

## Deepening of the recession due to the situation in Eastern Ukraine

For 2014, a decline in GDP of 6.5% is forecast. However, the trends behind this number are quite mixed.

**Timing.** During the first quarter, the GDP reduction amounted to only 1.1%, whereas a significant decrease of 13% is expected during the fourth quarter.

**Demand side.** Even though investment has slumped (-40.1%), net exports deliver a positive contribution to growth.

**Supply side.** A massive decline in industry (-12.6%) faces a positive development of agriculture (+ 4.8%); an increase in food production is also visible.

**Regional.** The Donbass (16% of GDP in 2013) is responsible for approximately 50% of the national GDP decline.

For economic policymakers, but also for international donors, it is essential to understand these very mixed developments before measures are taken to improve the situation. At the same time, this analysis shows that the main cause of the worsening of the recession is not the current economic policy, but the military conflict in Donbass. Without a stabilization of the security situation, economic development in 2015 remains highly uncertain.

### Deepening of the recession during the year 2014

This year, the real economic development proceeds very uneven. The decline in GDP in the first quarter amounted to only 1.1% compared to the corresponding quarter of the previous year. In the second quarter the decline amounted to 4.6%, which shows some, but still feasible deterioration. In the third quarter, the situation further worsened with a 5.1% decline. In the fourth quarter, the economic performance is expected to significantly decline by 13%.

At the beginning of 2014 this development was not predictable. That's why several GDP forecasts by various institutions had to be repeatedly revised downwards. The Government of Ukraine currently anticipates a decline of 6.0% for 2014. The IMF anticipates in its latest forecast 6.5%. Even more pessimistic are the corresponding estimations from the World Bank (8.0%) and EBRD (9.0%).

In the following analysis, the driving factors for this development -on both the demand and the supply side - are further investigated.

### GDP: Demand side

The following table provides an overview of the development of the main components of the aggregate

demand and its contributions to the estimated decline in GDP in 2014.

### Estimated development of demand components 2014

	Share of GDP 2013 (%)	Change yoy (%)	Contribution to GDP (p.p.)
Private consumption	73.4	-6.1	-4.5
Investment	15.7	-40.1	-6.3
Government consumption	19.4	-8.2	-1.6
Net exports	-8.5	-	5.9
Total	100	-	-6.5

Source: IMF, German Advisory Group, IER Kiev  
p.p.: percentage points

In 2014 investments decrease by 40.1% (in real terms) and are therefore on the demand side, the main reason for the sharp recession. Also the latest negative figures on FDI in the balance of payments indicate a net outflow of corresponding resources.

At the same time, it needs to be emphasised that net exports (exports minus imports) have a positive effect on GDP growth, although exports to Russia have fallen by more than 20%. A major reason is the sharp decline in imports, which is estimated at 21.7% (in real terms) in 2014. Besides the contraction of domestic demand, also the devaluation of the Hryvnia is an important factor. The latter supports exports, just like the opening of the EU market in the wake of the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU. During January-July 2014, exports in the EU increased by 13.3%.

### GDP: Supply side

Analogous to the analysis of the demand side, the table below provides an overview of the development of aggregate supply.

### Estimated development of supply components 2014

	Share of GDP 2013 (%)	Change yoy (%)	Contribution to GDP (p.p.)
Agriculture	6.4	4.8	0.3
Industry	17.4	-12.6	-2.2
Services	76.2	-6.1	-4.6
Total	100	-	-6.5

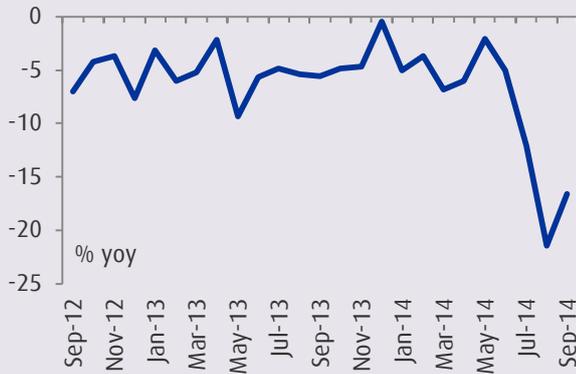
Source: IMF, German Advisory Group, IER Kiev  
p.p.: percentage points

As shown above, the huge decline in GDP is to a big extent caused by the industrial sector. Thus, the question arises, which industrial subsectors are most affected.

### Development of the industry and its subsectors

In contrast to GDP data, which are only available on a quarterly basis, and with a certain time lag, the development of industrial production can be tracked on a monthly basis. Currently data for September 2014 is already available.

#### Development of industrial production



Source: Ukrstat

The dramatic fall in industrial production in August (-21.4% yoy) was only partially reversed in September (-16.6%). The main reason for this development is a significant expansion of the food-processing industry (+13%), which benefited from the good harvest and the improved access to the EU market. Also other branches of light industry (textiles, pharmaceutical products) seem to develop fairly normal because they benefit from the devaluation and the associated import substitution. However, the development of the heavy industry, which is concentrated in the east of Ukraine, and is thus strongly affected by the current conflict, shows a completely different picture. Coal production declined by 57.4%, metallurgy by 28.3%. Also the machine building sector fell above average by 22.8%.

#### Regional development of industrial production

The development of industrial production can be also traced on a regional level, which gives an insight into the economic impact of the conflict in the east.

The current production decline in Donetsk Oblast amounts 59.5% yoy; in Luhansk the industrial production collapsed even as much as 85%! At the same time, it is important to note that those data are collected for the entire administrative district, regardless of the actual control over the area. In other regions of Eastern Ukraine, the decline is much lower, e. g. 4.2% Kharkiv or 10.1% in Dnipropetrovsk.

This reveals that the economic development in the Donbass and in the rest of the country varies considerably. The IMF forecast of a GDP decline of 6.5% for this year can be roughly divided into two -more or less equal- influencing factors: On the one hand, the

economically desperate situation in the Donbas, on the other hand the rather "normal" recession in the rest of the country.

#### Conclusion

As our analysis shows, the Maidan protests 2013/2014, which were mainly in the focus of the public, hardly had a negative impact on the real economy. In the first half of 2014 Ukraine's GDP declined, but not in drastic manner. The country fell into a normal recession, which is not really surprising considering the economic policy mistakes of the previous years.

The consequences of the military conflict in the Donbas, which were especially visible from the second half of the year onwards, show completely different characteristics. The destruction of infrastructure, in particular power generation and transport routes, and the general uncertainty have serious effects on the economy. Under such conditions, an economic stabilization is difficult to achieve. Thus, the cause of the worsening of the recession does not lie in the current economic policy, but in the military conflict in the Donbas. Concerning this matter, a sustainable solution also plays a key role for the economic development in 2015, which under the current conditions is very difficult to predict.

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#### German Advisory Group

The German Advisory Group on Economic Reforms, which is active in Ukraine since 1994, advises the Ukrainian Government on a wide range of economic policy issues and on financial sector development. The group is financed by the German Federal Ministry of Economics and Energy under the TRANSFORM programme and its successor.

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