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From heavy to light: Structural change in Ukraine's industry

Ukraine's industrial output has sharply fallen during the present crisis. But the industrial sector is also subject to a long-run relative decline, particularly due to weak performance of the heavy industry, long the economic backbone of Ukraine.

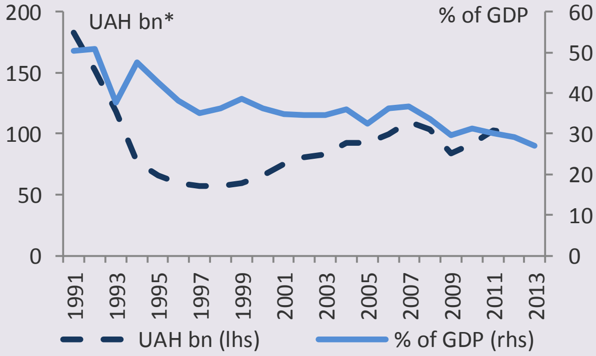
Due to lack of investment in new technology, often poor management and strong export exposure to the difficult Russian market, the economic importance of the heavy industrial subsectors, mostly in the South and East of Ukraine is shrinking. Light, labour-intensive industries such as food processing or automotive supplies are providing new growth, particularly in the West and Centre of the country.

This trend will continue in the short run, but growth in the newer industries so far does not compensate for the losses in the traditional industries. Supporting the growth of new industrial clusters should be a key objective of government, along with facilitating a restructuring of the heavy industry in the medium term.

Long run trend of industrial decline

In the first four months of 2015, industrial production was 22% below the level of the same period in 2014. Clearly, the conflict in the East of Ukraine has been the principal reason for this sharp drop. However, this shock takes place in the context of a long-run development in the same direction. The industry share of GDP has been steadily declining since the end of the Soviet Union in 1991.

Value added in industry



*Source: World Bank, *Values in constant 2005 prices*

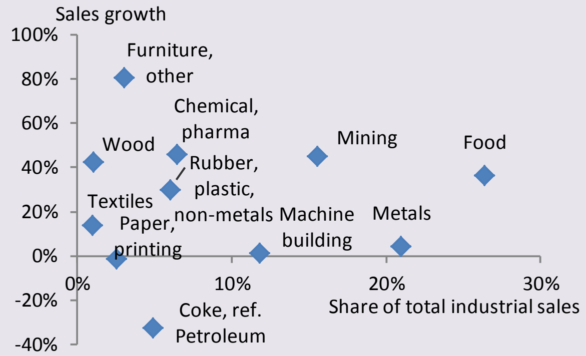
The 50% industry share in GDP of 1991 was, of course, unsustainable and largely due to a Soviet model of production. Industrial conglomerates also provided many services that are now the output of dedicated services companies. However, the fall of the industry share has continued in recent years. In 2013, it had declined to 27% of GDP (compared to 33% in 2008).

This is still a relatively large industry share, above the EU average of 23.7%. However, the reduction of the GDP share was not due to the faster growth of other sectors but mainly caused by weak growth in industry. Other Eastern European countries including Poland and Slovakia had also initially experienced a sharp decline of the industry share, but managed to stabilise the share at around 30% due to fresh growth and investments. Less competitive companies or subsectors decayed, but new firms in new areas produced stable growth and incomes. Finding and strengthening such new sources of growth will be crucial to ensuring Ukraine's future as an industrial economy.

A shift from heavy to light …

Elements of structural change are already visible in the evolution of Ukraine's industry. Sales of the different subsectors of industry developed differently already before the conflict. There is no clear correlation between relative size and growth of a subsector. Rather, growth was differentiated by the type of industry.

Subsectors: Growth and relative sizes, 2010-2013



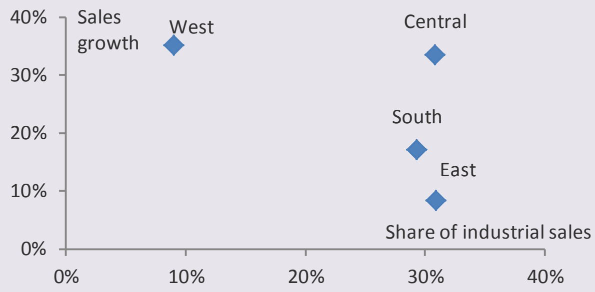
Source: Ukrstat, own calculations

Light, relatively labour-intensive subsectors such as food and wood processing or rubber and plastic grew stronger than most heavy subsectors such as metals and machine building. The growth of light industry in 2010-2013 could not make up for the decline of heavy industry to stabilize the GDP share, but it indicates that a structural shift in Ukraine's industry from heavy to light was underway before the conflict.

… and from East/South to West/Centre

As most of the metal and machine-building industry is concentrated in the East and South of Ukraine, the importance of these traditional industrial regions has started shrinking in comparison with the West and Centre of the country, where particularly the food industry is concentrated.

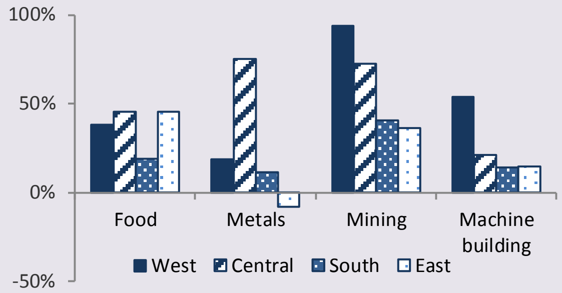
Industry growth and relative sizes by region, 2010-2013



Source: Ukrstat, own calculations

However, the stronger growth of the West/Centre regions cannot solely be attributed to a different sub-sector structure. Almost all major subsectors grew stronger in West/Centre than in South/East during 2010-2013. The reason for this growth differential is at a deeper level of industrial structure: In the West/Centre, industry is generally composed of smaller companies with less influence of major business groups, more foreign investor involvement and a smaller role of trade links with Russia.

Regional sales growth 2010-2013, four largest subsectors



Source: Ukrstat, own calculations

One prominent example of economic success is a growing cluster of automotive suppliers in the West, integrated in international supply chains and supplying leading global companies. This "light" machine building contrasts with many large companies in the East/South that are often operating with an outdated capital stock, lack investment, dynamic management and depend on trade links with Russia.

Recent developments in line with the trend

The depreciation of the Hryvnia's exchange rate has further boosted wage competitiveness and hence Ukraine's attractiveness for light industries. Exports to Russia, which have been shrinking since 2011, have dramatically dropped since mid-2014 and are unlikely to recover in the foreseeable future. The present conflict in the Donbas also mainly affects the metal industry. Apart from increased wage competitiveness and a remarkable resilience of industry in the West of Ukraine, the recent events constitute severe and negative economic shocks that reinforce the need to better exploit existing growth potential.

Policy implications

Ideally, Ukraine would both attempt to strengthen the growth of new, light industries and to aid the recovery of the heavy industry. But under current circumstances, attracting investment into the heavy industry in the East/South will be extremely difficult, although a restructuring of this industry should also be assisted in the medium term.

In the short run, low-cost means of supporting growth in the light industries should be the government's priority. One attractive option is to establish "cluster councils" for successful business clusters. These councils require little government involvement and not only help to improve communication between companies and government, but also magnify the visibility of success stories to potential investors.

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For a detailed analysis of the subject, please refer to Policy Paper PP/03/2015 "The industrial sector of Ukraine: Trends, challenges and policy options".

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German Advisory Group

The German Advisory Group advises since 1994 the Government of Ukraine on a wide range of economic policy issues. The group is financed by the German Federal Ministry of Economics and Energy under the TRANSFORM programme and its successor.

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