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IN-DEPTH RESEARCH ON ECONOMIC OPPORTUNITIES IN EAST UKRAINE

Purpose of the in-depth research:

To provide potential investors with guidelines and advice regarding East Ukraine.

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This research was conducted through support provided by the U.S. Agency for International Development (USAID) within the USAID Economic Resilience Activity. The author's views expressed in this publication do not necessarily reflect the views of the USAID or the United States Government.

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INTRODUCTION

East Ukraine is an ill-fated region that suffers from a series of negative perceptions both in Ukraine and abroad. The explanations are obvious. Yet it should not be a reason to discard this region as a whole. Instead we are interested in this research to introduce current situations and challenges related to the region and to turn them into economic opportunities.

East Ukraine, formerly known as the Donbas, used to be **one of the industrial powerhouses of the USSR and one of the largest coal basins in Europe**. It has suffered from several economic and financial crises before it was hit by the war in 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 emigration of productive population compounded many other challenges for the regional economy. A recent study by the Vienna Institute for International Economic Studies (wiiw) study estimates the **minimum costs of reconstruction at an abyssal USD 21.7 billion**. These costs include damage to physical capital (44%), human capital expenditures (40%), and mitigation of environmental threats (16%). The challenges that East Ukraine faces are colossal, notwithstanding they were complicated by the Covid-19 pandemic.

Now that the military tensions have cooled down, the aforementioned challenges are to be understood within a **wider scope of crisis resolution and transitioning economy**, which brings a whole set of opportunities and investment possibilities. National authorities as well as Ukrainian and international partners and NGOs dedicate special care to the region's recovery. In October 2019, the "Rethinking Donbas: Unity and Investment forums" was held in the port city of Mariupol on the Azov coast under the leadership of newly elected President Volodymyr Zelenskyi. It was a fruitful occasion to stir up the interests of partners and investors. Since then, the French government committed EUR 64 million to creating a clean tap water distribution system for the city of Mariupol. Chinese investors plan to build a giant wind power plant in the region. Turkish companies are among prime agents for creating a technological park in Mariupol. The International Bank for Reconstruction and Development recently allocated a USD 100 million loan aimed at repairing roads in the Luhansk region and improving productivity of the agriculture. There are many more cases of investments and ambitious projects. They show that East Ukraine enjoys unprecedented solidarity and interest that is to benefit to the overall region and its network of Small and Medium Enterprises (SMEs). Plus, the idea of establishing a special economic zone has been under serious consideration for some time now.

Given the circumstances, a rebuilt and renewed East Ukraine may become "the center of new approaches to production. The tragedy of the war has turned Ukraine's industrial centers into ruins, but this devastation also creates space for **bold innovations and original thinking**, which are not always possible in more developed economic conditions," Vice Prime Minister of Ukraine and Minister for Reintegration of Temporarily Occupied Territories Oleksii Reznikov declared recently. He also added that the Covid-19 pandemic creates a new set of opportunities as many countries are recognizing the advantages of diversifying away from China and having high-quality production capacity closer to home. "As one of the EU's largest neighbours, Ukraine is ideally suited to fill this role, while the Donbas region has many of the specific attributes necessary to play a leading part. **East Ukraine, aka Donbas, is not an opportunity to be missed.**

This in-depth research aims to provide guidelines to entrepreneurs and potential investors to introduce them to current challenges and opportunities in East Ukraine. It is conceived as part of a wider communication's strategy to promote East Ukraine as a land of new economic opportunities that is linked to an overall atmosphere of changes and reforms across all Ukraine.

In this research, we shall go over several topics, starting with some hints on geography and history, transportation and access to the region, security aspects, population and workforce and defining features of the regional economy. We shall then highlight a few of the recent evolutions regarding the business climate in East Ukraine and provide investors with some practical advice.

I. SOME HIGHLIGHTS ON GEOGRAPHY & HISTORY

East Ukraine is **much more diverse** than the widely accepted image of Donbas as a coal basin and a region of heavy industries. It is bordered with fertile agricultural areas to the north (Sloboda) and to the west and south (Pryazovia). The part dominated by the dry steppe in the south-east corner of East Ukraine was scarcely populated for centuries. Hence it was named “empty fields” under the Russian empire.

The region took a drastic turn in the mid-19th century under the impulse of the tsarist industrialization policy. **Dozens of European entrepreneurs and investors were invited to boost the development of the region.** The brightest example of such phenomenon is the city of Donetsk: from its foundation in 1869 until 1924, Donetsk was called Hughesovka in honor of its founder, the British industrialist John Hughes. The growth of Lysychansk in the Luhansk region was closely tied to Belgian industrialist Ernest Solvay, while British businessman Charles Gascoigne is considered the founder of Luhansk itself. Hence the history of East Ukraine is much more complex than the Russian and Soviet pictures are made to believe. Many towns and villages throughout the region actually trace their roots back to Greek and German colonists, while the small town of Novhorodske just outside Donetsk was known until 1951 as “New York”.

Still, East Ukraine as we know it today has been **shaped first and foremost by its Soviet legacy.** Together with the Ural region, Donbas used to be the largest coal basin to supply all of the USSR. Upon the collapse of the communist system, Donbas naturally became a major economic center in independent Ukraine. Despite gradual degradation of the infrastructures, the region used to contribute to some 15% of the GDP until 2013. Most of urban centers and industrial infrastructures developed during the Soviet era and the legacy is visible in the organization of the productive structures, in the local administrations as well as in the collective mentalities. The Soviet myths connected to miners’ pride (Stakhanov’s legend), labor’s glory and infinite resources of the coal basin are still widespread.

It is important to understand the subtle historical and geographical complexities of East Ukraine. Its rich and diverse past is hidden under a thick layer of Soviet industrial myths and authoritarianism. The war starting in 2014 exacerbated the emotional dimension of such memories. Yet there are now **many initiatives to rediscover the pre-Soviet past** of East Ukraine and to bring forward a more nuanced identity of the region. Likewise, the dramatic decline of heavy industries leads to **a rediscovery of the rural traditions and agricultural potential** of East Ukraine.

2. TRANSPORTATION AND ACCESS

East Ukraine has the reputation of an isolated and inaccessible region in the easternmost corner of Europe. Indeed, Donetsk is located some 670 kilometers south-east of Ukraine’s capital Kyiv. Luhansk is located further east, some 770 kilometers from Kyiv. These two regional centers are inaccessible to foreigners as they are now located in Non-Government-Controlled Areas (NGCA).

Yet it is **more and more convenient to access** the Government-Controlled Areas (GCA) thanks to continuous improvement of infrastructures. There are no EU-style highways yet the “Big

Construction” program under President Zelenskyi aims at modernizing interregional connections. For example, much work has already been done on the road connection between the Sloviansk-Kramatorsk-Kostiantynivka urban area in Donetsk Oblast and the Rubizhne-Sievierodonetsk-Lysychansk area in Luhansk Oblast. Connections between the north and the south of the government-controlled areas are still problematic because of the geography of the contact line. Despite remaining issues, East Ukraine’s reputation as a remote region is unfair. It is very much accessible from different parts of Ukraine and well-connected to export routes. Furthermore it is home to skilled employees and competitive companies.

By road: the table below indicates the driving time from major regional capitals to Kramatorsk (de facto capital of the government-controlled Donetsk Oblast), Sievierodonetsk (de facto capital of the government-controlled Luhansk Oblast) and the port city of Mariupol (in the government-controlled Donetsk Oblast)

	Kramatorsk	Sievierodonetsk	Mariupol
Kyiv	9h - good and average quality road	10h - good and average quality road	11h - good and average quality road
Dnipro	4h15 - good quality road	5h50 - average quality road	4h30 - good quality road
Kharkiv	3h - good quality road	3h45 - average-quality road	6h50 - average quality road
Zaporizhzhia	4h30 - average quality road	6h - average quality road	3h - good quality road

Bus connections are plenty and they are used to connect the most remote places.

By train:

- Kyiv-Kramatorsk: several connections daily. The shortest connection is a high-speed intercity train. It is a 6h11 journey. The longest trip takes 11h02.
- Kyiv-Sievierodonetsk: several connections daily. Shortest: 11h57. Longest: 14h32
- Kyiv-Mariupol: several connections daily. Shortest: 15h01. Longest: 18h49.
- Most interestingly, a new connection opened between Kyiv and Avdiivka, a city on the very edge of the contact line. The journey is 13h51-long.

The railway connection is the most efficient for local producers **to transport their goods to the Odessa ports and to prepare them for exports** from Ukraine. Transportation is reliable and affordable - depending on the frequency and the needs.

By plane: No airports operate in East Ukraine due to the conflict situation. But, the closest air connections leads to Zaporizhzhia, Dnipro and Kharkiv. The airports of these cities service both domestic and a large number of international flights.

Within east Ukraine it has to be pointed out that **moving around is easier and easier** since the change of status of the conflict zone from Anti-terrorist Operation (ATO) into the Joint Forces Operation (JFO). Access to the vast majority of cities and areas is usual, only the access to a narrow strip along the contact line requires special permit. But it is not a common business destination.

3. SECURITY ASSESSMENT

It is important to understand government-controlled East Ukraine for what it is today, that is to say **a wide and peaceful region with a very localized low-intensity conflict on its margins**. The 400 kilometer-long contact line remains hard to cross - especially since the outbreak of the Covid-19 pandemic - yet the most violent episodes of the armed conflict are long over. The military positions did not move significantly since the 2017 series of Ukrainian military actions to push the frontline away from the city port of Mariupol. **A ceasefire is in place** since 27th July 2020. It is the first time since 2014 that a truce holds continuously for more than a few weeks. Despite occasional infighting and some casualties on both sides, fights remain extremely localized and of low intensity. Neither side uses heavy artillery for many months.

It has to be pointed out that occasional infighting usually occurs overnight. Daytime is very quiet. To emphasize: **it is very localized**. The access to the contact line and to the military positions is restricted to authorized personnel and accredited visitors who need to visit the area. In any case, there are few if any reason to visit the land strip along the contact line. The rest of the region lives a sound and normal life. Ukrainian military forces are on guard 24/7.

Public safety in large urban centers is guaranteed by Ukrainian law enforcement agencies. The **crime rate is remarkably low** compared to the rest of the country. A 2018 study by the national police estimated the crime rate in the Donetsk region at 48,4 crimes per 10 thousand inhabitants. It was then the lowest crime rate in Ukraine. The deployment of large units of police, army and OSCE observers contributes to guaranteeing law and order in the region. It may seem paradoxical yet **East Ukraine is among the safest regions to live and to work**.

4. POPULATION AND WORKFORCE

Out of the about 10 million population in Donetsk and Luhansk oblasts before 2014, one estimates that between 6 and 7 million people are left in the area. More than 3 million persons are believed to live in the NGCA. The other part lives in the NGCA. 10% of the population is below 20 years old. 37% is below the age of 40. The majority of the population in East Ukraine is above the age of 40. The birth rate is 5.1 per 1000 people. These statistics point out to a demographic decline and to the ageing of the population. Yet these are not fatalist figures as repeated studies indicate that a large part of the pre-2014 population wishes to come back to their native regions. Furthermore workers who moved to different parts of Ukraine or to different countries after 2014 gained valuable experience and qualifications. Hence complementary workforce is available on demand and ready to move to East Ukraine from different parts of the country.

Among the categories of workers who are active and potentially available for hire in East Ukraine, the groups of low-qualified manual and industrial workers are the most numerous and the most visible ones. Due to economic restrictions, many of them redirected to the retail and transport sectors yet most of them look actively for jobs in their fields. Industrial outsourcing of EU-based companies has proved beneficial in several cases in terms of production costs and efficiency (see the case of AG&K in Rubizhne or Tana in Sievierodonetsk). Highly-Qualified industrial workers such as engineers, chemical and technical experts are also quite present in the area. Last but not least, IT engineers make up the new golden fleet of East Ukraine workforce thanks to their high qualifications and high added-value.

4.1. EDUCATION

The government-controlled Donetsk and Luhansk oblasts are hosts to a wide network of university and educational institutions. Thanks to the industrial aura of the region, many of these institutions are **specialized in scientific and medical sectors**. The relocation of many of the pre-2014 universities to government-controlled areas has ensured that prestigious institutions continue to operate within the internationally-recognized Ukrainian education system.

Main educational institutions in the region of Donetsk:

- Donetsk national technical university in Pokrovsk
- Mariupol state university in Mariupol
- Donetsk national medical university in Lyman
- Pryazovskyi state technical university in Mariupol
- Donetsk state university of management in Mariupol
- Donbas national academy of civil engineering and architecture in Kramatorsk

A full list of institutions of higher education in the government-controlled parts of Donetsk Oblast (47 of them) is available here: <https://registry.edbo.gov.ua/high/14/>

Main educational institutions in the region of Luhansk:

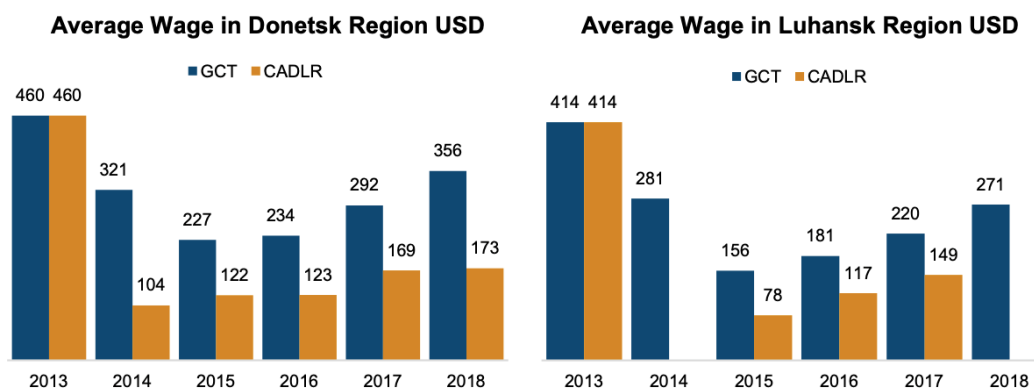
- Luhansk state medical university in Rubizhne
- Luhansk national agrarian university in Kharkiv
- Luhansk Taras Shevchenko national university in Starobilsk
- East Ukrainian national university in Sievierodonetsk

A full list of institutions of higher education in the government-controlled parts of Donetsk region (23 of them) is available here: <https://registry.edbo.gov.ua/vishcha-osvita/44/>

As a result, this pool of young students makes **a valuable offer of young qualified workforce**. Most of the graduates wish to stay in their native region by their relatives. It is both for family reasons and for economic reasons: to move to a different region to keep on studying or to find a job may prove costly.

4.2. COST OF LABOR

The graph below indicates the trends in the local salaries since 2013. It has to be pointed out that the cost of labor in the East of Ukraine is less than in the rest of the country despite similar levels of qualifications.



Note: All data in current USD. Data for the CADLRs of Luhansk region for 2015-2017 include Luhansk city only. Data for the CADLRs of Donetsk region for 2014-2017 cover only selected months: 2014: December; 2015: October-December; 2016: April; 2017: June-October. The average wage for 2013 is assumed to be equal across the territories.
Source: DNR-Live (2019), Novorosinform.org (2016, 2018), Ukrstat (2019).

Source: Study by the Vienna Institute for International Economic Studies (wiiw), June 2020.

5. STRUCTURE OF THE REGIONAL ECONOMY

East Ukraine was previously known as a major coal basin and as an industrial center. Industry is still quite important in the area yet the picture is more diversified now. From 250 operating coal mines in the mid-1990's, there are less than a hundred now in operation. Most of them are located in NGCA. **Heavy industries are in decay** although some of them managed to resist to the shocks of the past few years. Metallurgical factories from the Metinvest group, part of Rinat Akhmetov's System Capital Management holding (SCM) are still integrated with the rest of Ukraine and with export networks. Yet a recent study by the Swiss Center for Humanitarian Dialogue shows that businesses that employ more than 251 persons make up only 3% of the business sector in the government-controlled Donetsk Oblast and nothing in the Luhansk Oblast. Hence **SMEs are the backbone of the regional economies**. The very same study in the Donetsk Oblast shows that services make up 34% of the business sector, retail trade 22%, manufacturing and industry 19%, extractive and processing industry 8% and construction 8%. Figures are relatively similar in the Luhansk Oblast.

It has to be pointed out that both access to energy sources and to facilities rentals are quite affordable in East Ukraine depending on the needs and on the chosen location.

Some of the sectors to consider investing in:

- The Information and Communication Technologies (ICTs). Thanks to a large pool of IT engineers and a favorable tax regime in Ukraine, it is a booming sector in several regions in the country, including East Ukraine.
- Industrial outsourcing. As heavy engineering, whose the main customer base was Russia, has declined, the skillsets could be easily redeployed to the light engineering sector. Across the

region, many factories have already reconverted into centers of outsourcing and supply platforms for EU-based customers.

- Medical and scientific research. Such centers of analysis and laboratories as PharmBiotest in Rubizhne capitalize on the affordable conditions to run businesses and to hire qualified specialists.
- Agriculture, especially in the north of the Luhansk region. The yet unused potential of the regional agricultural structures make it **an untapped resource to invest in as soon as possible**. Furthermore the upcoming opening of the land market is set to create many opportunities in overall Ukrainian agriculture.
- Micro-businesses. Thanks to the support of international and Ukrainian NGOs and to preferential bank loans, it is possible to start micro-businesses in East Ukraine with favorable conditions.
- Entertainment and culture. The investors and entrepreneurs who may answer to the question “what to do after work hours? Where to go in one’s free time” hold the keys to the region’s reconstruction and future. The rich and diverse historical and cultural legacy of East Ukraine (see section I.) make up a virtually untapped reservoir of touristic entertainment and regional branding.
- Environment protection and renewables energies. The region needs a complete ecological overhaul. As environmental issues have been neglected up till recently, much has to be done and the investing stakes may be low for SMEs (thermal isolation, cleaning up of public spaces, sorting out of garbage, etc.)

6. RECENT EVOLUTIONS AFFECTING THE BUSINESS CLIMATE

The October 2019 investment forum in Mariupol clearly illustrated that East Ukraine is a priority of the Ukrainian government, both in terms of peace negotiations and economic recovery. Since then, the interest has not faltered:

- President Zelenskyi seriously considers the establishment of a special free economic zone to create favorable conditions for investors.
- Road repairs have been very intense as part of the “Big Construction” government program. The road from Sievierodonetsk to Stanytsia Luhanska is a flagship of this program in East Ukraine.
- The French government has pledged support for a EUR 64 million program to create a sustainable clean water distribution network for the 500,000 inhabitant-city of Mariupol. The project is due to be completed by 2024.
- Again in Mariupol, Turkish companies are most interested in the development of a technological park to invest in IT industries.
- Chinese energy construction firm PowerChina has joined hands with Ukrainian developer WindFarm to build an 800-MW wind farm. The venture plans to invest more than USD 1 billion.
- German development bank KfW signed a EUR 25 million contract to provide housing for displaced persons.

- The International Bank for Reconstruction and Development allocated EUR 100 million to repairing roads in the Luhansk Oblast and improving productivity in the agricultural sector.
- Part of a new European Bank for Reconstruction and Development EUR 300 million loan will be allocated to regional roads and infrastructures.
- COFCO, a Chinese state-run food-processing company, signed a memorandum to pump \$50 million in developing port infrastructure in Mariupol, which would boost cargo traffic by 2.3 million tons.
- Metinvest group and French company Air Liquide signed an investment contract worth USD 25 million to increase energy efficiency and reduce emissions at the Metinvest factories. The overall price of the project is USD 78.3 million. Its implementation will create 1,000 jobs.

Even by a pessimistic estimate that only half of these projects comes to light, the above list **demonstrates how appealing East Ukraine is to both Ukrainian and international investors and partners.**

One has to add **the overall decentralization reform** that frees the potential of the rural areas across Ukraine, East Ukraine included. The planned opening of the land market from September 2021 onwards is likely to boost the development of agriculture and to enhance the modernization of rural areas. It will definitely benefit entrepreneurs and investors.

7. PRACTICAL ADVICE

To settle in East Ukraine may prove challenging. Here is a short list of advice for potential investors to consider before making any move:

- Understand the administrative procedures and the legal requirements regarding registration, residence permit, construction permit, employment, taxes, etc.
- Look for accredited interpreters who are not necessarily connected to the area or to the people you wish to partner up with.
- Due diligence on potential partners and competitors is obligatory.
- In a place such as East Ukraine, security assessment is mandatory. Although it does not concern that much military issues as stated above, it is more about the presence of landmines and about environmental challenges.
- Do check on the transportation facilities. Although it is easier and easier to connect with the rest of Ukraine and abroad, it may still be a challenge in different areas.
- Do compare different facilities before deciding on any rental - purchase. Abandoned industrial spaces are plenty in the area yet they are not all ready for use.
- Contact regional level authorities and donor funded initiatives and ask for guidance.

CONCLUSIONS

Despite its longstanding issues, East Ukraine is a place to consider for different types of investments, be it industrial outsourcing or innovating IT engineering. The region is now peaceful thanks to a valid ceasefire and ongoing peace negotiations. The destruction of a previous economic model creates the opportunity to contribute building an innovating economy and to integrate it to the rest of the country's economic networks.

Several sectors deserve particular attention, namely medical research, IT engineering and agriculture. The support of Ukrainian and international partners and NGOs has to be used to foster any investment project.

East Ukraine is now in a transitioning state. Recently-negotiated projects and loans are to produce results within a few years once the fallout from the Covid-19 pandemic will fade. It is now that potential investors and entrepreneurs have to look into the possibility to start new projects and investments in East Ukraine.

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