers in Ukraine.

### Suggested steps for the recovery of the Donbas region

1. Total reassessment of potential of regional development, and the main goals and priorities for development in the region.
2. New life for old industries, by finding ways to make them more competitive.
3. New logistics – the logistics of the region should be strategically rebuilt considering new boundaries.
4. Reloading social capital.
5. Transparent financial instruments.
6. Modern organisational forms, which can be tested in territory of regions, communication between companies.
7. Pilot projects based on specific sectors, in coordination with other regions.
8. Attention to environmental issues, including through independent studies and a robust system of monitoring of the conflict zone.
9. Education for the new generation, as well as the efforts to reconsolidate the human capital.
10. Moving up the value chain, from raw material to added value products, and high value manufacturing, especially to tie in to more advanced markets in the EU.

### Sectors and policies identified as having the greatest potential

1. Agricultural business, as a possible future engine for growth – before the conflict this was the third largest sector and the potential for growth still remains;
2. Light engineering – as heavy engineering, whose the main customer base was Russia, has declined, the skillsets could be easily redeployed to the light engineering sector;
3. ICT – Donetsk has a flourishing interest in ICT, which would provide an excellent opportunity to capture young human capacity;
4. Microloans and finance. Microfinance institutions could help build microbusinesses, also through existing skills, mentoring and assistance by IDPs.
5. SME support in several sectors.

#### Endnotes

1 Since the introduction of a trade ban by the Ukrainian authorities in March 2017 (in response to the expropriation of Ukrainian assets in NGCT), all enterprises in NGCT are excluded from accessing Ukraine, for most previously the largest market.

2 See Ukraine — National Monitoring System: The Situation of IDPs (March 2018), available at [https://displacement.iom.int/system/tdf/reports/nms\\_round\\_9\\_eng\\_press\\_0.pdf?file=1&type=node&id=4962](https://displacement.iom.int/system/tdf/reports/nms_round_9_eng_press_0.pdf?file=1&type=node&id=4962)

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