

World Scenario Series

# Scenarios for Ukraine

Reforming institutions, strengthening  
the economy after the crisis

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# Preface



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The World Economic Forum initiated the Scenarios for Ukraine process in early 2013 in anticipation of a year of momentous decisions for the country. Over the past months, fundamental changes have taken place in Ukraine's domestic and international politics, and the country is now at the centre of an unprecedented crisis. Beyond these severe geopolitical uncertainties, the country's economic foundation is challenged by longstanding internal political divisions, poor governance and global economic transformations.

How best to achieve and implement the required economic and societal reforms is a discussion that should involve the entire Ukrainian society. The geopolitical crisis over Ukraine has understandably drawn the attention of decision-makers on how to avoid a further escalation of tensions. However, the popular upheaval that began in late 2013 and the political changes that followed have only reinforced the need for a serious dialogue on the long-term future of the country.

Ukraine's long-term challenges remain, irrespective of the geopolitical stand-off: from strengthening its domestic institutions and improving the investment climate to addressing developments in global energy and commodity markets as well as forging reliable and lasting trade relations with all its partners.

Undoubtedly, decisions on those important questions need to be grounded in a broader long-term vision for the country. Hence, Ukraine needs to build a broad societal consensus on a compelling modernization strategy, fostering its long-term economic and social development. Implementing such a strategy is a mammoth task that will take time and can only be carried forward with visionary leadership, wide public support and benefits distributed equally across society.

The Scenarios for Ukraine seek to contribute to this long-term process by providing an impartial platform for engaging the wide range of stakeholders in a constructive and forward-looking policy dialogue. These scenarios build on a comprehensive stakeholder consultation convened and facilitated by the World Economic Forum over the course of 2013, involving more than 300 decision-makers, business and civil society leaders and leading experts from Ukraine and beyond. Through a series of interviews and thematic workshops in Kyiv, London and Dnipropetrovsk, and a high-level Strategic Dialogue in Kyiv, these stakeholders explored different perspectives on how global, regional and domestic developments may affect and transform Ukraine in the decades ahead.

This process included stakeholders from all parts of society, including those who are now driven apart on opposite sides of the ongoing political crisis. Irrespective of which political path Ukraine chooses in the future, the scenarios presented in this report can serve as a basis for constructive policy discussions. They focus on possible pathways for the country's economic development – a perspective that is crucial even as broader geopolitical questions loom large.

The hope is that this process will continue to foster a forward-looking dialogue that ultimately leads to more effective cooperation among stakeholders within Ukraine and among its partners in the EU, Russia and beyond. For this to happen, cooperation and trust are crucial to building a prosperous, innovative and inclusive economy in Ukraine.

# Executive Summary

Despite the current crisis, its geography, strong natural resource base and human capital make Ukraine well placed to leverage the next phase of globalization – defined by a soaring middle class in emerging markets – and achieve high levels of prosperity. However, institutional weaknesses coupled with the absence of a long-term development strategy are severely constraining the modernization of its economy, just as the country needs to adapt to a shifting global context.

Through a year-long strategic dialogue process, more than 300 decision-makers, government, business, and civil society leaders as well as leading experts sketched out different pathways for Ukraine's future economic development. Stakeholders focused on three strategic challenges that determine the extent to which Ukraine can unleash its potential and benefit from the changing global environment.

## Adapting to Shifting Geographies of Demand in the Global Economy

As demand for some of Ukraine's traditional exports wanes, and emerging markets transition to greater domestic consumption, Ukraine needs to reposition itself in global markets and retool its economy in line with such transformations.

## Fostering Higher Levels of Value Creation in the Ukrainian Economy

Across all sectors of the economy, significant new investments are needed to increase productivity and technology adoption, which in turn requires supportive institutions and a competitive market environment.

## Reducing Energy Intensity and Ensuring Reliable Access

As one of the most energy intensive economies in the world, that is also highly reliant on energy imports, the country urgently needs to focus on a reliable investment climate with a special focus on the reform of energy prices.

Central to all these challenges is the imperative to build a more supportive institutional environment based on effective cooperation among all stakeholders. The matrix of improving institutions, combined with external economic forces, sketch out the framework for the three scenario pathways that resulted from the strategic dialogue process.



**Unlocking the Virtuous Circle** is a scenario of fundamental transformation in which stakeholders emerge with a widely-shared commitment to a new social contract based on transparency and reorientation of state expenditures. This provides fiscal space to support the modernization of the economy and unlocks a virtuous circle across sectors.



**Lost in Stagnation** is a scenario of collapse. While the global economic context worsens, Ukrainian stakeholders fail to find common ground on a strong forward-looking agenda, leaving the country stuck in a rapidly escalating downward spiral.



**Back to the Future** is a scenario of selective change in which the unreformed system finds a new equilibrium. Deteriorating external conditions create a sense of urgency for targeted top-level actions that support strategic sectors and catalyse new trade and investment perspectives, but stop short of transformative change.

Exploring these different pathways to the future is important not so much to predict what is most likely to happen, but to explore the possible consequences of actions or inactions today. It will also help to frame ongoing policy discussions in a clear and structured long-term perspective. As such, the scenarios are conceived as a trigger for further conversations about the key priorities for the way forward for a post-crisis Ukraine.

The consensus emerging from this process is that any future agenda for Ukraine needs to espouse the following characteristics: be based on strategic rather than tactical thinking, follow inclusive rather than divisive processes, and take a comprehensive rather than piecemeal approach.

# Post-crisis Roadmap for the Ukrainian Economy

Recognizing the complexity of the situation in which Ukraine finds itself today, this report does not primarily focus on questions of security or geopolitics, but instead aims to contextualize sweeping global trends and highlight internal choices that decision-makers in Ukraine face with respect to the country's long-term socio-economic development. The interplay between domestic and global developments, as outlined in this report, is central to the post-crisis roadmap for the Ukrainian economy. Looking through the lens of long-term scenarios intends to inform decisions that need to be taken today in order to put Ukraine on a track to sustainable economic growth.

As Europe's sixth largest consumer market, Ukraine has many endowments which position it for economic success: strategic location, some of the world's most fertile land, and a highly educated population. It also enjoys a long-established comparative advantage in the metals sector as well as in other manufacturing and technology industries. Neighbouring Russia as well as four EU countries, Ukraine also has direct access to the dynamic markets of the Middle East through the Black Sea. All this could make the country a key player in tomorrow's global economy. Indeed, the next phase of globalization provides Ukraine with tremendous opportunities, as deep transformations in emerging markets and burgeoning middle classes in Asia and beyond will reshape global consumption and production patterns.

Yet, an assessment of economic indicators since independence shows a country performing well below its potential. The absence of long-term strategies, institutional weaknesses, entrenched political divisions and widespread corruption have made it difficult for successive governments to implement even well-intended reform efforts. As one civil society leader argued, "since Ukraine's independence, consecutive governments displayed an utter lack of vision and focused exclusively on narrow, short-term interests, which made it impossible for the country to advance."

After the difficult transition of the 1990s, the country experienced an economic boom in the early 2000s with average growth rates of up to 7%.<sup>1</sup> But this growth was largely driven by particularly favourable external conditions that allowed Ukraine to reap quick wins in the metals and chemicals sectors on the back of the global commodities boom. Soaring steel prices and, for much of the period, cheap natural gas imports from Russia supported significant improvements in the country's terms of trade, while highly liquid international capital markets simultaneously fuelled foreign direct investment (FDI) inflows into the country.

Notwithstanding this period of strong growth, the country's weaknesses in terms of governance and business climate remained unaddressed. A business leader highlighted that "favourable external conditions could have been used to develop a strong institutional foundation." Instead, "those in power focused on dividing the pie of the Ukrainian economy rather than growing it".

The absence of major structural reforms, deteriorating investment conditions, and low competitive pressures in the market created an extremely fragile economy which became heavily dependent on a few commodity-based exports for growth. Not only did this model limit the tremendous entrepreneurial potential of the country's educated workforce, but it also constrained the country's ability to adjust to and benefit from shifting dynamics in the world economy.

The impact of the 2008 global economic crisis illustrated the vulnerability of this model: Ukraine's GDP contracted by almost 15% in 2009 (versus a 3.7% average in OECD countries), and was followed by a slow recovery in the ensuing years.<sup>2</sup> The drying up of cross-border capital flows as capital markets became more risk averse, persistently high corruption and poor public management further weakened the country's unsustainable fiscal situation. Amid the current geopolitical crisis, Ukraine's economy is extremely fragile and dependent on significant external support.

## The Scenarios for Ukraine Process as a Post-crisis Roadmap

Against this background, the Scenarios for Ukraine process seeks to contribute to a constructive and forward-looking policy discussion about a sustainable post-crisis growth path for the Ukrainian economy. The overarching question in this long-term outlook is to what extent and under what conditions could deep reforms and improvements in Ukraine's institutional environment enable the modernization of the Ukrainian economy. This question also structures the assessment of how the country can address the main strategic challenges resulting from the changing global economic context: adapting to shifting geographies of demand in the global economy, fostering higher levels of value creation, and reducing energy intensity and ensuring reliable access.

# Strategic Challenges Emerging from the Shifting Global Context







# Adapting to Shifting Geographies of Demand in the Global Economy

Soaring global steel prices fuelled much of Ukraine's growth in the early 2000s. The country is the 6<sup>th</sup> largest iron ore<sup>3</sup> and 8<sup>th</sup> largest steel exporter<sup>4</sup> worldwide. Metallurgy has been the fastest growing sector in Ukraine for much of the past decade. While other sectors are beginning to gain greater shares in Ukraine's export mix, for instance food processing beyond mere agricultural production, the country's overall economic structure remains geared towards a world economy which consumes large amounts of base commodities.

Given the distinct possibility of a long-term slowdown in emerging markets, of a Chinese domestic economic rebalancing, and of a move towards a more carbon-conscious world, this growth model seems increasingly out of sync with global economic realities. It is also highly vulnerable to downturns in global demand and, in the absence of strong institutions, may suffer from elements of the resource curse.

## The End of the Commodities Supercycle

China has been the dominant factor behind Ukraine's commodities-based growth story, consuming a disproportionate share of the world's hard commodities. China's share of global steel demand rose from 16.4% in 2001<sup>5</sup> to 47.5% in 2012,<sup>6</sup> as its investment-driven economy soaked up global steel supplies. Commodity prices rose to record highs as producers struggled to meet this booming demand. While this period brought lavish profits to Ukraine's metals sector, global steel production simultaneously caught up with these new demand levels, and Ukraine failed to gain significant new market shares. China now produces well over half of the world's steel, and even Ukraine's traditional export markets in the Middle East are building up their own steel industries.

This significantly increases competitive pressures on Ukraine's metals sector, especially in the relatively lower value-added segment in which Ukrainian producers compete. At present, its basket of metal products falls into the low quality range of iron and steel, mostly used for construction and piping, given that the country's private sector largely failed to use the boom years to upgrade Ukraine's industry to higher levels of value creation. With domestic use for its steel products constrained by the low economic activity and dim growth prospects, Ukraine is almost entirely dependent on external demand, making it vulnerable in an increasingly competitive market.

Pressure on Ukraine's metals sector is accentuated by the fact that China's demand for hard commodities is beginning to fade as the country transitions from investment to consumption-driven growth. After reaching their historical

peak in July 2008, average global steel prices more than halved within the 10 months following the global financial crisis and, despite a relatively quick recovery, metals markets remain highly volatile.<sup>7</sup> With steelmaking capacity having outstripped consumption, overcapacity is prevalent not only in China, but also in all of Ukraine's main export markets.

## Emerging Consumer Markets

While demand for hard commodities could decline even further, the economic transition in China and other emerging market economies provides new opportunities for services and consumer goods exports. Whether or not Ukraine will be able to reposition itself in global markets and retool its economy in line with such transformations will be a defining factor in the country's ability to ensure sustainable prosperity for generations to come.

If Asia was once considered the world's workshop, over the next 10 years it will also become its fastest-growing consumer market.<sup>8</sup> Discretionary spending is already rising across all income levels, and if China's rebalancing is successful, wealthier Chinese consumers are likely to fundamentally reshape global consumption patterns. The growth of a new middle class will likely come with significant changes in dietary habits and trigger a boom for meat and grain producers.

As home to the world's most fertile soil and one of the few agricultural markets with significant potential for productivity gains and land-use increases, Ukraine could be set to gain significantly from this shifting global consumer landscape. An added opportunity for Ukraine rests in the major transformations currently being experienced by the global food and agribusiness industry where changes are occurring in product characteristics, technology use, company structures, and supply chains as well as processing cycles. As a leading executive in the agricultural sector points out, "Ukraine could position itself as a leader in this transforming global agri-food industry". But, as he also argues, "in order to do so, the country needs to adopt a global outlook, unlock investments and develop strong links with new markets".

China's recent negotiation of a long-term lease of 5% of Ukraine's total landmass, or 9% of its arable farmland, to feed Chinese consumers is a case in point. It demonstrates the potential for Ukraine to become a key player in this market. But it also highlights the importance of leveraging this increasing demand to upgrade Ukraine's agri-food industry and to move to the centre of global food supply chains. Otherwise, Ukraine's agricultural sector may well become characterized by elements of the resource curse.

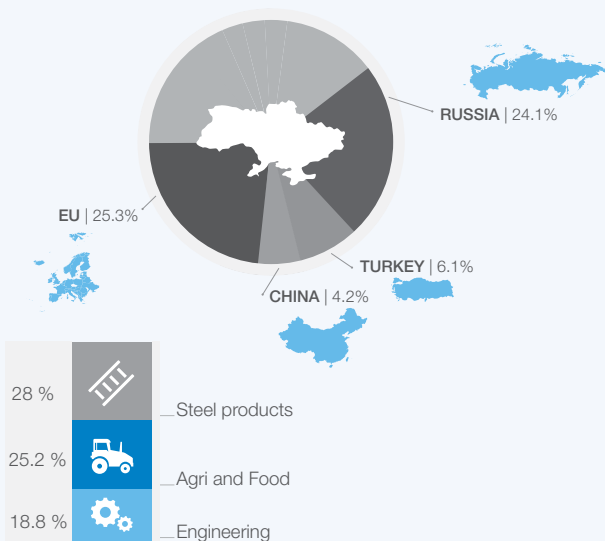


## New Trade Links

New centres of growth that lie beyond Ukraine's traditional trade partners – the EU and Russia, which together account for 50% of Ukraine's total exports – may at first glance be seen as easy markets for entry and growth. Demographic and economic growth is centred in fast-moving emerging markets of Asia, the Middle East and Africa. Developing strong footholds in those regions is absolutely vital, but it will require astute long-term strategies supported by new instruments for proactive trade promotion and export financing.

### 50% of Ukraine's exports go to the EU and Russian Federation

Source: WTO 2013; Investment Capital Ukraine 2013

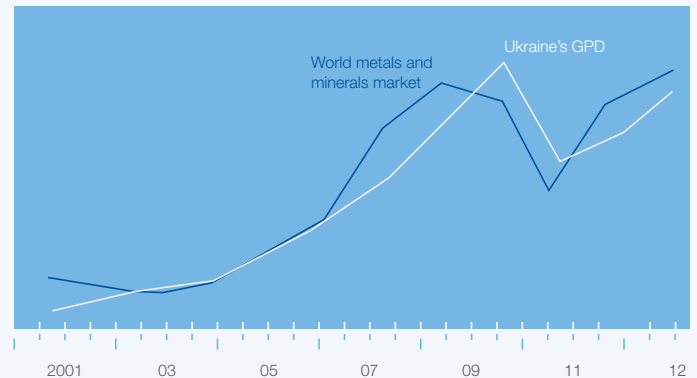


Perhaps more importantly, succeeding in these markets will also require Ukraine to improve the quality of its offer. As demonstrated by the example of Ukraine's Eastern European neighbours, integration into existing value chains, such as the German-Central European one, can become a springboard for accessing new markets and simultaneously upgrading the technological basis for production.<sup>9</sup>

Doing so may come at a steep cost in the short term, yet it holds the key to an upgrade of Ukraine's capabilities that will have a positive impact on the country's overall trade position. In a context in which geopolitical tensions may create new obstacles to trade, this is even more important.

### Ukraine's GDP is closely tied to metals and minerals price fluctuations

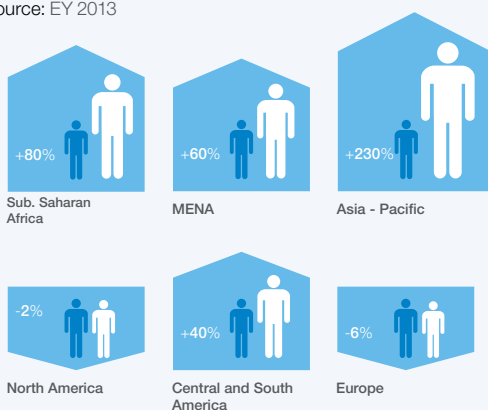
Source: World Bank DataBank



### A growing global middle class of consumers represents a new opportunity for Ukraine ...

(middle class growth from 2009 to 2030)

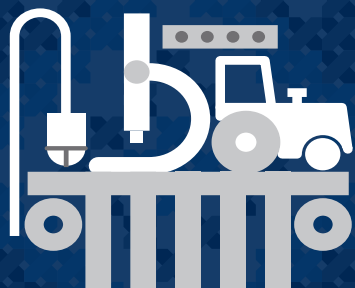
Source: EY 2013



### ... Particularly in response to growing food demand

Source: FAO 2013





# Fostering Higher Levels of Value Creation in the Economy

Opportunities stemming from this shifting global context are clear. Ukraine could indeed position itself at the centre of global consumer market value chains and emerge as a winner in the next phase of globalization. But this does not depend solely on the exploitation of the existing factors of production that Ukraine is so strongly endowed with. Knowledge, technology absorption and innovation are crucial to increase productivity and sophistication in the use of these assets, drawing on the country's strong human capital.

However, weak institutions and a poor investment climate are stifling Ukraine's potential to excel in all segments of the economy. A senior business leader argued: "The political situation in the country used to motivate entrepreneurial inaction; it taught people to do nothing, to be in a defensive mode instead of trying something new, starting a business or expanding operations." Another executive elaborated: "There was no feeling of safety among owners, which made them unable to commit to long-term investments."

## Upgrading Existing Strengths

In the metals sector, production increases and competitiveness depend heavily on investments, most importantly in energy saving technologies. Ukraine's metallurgical sector is largely characterized by an outdated and inefficient production model inherited from the Soviet Union. Investments in newer production technologies could significantly decrease energy costs and increase productivity. Technology upgrades would also allow Ukrainian steelmakers to move from semi-finished to higher value added products and thereby tap into less volatile and more profitable market segments. As one industry insider points out, "in its current composition, Ukraine's steel industry effectively competes with scrap metals on global markets". According to some estimates, labour productivity in Ukraine's steel sector is more than 80% lower than that of the United States.<sup>10</sup> Hence, moving up the value chain and increasing productivity is an imperative for remaining competitive.

The agri-food sector faces a similar challenge. The country's ability to fully leverage its unique endowments is limited by low productivity, certification challenges and an opaque regulatory environment. Restrictive laws of land ownership and past experiences with privatization of state assets do not inspire investor confidence and, ultimately, help shield politically connected businesses from genuine competition.

Underperformance of the agri-food sector is, in large part, self-imposed and could be overcome through limited but concerted policy efforts. Significant investments are necessary to improve transport infrastructure and storage,

which are crucial for modern food supply chains. Land reforms and infrastructure upgrades combined with wider use of high-quality fertilizers and consistent application of high-tech machinery would allow Ukraine to increase the quality and quantity of its output while improving profitability across the value chain.<sup>11</sup>

## The Imperative of Strong Institutions

Across all these sectors, it is evident that without unlocking significant new investments in infrastructure, machinery, and technology, as well as retooling the education system to help grow Ukraine's talent pool and sustain technology adoption, the country will struggle to remain competitive and generate long-term prosperity.

FDI and partnerships with multinational firms that enable technological transfers are crucial for this. But deficiencies in the rule of law as well as weak intellectual property rights protection deterred many potential investors in technology-intensive sectors. As one industry leader said, "We didn't perceive this market as a level playing field and face high uncertainties for long-term planning." Other investors in technology-intensive sectors maintain that access to skilled labour is an increasing barrier to their operations in Ukraine, partly because many skilled professionals are leaving the country.

What connects all these challenges is the imperative to strengthen institutions and maximize use of the country's physical and human assets. As one executive put it, "The most important thing is clarity. The country will need to start looking strategically at its economic development and it cannot continue changing policies every six months." In other words, it comes down to reliable institutions that effectively steer public policies towards long-term goals and generate the requisite levels of trust within society as well as the business and investor community. As one business leader argued, "We lacked any sense of a service-oriented public administration and understanding of the government's role in fostering value-creation in the economy to the benefit of everyone." As a consequence, "there was an utter lack of trust between the government, businesses and the society and this affected the economy."

## Competition for Innovation

Beyond formal public service institutions, what is currently lacking is a systemic approach to economic modernization and market-based incentives for innovation. Small and medium-sized firms (SMEs) are playing an important role not only in generating employment, but also in innovation and technology adoption.

Yet, conditions for SMEs are particularly difficult in Ukraine. On indicators that pose important barriers for small enterprises, such as obtaining electricity or paying taxes, Ukraine remains among the worst performers worldwide, ranking 172<sup>nd</sup> and 164<sup>th</sup> respectively, out of 189 countries in the World Bank's Ease of Doing Business Index.<sup>12</sup> As one technology entrepreneur explains, "what we need is no less than a sea change in the way the country looks at SMEs. Currently there are still too many barriers for private entrepreneurs".

Nowhere is this more apparent than in the IT sector, which according to many stakeholders could become a real backbone of the future Ukrainian economy. While Ukraine has a large pool of highly qualified programmers, many of them have been operating in the shadow economy, providing services for companies elsewhere in the world.

More fundamentally, the domestic market lacks competition, and therefore pressure for innovation. While transitioning to market economy structures after independence and then to the period of high growth in the 2000s, the Ukrainian economy has moved towards a low equilibrium of high entry

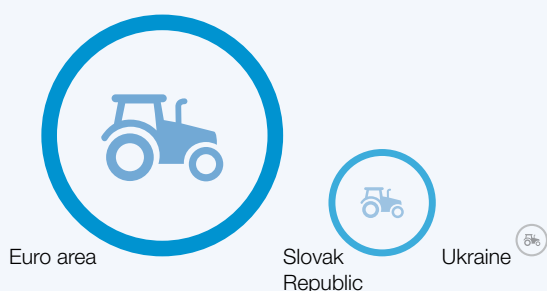
barriers for non-insiders, limited incentives for technology adoption, and high concentration on base commodities. Such worrying trends can only be overcome through enhanced competition at all levels, and SMEs will have to play an important role in this.

Moreover, greater internal value creation will also support the country's growing middle class, strengthening Ukraine's domestic market and decreasing its dependence on external factors. Even though global commodity markets are slowly recovering, even strong sectors, such as steel production, are facing increasing competition and cost pressures as emerging markets expand capacity and Ukraine's cheap energy advantage disappears.

This leads to a broader argument: fostering higher levels of value creation in the economy cannot be mandated; it is the outcome of a process of modernization that can only flourish in a supportive institutional environment. As a leading academic puts it, "the economy develops as a system; deficiencies in areas such as healthcare, public finances, pensions – although not directly linked to businesses – all go hand in hand and affect the performance of the economy."

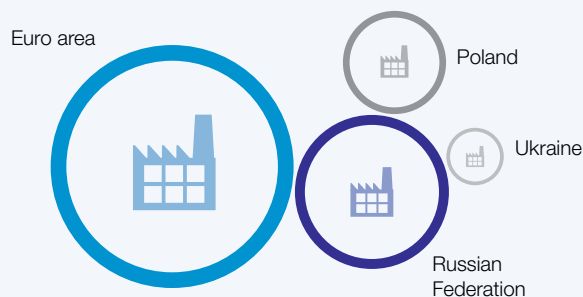
**Ukraine's agricultural and industrial productivity is low**  
(agriculture value-added per worker)

Source: World Bank DataBank 2013



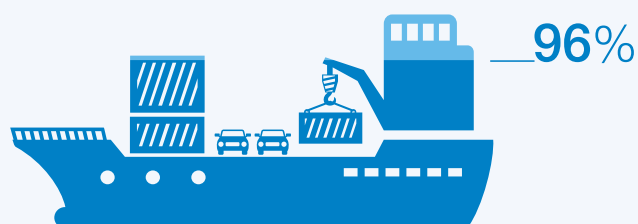
**(industry value-added per worker)**

Source: World Bank DataBank 2013



**Infrastructure represents one of the key bottlenecks**  
(cargo handling volume % of maximum port capacity)

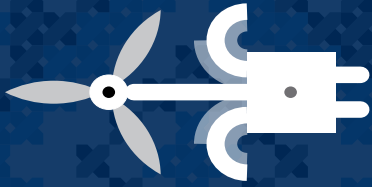
Source: OECD 2012



**Ukraine mostly exports low added value products**

Source: Press office of the President of Ukraine 2013





# Reducing Energy Intensity and Ensuring Reliable Access

Being one of the most energy-intensive economies in the world, Ukraine is also highly dependent on gas imports. The country's energy intensity is more than five times higher than that of Qatar, which has the third largest natural gas reserves in the world.<sup>13</sup> Roughly half of Ukraine's economic output is based on major gas-consuming industries, such as metals, fertilizers and power generation. Industries sensitive to the price of gas account for about 60% of GDP and half of the country's export earnings.<sup>14</sup> At the same time, almost two-thirds of the gas consumed in Ukraine is imported from Russia, which makes it extremely dependent on this one source of energy supply.<sup>15</sup>

Despite more than doubling import gas prices, utility tariffs have been adjusted only marginally since 2006, which means that the government is heavily subsidizing energy consumption. In fact, domestic household utility tariffs are well below cost recovery, creating a massive fiscal burden for the government, which severely limits its fiscal space for other important public service expenditures. Energy subsidies represent approximately 6% of the country's GDP<sup>16</sup> and result not only in a structural financial loss of US\$ 2.5 billion annually, but also in disincentivizing energy saving behaviour among the population and industry.<sup>17</sup>

A non-transparent energy market and artificially low prices furthermore represent a barrier for the development of domestic energy production. While self-evident, this challenge is not easily solved. Addressing energy pricing will upset the status quo that some have been benefitting from. However, it will most certainly help unlock investments, be it from domestic sources, new players entering the market, or international assistance programmes.

## Unrealized Potential

Although the current stand-off with Russia is likely to affect Ukraine's energy situation in the short-term, shifts in the global energy landscape provide Ukraine with new opportunities for diversifying its energy supplies. The shale gas revolution in the United States is already putting pressure on gas markets globally. New geographic options ranging from Central Asia to Iran as well as potentially de-escalating tensions in the Middle East could all put further downward pressure on energy prices.

Amid these developments, Ukraine has started to explore possibilities for the development of an LNG terminal on the Black Sea coast which, according to some estimates, would allow it to tap into gas supplies from the Persian Gulf as well as from the South Caucasus. Institutional progress, however, will be a precondition for the kind of investments required for such grand projects.

Recognizing the time required to bring complex LNG infrastructure on line, it would be unrealistic to expect significant diversification of gas supplies in the near term. While Ukraine's accession to the European Energy Community in 2011 has yet to deliver a transformative effect on Ukraine's domestic energy market, given that implementation of policies has been slow, closer integration with the European energy market holds significant potential for Ukraine. The adoption of European legislation on market regulation could also have positive effects on investment decisions and the operations of international energy companies in the country.

Possibly the greatest promise for Ukraine's energy security lies in exploiting its domestic energy potential, in terms of both production and reduced consumption. According to some estimates, with the right policies and investment conditions, Ukraine's domestic conventional or shale gas production could double within a few years. Although the current crisis may taper some of the underlying premises, projections for possible shale gas extractions see Ukraine as one of the most promising markets in Europe. The Donbas Basin in Eastern Ukraine, for example, is estimated to be almost twice as big as the largest shale reserves in the United States.<sup>18</sup> Before the current stand-off, several global energy companies signed agreements that could lead to multi-billion dollar investments to develop Ukraine's shale gas and offshore resources.

Beyond these fossil fuels, the country also has a significant renewable energy potential, in terms of wind, solar and biomass. While investors start developing these alternative resources, some complain that "officials have so far failed to recognize the full potential that renewable energy could unfold in the country." As in other sectors, the barriers for entry have been particularly high and often prohibitive for small and medium-sized companies that are at the forefront of Europe's green energy industry.

## Incentivizing Greater Efficiency

The key to modernizing Ukraine's energy sector is energy pricing reform. Despite the political costs associated with reforming energy subsidies, greater energy efficiency and increased domestic production will only be achievable in a transparent system built on market pricing. This includes taking on vested interests and fighting corruption in a sector that has possibly seen the most far-reaching transgressions under all successive governments.

While many official strategies have been declared over the years to address Ukraine's energy efficiency and domestic production challenges, implementation has mostly

floundered. As such, energy reform essentially consists of the basic challenge of building efficient and results-oriented public institutions.

## Revisiting Institutions

Combining all the different alternative sources of supply with measures to develop more efficient consumption, Ukraine could surely become a more prosperous country while concurrently reducing its dependence on a single energy and import source. Energy sector expenditures have so far misdirected a significant part of Ukraine's fiscal resources, which could be deployed in areas where societal returns are much higher, such as supporting entrepreneurship,

innovation and modernization of the economy. In fact, most of the measures that would allow for greater domestic energy efficiency and attract energy investments would also have significant positive effects on other parts of the economy.

Creating transparent energy market institutions and a reliable investment climate could indeed be a stepping stone for a much wider transformation of Ukraine's economy. As one executive argues, "Ukraine's energy dependence is not about the lack of alternatives, it is about the ability to implement reforms and develop long-term strategies".

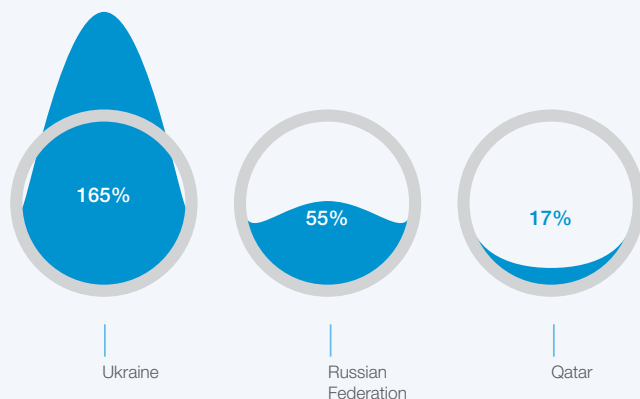
Ukraine's energy intensity is high  
(Total primary energy consumption per dollar of GDP, thousand Btu/2005 US Dollars)

Source: IEA 2010

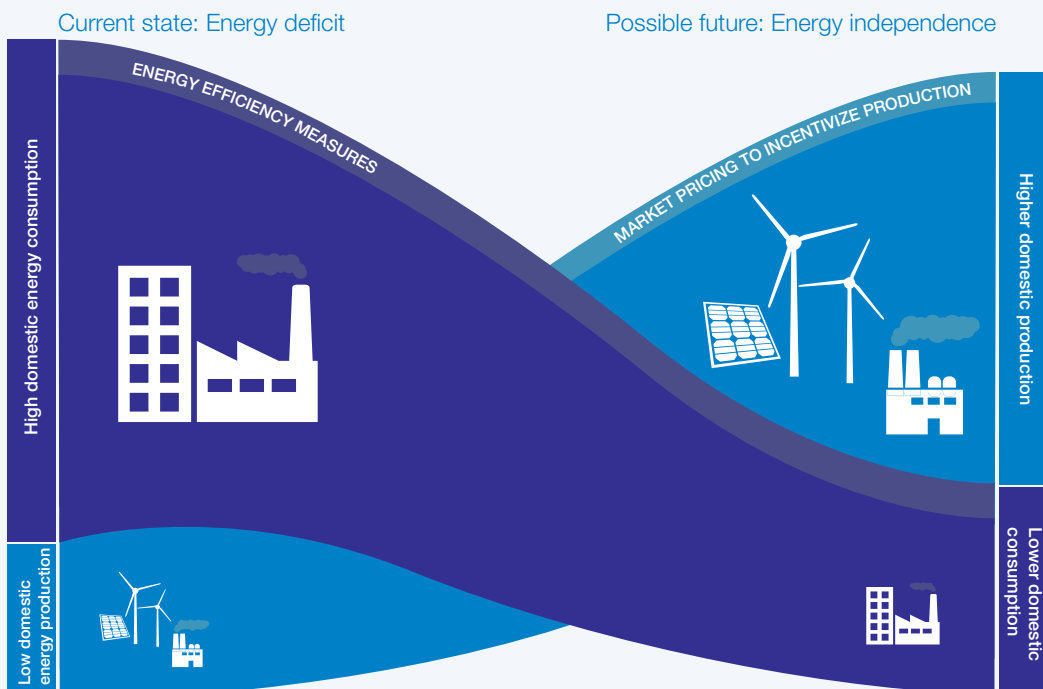


Ukraine is highly dependent on imports  
(Total energy consumption as % of domestic production)

Source: IEA 2012



Lowering energy intensity and achieving price parity between imports and domestic production could help bring energy independence to Ukraine





# Institutions and Growth: Insights from the Economic Literature

The central importance of institutions that has been highlighted throughout the scenario process is supported by a wide body of literature linking the quality of institutions with the growth performance of different countries. In this literature, institutions have been defined as the “rules of the game”, or the multitude of human-devised formal and informal constraints that shape human interactions in societies.<sup>19</sup> The most widely used measure of the quality of institutions is the Worldwide Governance Indicators (WGIs) produced by the World Bank and based on the following, more specific definition: “Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.”<sup>20</sup> The World Economic Forum’s Global Competitiveness Index also measures the quality of institutions as the basic competitiveness requirement.<sup>21</sup>

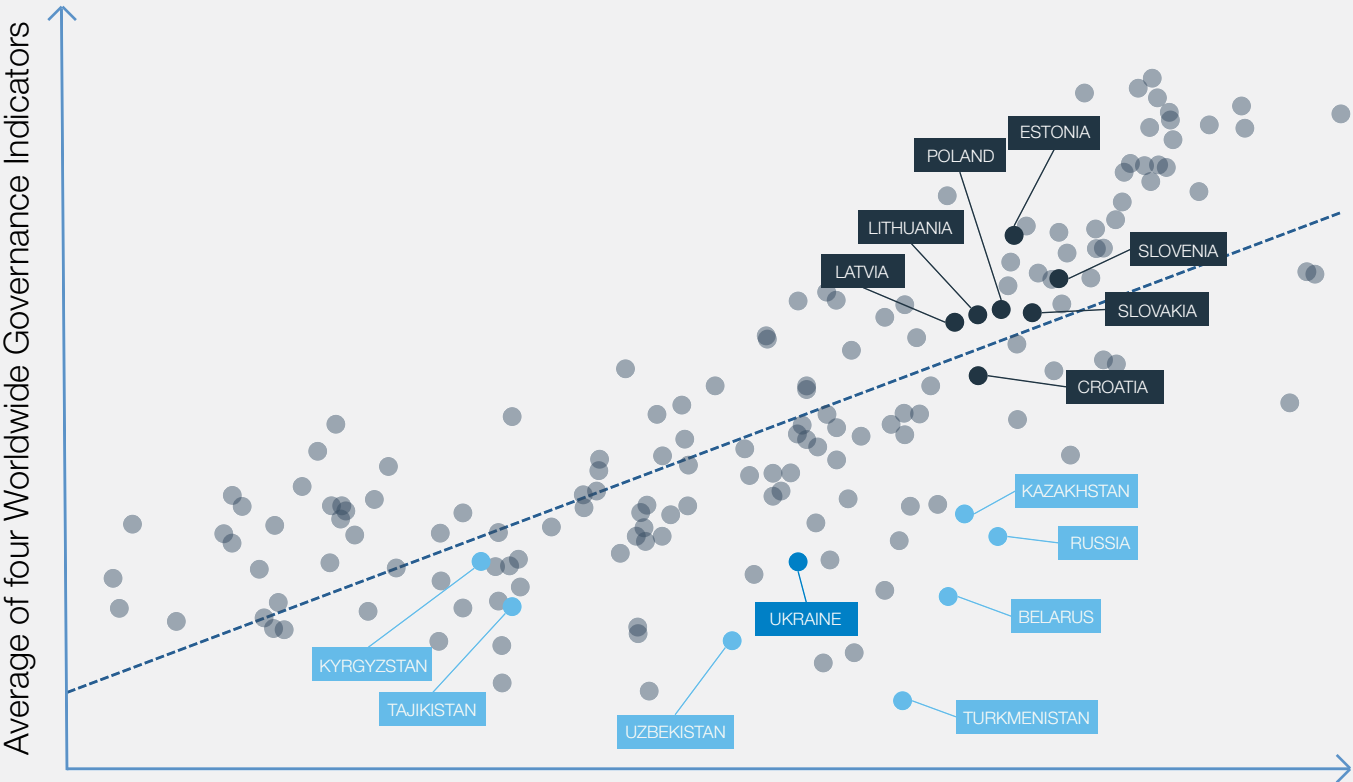
Early studies on institutions and growth have argued that “the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment.”<sup>22</sup> In recent years, a series of other studies have focused on the links between institutional quality

and growth. Taking a historical perspective, Acemoglu, Johnson, and Robinson (2002) argue that: “a cluster of institutions ensuring secure property rights for a broad cross section of society, which we refer to as institutions of private property, are essential for investment incentives and successful economic performance. In contrast, extractive institutions, which concentrate power in the hands of a small elite and create a high risk of expropriation for the majority of the population, are likely to discourage investment and economic development.”<sup>23</sup>

In its latest outlook on the region, the European Bank for Reconstruction and Development notes: “Economic and political institutions play a key role in defining a country’s long-term growth potential. Countries with a stronger institutional environment – effective rule of law, a good business climate, more secure property rights and market-friendly social norms – are better positioned to attract investment, to participate in trade and to utilise physical and human capital more efficiently.”<sup>24</sup>

Nonetheless, Ukraine, as well as other post-Soviet countries in Eastern Europe and Eurasia, has weaker institutions than countries with similar levels of economic development. The difference is particularly stark when comparing Ukraine with its neighbours that joined the European Union in the early 2000s. (see chart on p. 15)

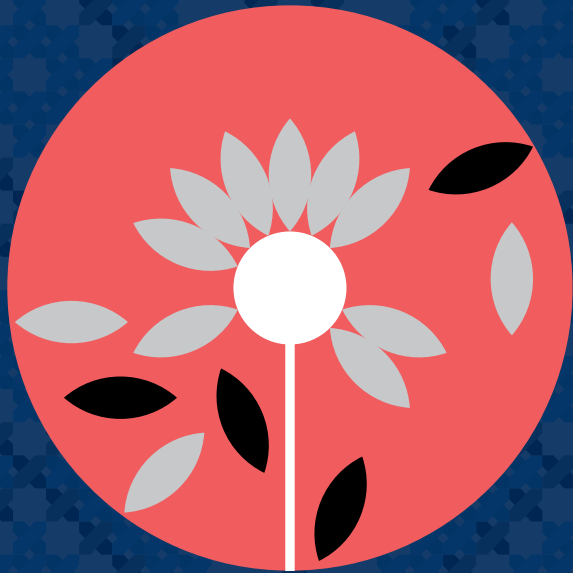
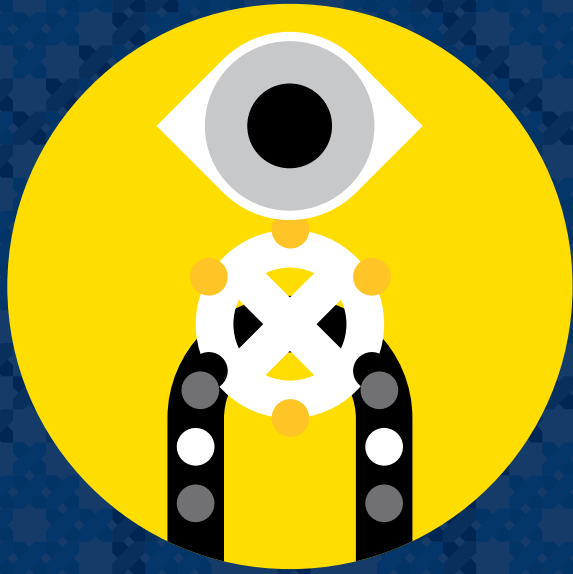
Ukraine has weaker institutions than countries with similar levels of economic development



Log of income per capita (PPP)

Based on European Bank for Reconstruction and Development Transition report 2013

# Scenarios



# Scenario Framework for a Post-crisis Ukraine

Central to the three challenges discussed in the previous section is the interplay between Ukraine's external economic conditions, determined to a large extent by the dynamics of the global economy, and its domestic institutional environment, dependent on the actions and effective collaboration of all actors in society.

## Key Dimensions

### Institutional Environment

To what extent will Ukraine's domestic institutional environment be supportive or unsupportive to the full development of the country's physical and human assets?

#### Unsupportive



#### Supportive



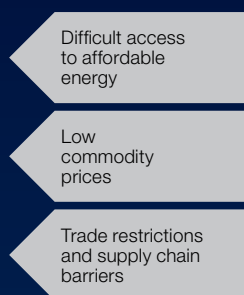
Note: An unsupportive institutional environment may result from lack of vision, sustained inaction and failure to implement reforms. High levels of polarization, political deadlock and focus on short-term priorities are all elements that contribute to this outcome.

Note: In a variety of pathways for institutional reform, the two extremes stand out. The first prioritizes efficient public services and low barriers to doing business over trust and inclusive institutional processes (top-down model of institutional change). The second puts emphasis on inclusive processes and high levels of trust as a basis for building a more holistic institutional reform agenda (bottom-up model of institutional change).

### External Economic Conditions

Will the global economic context result in favourable or unfavourable external conditions for Ukraine's economic model as we know it today?

#### Unfavourable



#### Favourable



Note: Although global energy prices could decline, it is uncertain if and how that would translate into cheaper and more predictable gas import prices for Ukraine. At the same time, a changing composition of global growth where prices for hard commodities grow slower while energy prices remain high could equally result in a less favourable external environment for Ukraine.

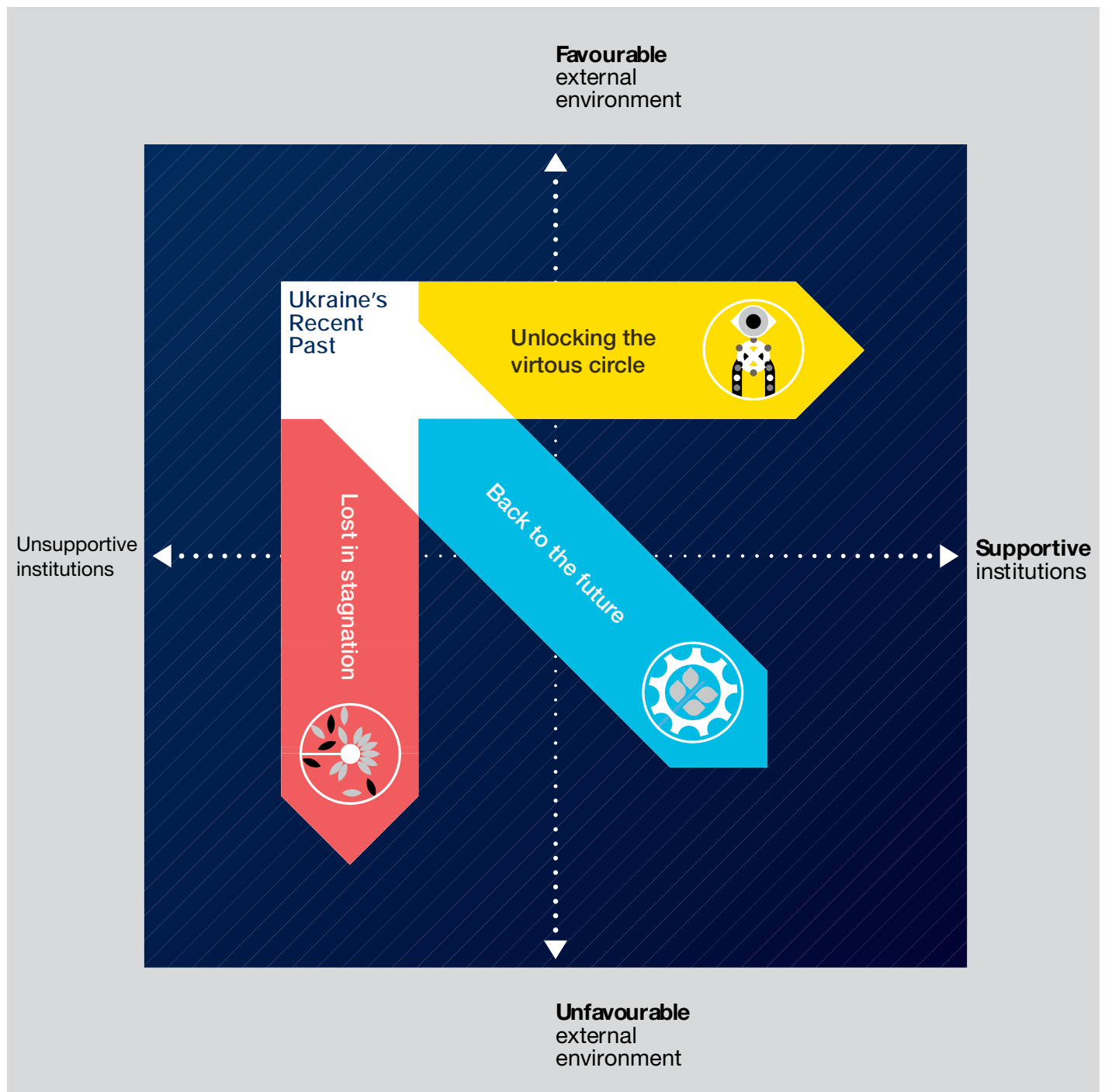
Note: A favourable external environment for Ukraine can also result from different macro-conditions. Renewed investments and stimulus programmes could revive the commodities boom of the early 2000s. Similarly a gradual transition to lower energy prices and increasing sources of supply coupled with high growth and strong demand for food as well as for sophisticated metals products could represent a favourable context for Ukraine.



These two dimensions also emerged as the scenario framework on which stakeholders based their exploration of the three alternative pathways to the future. While Ukraine's recent past was characterized by extremely favourable global conditions that masked a largely non-supportive domestic institutional environment, the extent to which these external conditions will remain favourable or not and how society at large will react in building a supportive institutional environment remains highly uncertain.

Exploring these different possible pathways to the future is important not to predict what will happen, but as an exploration of possible consequences of actions or inactions today. They also help in framing ongoing policy discussions in a clear and structured long-term perspective. As such, they are seen as a trigger for further dialogue about the key priorities for the way forward for Ukraine.

## Pathways for Ukraine's long-term economic development



# Unlocking the Virtuous Circle







## External Economic Context

This scenario takes place against the background of emerging market economies transitioning towards slower but more robust growth models. Global demand for commodities remains high. Combined with open trading systems and easing of tensions with Russia, intra-regional trade is intensifying and there is renewed investor appetite for frontier markets. Ukraine benefits from relatively favourable terms of trade.

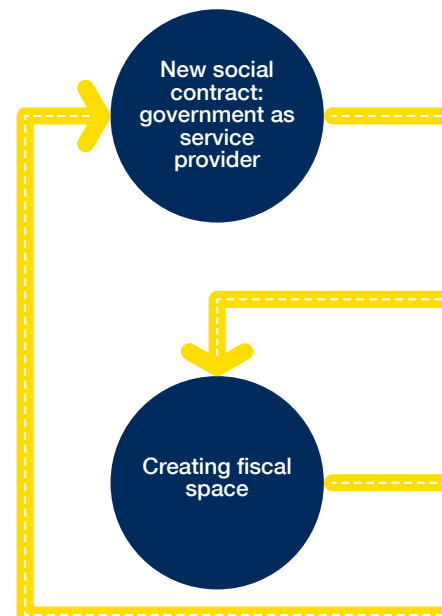
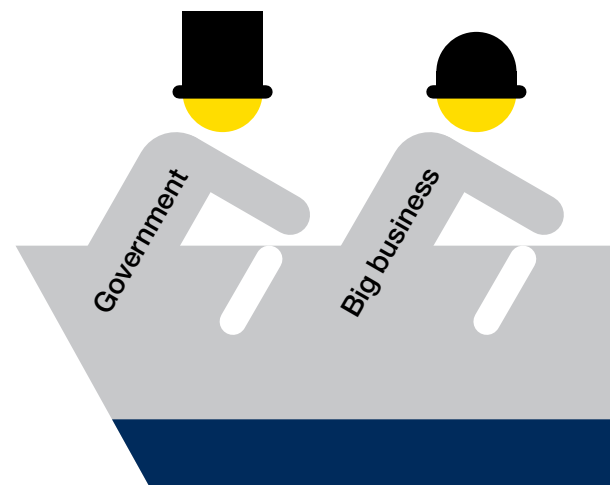
## Post-crisis Pathway

A widely-shared consensus for moving beyond Ukraine's unfulfilled promises allows reform-minded leadership to push through sweeping changes. Rule of law and gradual transformation of the role of the state based on transparency and accountability become the pillars of a new economic and societal model, aligning stakeholders like no other reform proposal before. The perspective of a new social contract provides an environment that nurtures a virtuous circle, unleashing the country's dormant entrepreneurial spirit, innovation potential, and cooperation at all levels to reinforce subsequent steps of much needed reforms.

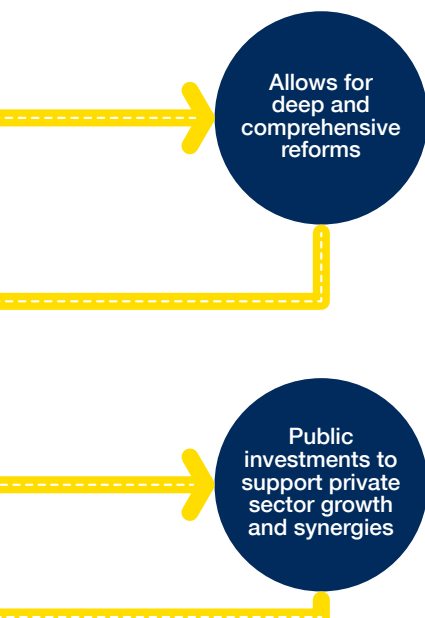
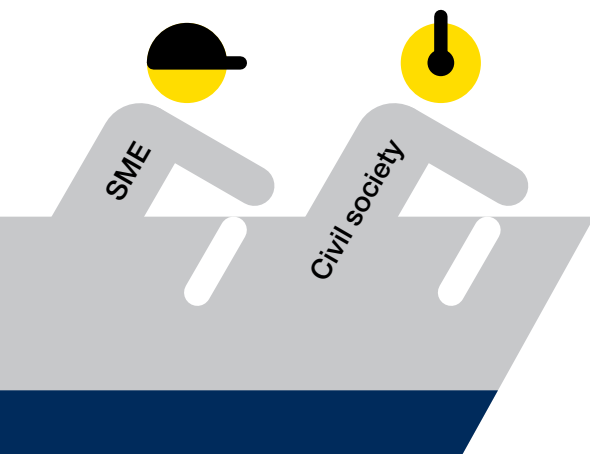
While fiscal adjustment is not possible without refocusing public transfers, decisive measures to introduce transparency make stakeholders increasingly aligned behind the necessity of these steps. Energy subsidies and an overall inefficient use of public funds have come to paralyse the government in an unsustainable cycle of rising costs and declining returns. Growing tired of poor quality of public services, Ukrainians are excited about a complete reconception of the nature of relations between the state and society. This helps rebuild trust and guarantees support for the necessary changes.

Citizens and businesses welcome this new context consisting of more focused public spending and greater freedom from red tape and a controlling state that interferes in the affairs of firms and citizens. A "black hole" of government tenders that had siphoned off billions from national and local budgets via many elaborate corruption schemes is closed. Private investment and business activities thrive due to the stimulus of competition rather than on the back of connections and political patronage. This is also a key factor for greater foreign investment and technology transfers as Ukraine becomes integrated in existing production value chains. The resulting growth impetus creates even more fiscal space for greater public investments in soft and hard infrastructure as well as better quality public services.

**A new social contract between the state, business and society built on transparency, mutual trust, and the emergence of a public-service culture across Ukrainian institutions underpins transformational change in the economy. Disillusioned with the status quo, stakeholders unite behind this difficult but promising transition. Widely-supported**



sweeping reforms yield significant inflows of investments, productivity gains, and a wholesale restructuring of the economic model. While remaining fragile and dependent on the continuous cooperation of all actors, this virtuous circle begins to deliver inclusive prosperity throughout the society.



## Implications

Perhaps the biggest transformation is seen in the energy sector that stood at the outset of this virtuous circle. Gas subsidies for households have progressively been phased out and replaced by more targeted support for the most disadvantaged groups. Modernization of the country's energy production, transmission and consumption became possible with transparent pricing and market access that brought in a flurry of investments. In a more competitive environment, domestic production of conventional, offshore, and shale gas scales up quickly, as Ukraine edges closer towards energy independence.

Both within and beyond the energy sector, FDI has brought new technology and knowhow into the country, as private domestic and foreign investors responded positively to signals of improved governance. The different components of the national economy not only thrive in this more favourable and open institutional environment, but also benefit from increasing synergies and spillovers between sectors. For instance, developments in the agricultural sector trigger increasing demand for better infrastructure, machinery and fertilizers which in turn positively impacts the metallurgical, manufacturing and chemical sectors and ultimately reinvigorate domestic producers and service providers.

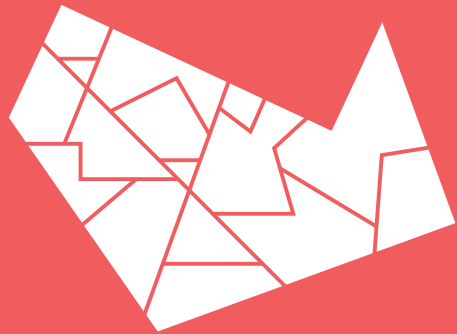
While long considered part of the old economy, the agricultural sector has also become a key driver for Ukraine's emerging high tech industry from chemicals and fertilizer production to bio-tech and seed development. The sector is also increasingly characterized by a wide range of small and medium-sized companies that benefitted from long awaited land reforms and a progressively more favourable business environment. Indeed, SMEs are probably the greatest beneficiaries of the reforms, as innovative entrepreneurs are encouraged to play a more active part in the country's economy.

Domestic consumers as well as the wider services economy also become important drivers of this economic virtuous circle. A growing middle class, which is also internationally mobile, drives expectations for more efficient institutions and becomes central to the economy's value creation.

As such, this is the scenario of a fundamental political, economic and societal transformation. Ukraine is not at the crossroads anymore, it has reinvented its economic model based on a new social contract that forms a sustainable and resilient basis for its future prosperity.



# Lost in Stagnation







## External Economic Context

While energy prices remain high, global demand for base metals is at its lowest, and a quick rebound is not expected due to a worldwide overcapacity in the recent boom period. Geopolitical competition prevails in the region, and increasingly conflictual trade relations make it difficult for Ukrainian businesses to access regional and global markets.

## Post-crisis Pathway

Unable to meet the leadership challenge resulting from the crisis, decision makers fail to build the requisite momentum for deep reforms. While there is an abundance of talk about reform commitments and strategic plans, stakeholders largely work against each other behind the scenes rather than developing a concerted vision for reforming the state and society.

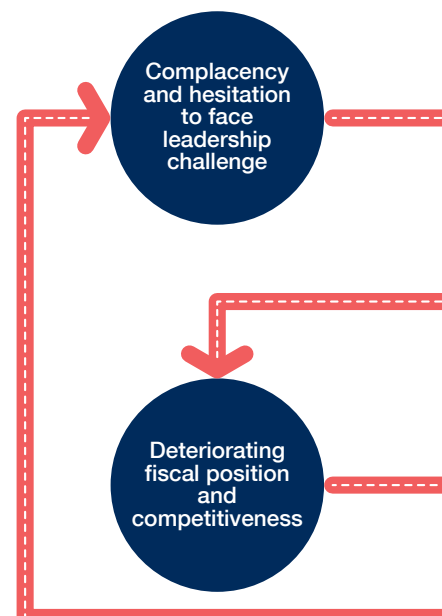
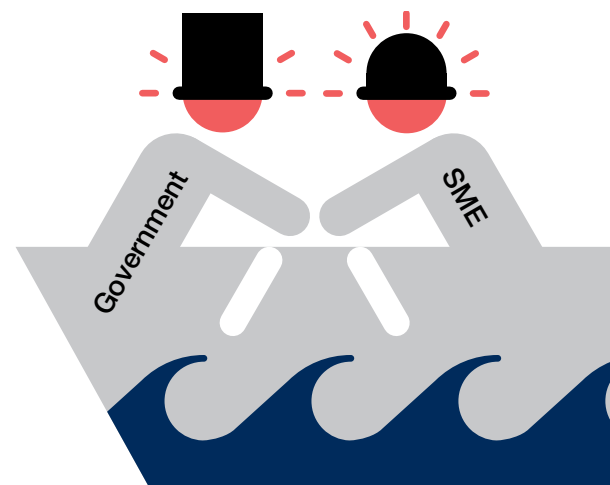
Short-term mentalities and political infighting continue to dominate policy discussions at the expense of substantive discussions on economic and societal reforms. The difficult task of unifying the country and rebuilding relations with the neighbours is abandoned by unscrupulous politicians pursuing their own personal goals. In doing so, they contribute to an even further polarization of society. Growing separatist sentiments, failure to establish justice and escalating grievances pull the country apart and disable it from moving forward.

Return of kleptocracy, coupled with unhelpful interference from the outside lead to a relentless decline of an already ailing economy. As the fiscal position moves from one crisis to the next, with stop-gap measures failing to stimulate lasting change, investor weariness leads to significant capital flight and brain drain. Frustrated with the missed opportunities in the country and with the constantly changing regulatory environment, foreign investors increasingly turn their back on the country, leaving the market with even less competition and incentives for modernization.

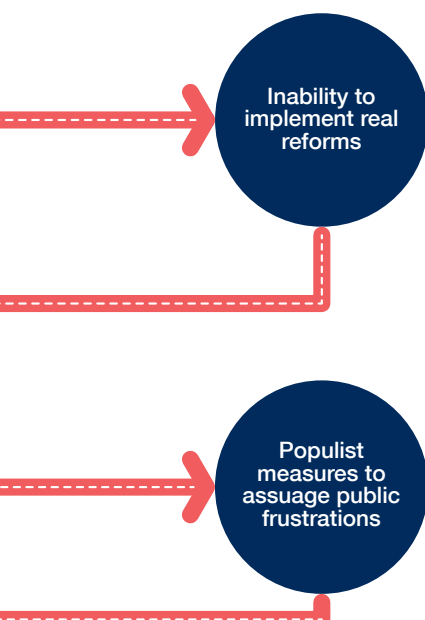
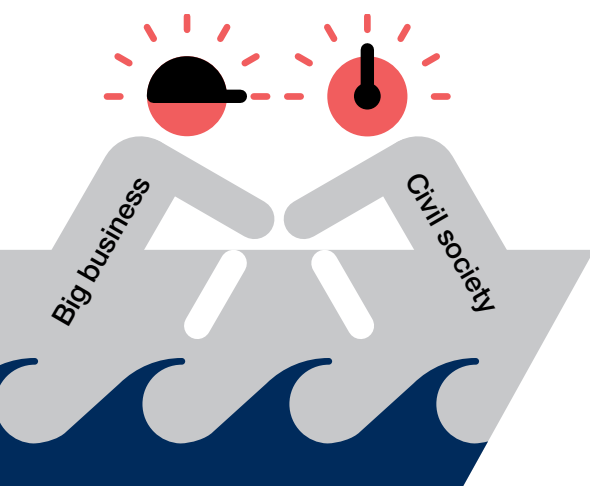
As Ukraine's credit ranking is downgraded yet again, escalating costs of financing coupled with high energy prices, keep the steel sector inefficient and its output of poor quality. The imperative to modernize is weakened by declining sophistication in the domestic market. Disappointment replaces the optimism of the last decades about a vibrant national IT sector. An unfavourable business climate and lack of investment impede a transition in this sector from outsourcing to innovation and development.

While high food prices worldwide offer a welcome respite for the country's economy, even the agricultural sector,

**Stakeholders fail to find common ground on a strong forward-looking vision for the country. The inability to implement deep reforms through concerted efforts of all actors in society leaves the economy highly fragile as the external environment**



continues to deteriorate. While some try to find solace in expectations of improvements in the external conditions, the country is increasingly stuck in a rapidly-escalating downward spiral.



which could have served as Ukraine’s buffer in bad times, remains too weak to have any kind of impact. Deteriorating infrastructure and cumbersome customs procedures create severe bottlenecks for the much needed export revenues.

What many stakeholders fail to acknowledge is that they are walking into the abyss as all actors strictly focus on dividing a “shrinking pie” and fail to work towards the common good.

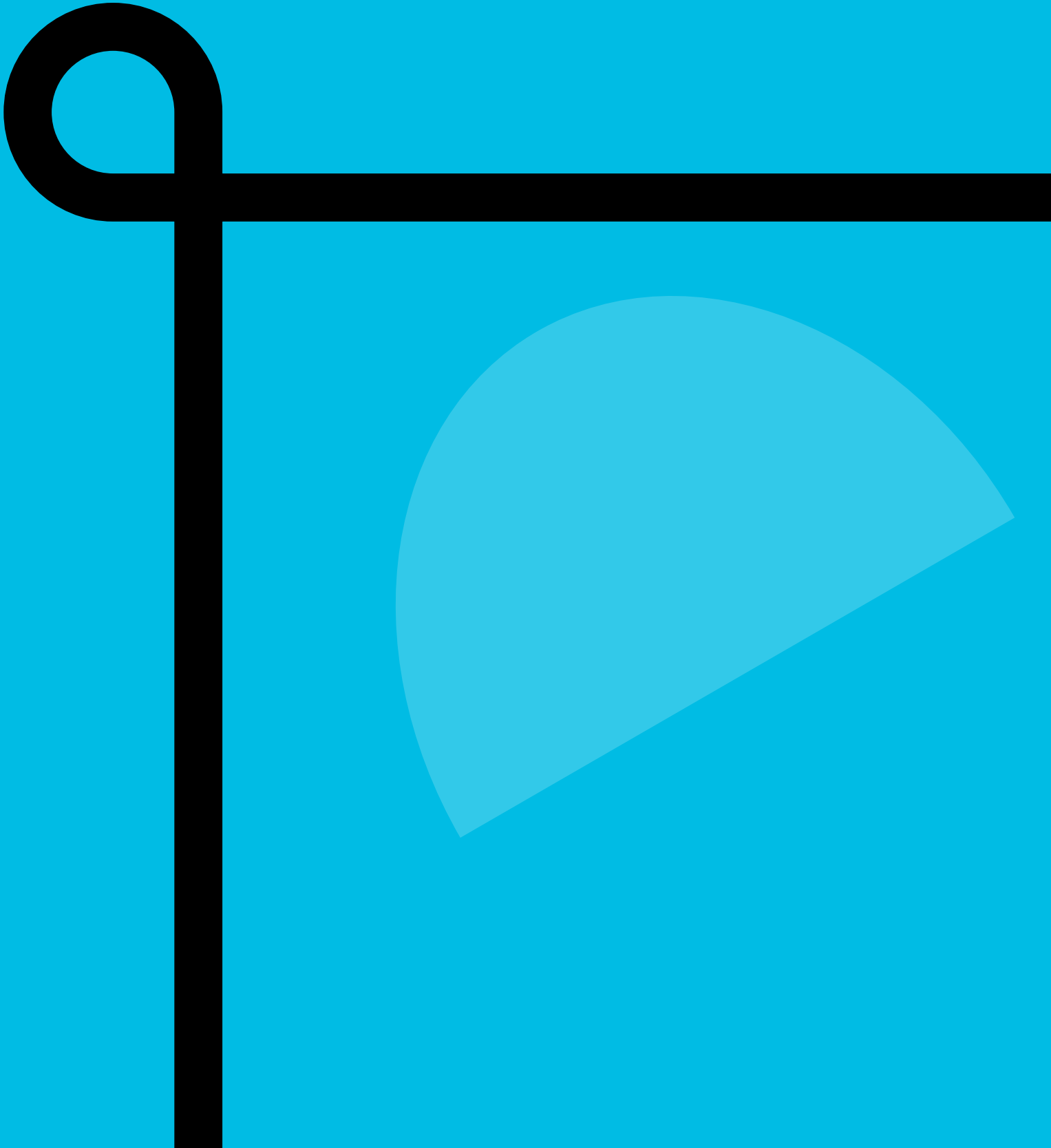
## Implications

Highly dependent on the export of a few base commodities, Ukraine fails to exploit its competitive advantages. As a result, the economy remains undiversified and growth anaemic; which makes it nearly impossible to close the widening fiscal gaps. Its declining demography puts additional pressures on growth prospects and pension systems. Effectively, the country finds itself in an economic Catch 22, as it is unable to grow itself out of its debt while building ever more debt in the process. Despite institutional weaknesses, multiple downgrades of sovereign credit rating, and escalating costs of borrowing, the state soaks up large portions of the country’s resources as public sector employment soars.

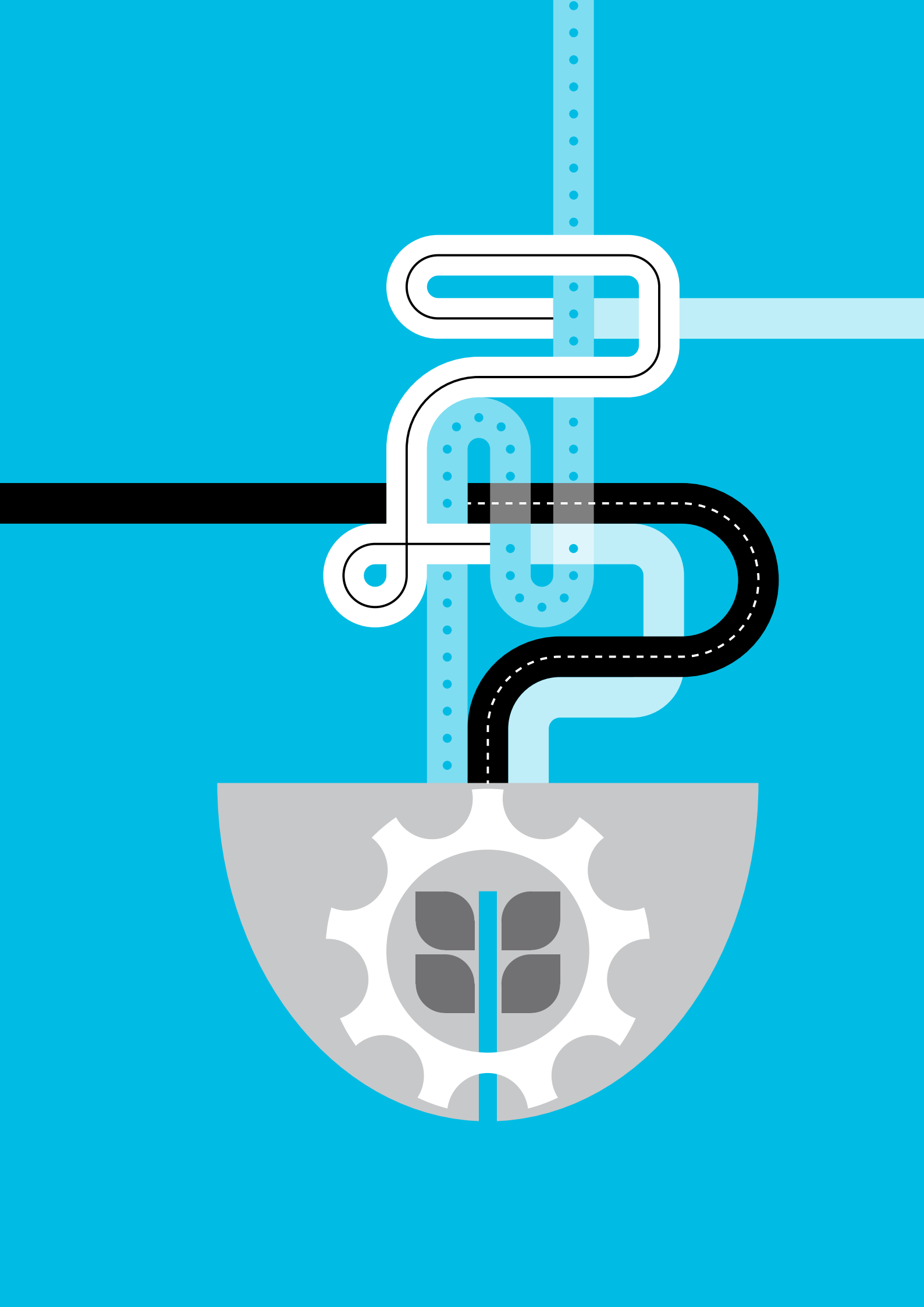
State-owned enterprises (SOEs), especially in the energy sector, risk bankruptcy and already weak public infrastructure is in a state of utter despair. The unreformed pension system is on the brink of collapse as Ukraine’s aging population exacerbates dependency ratios to unprecedented levels. Nonetheless, populist measures to justify inaction are increasingly met with widespread apathy in the population, which further drives complacency in policy-making; leaving the country in sustained crisis. Some will be more strongly hit than others, but there will be no winners in this scenario. Even the most successful companies suffer from devaluation of their assets and restricted access to capital markets.

This is the scenario of polarization and inability to act that inadvertently leads to a downward spiral. Even if unwillingly or unconsciously, the inability to agree on a common agenda makes stakeholders the culprits of gradual but certain economic and societal decline.

# Back to the Future









## External Economic Context

Global energy prices remain high as expectations of the possible expansion of the US shale gas revolution to other regions of the world never fully materialized. Despite resuming global growth, overcapacity remains a key challenge in the global steel industry and trade relations are conflictual. Such conditions are a clear challenge to Ukraine's growth model of the past decade. However, steady population growth coupled with soaring middle class consumers in emerging markets increases the pressure on food markets turning agriculture around the world into an increasingly strategic sector.

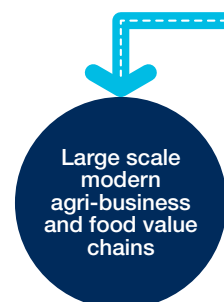
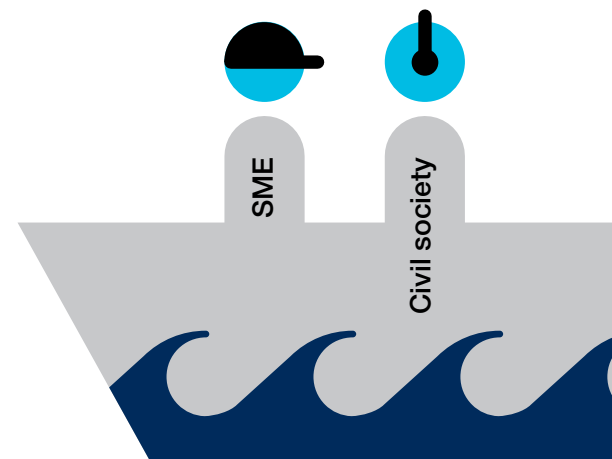
## Post-crisis Pathway

A post-crisis government finds itself under tremendous pressure to act, to show results, and to grow the economy. Stamping out corruption and overcoming vested interest proves too difficult a task; and thus efficiency is chosen over real reforms and quick wins over long-term vision. Big business establishes its position as a co-pilot with the government and promises to lead the country out of the crisis.

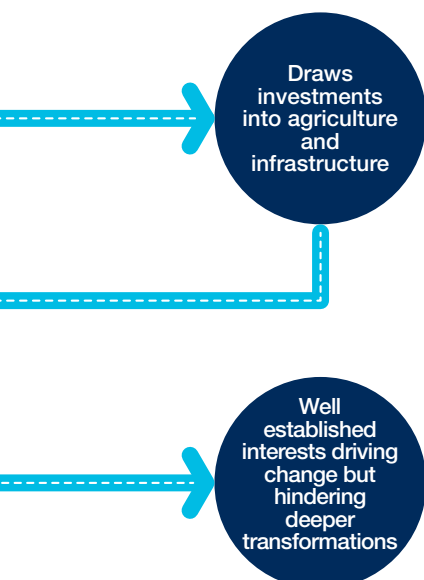
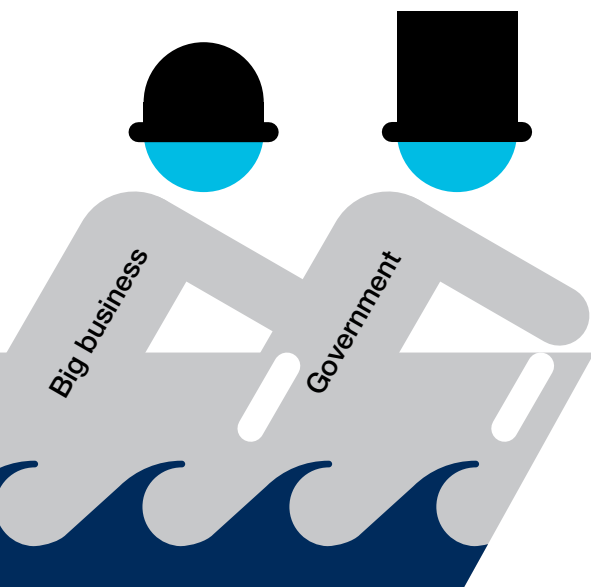
Aware of the enormous wealth buried in Ukraine's black soil, policy makers implement targeted measures to channel investments into this strategic sector. The priorities of the National EXIM Bank, Development Bank and National Project Agency are redefined to focus on the development of the country's agriculture and the upgrade of its infrastructure. Investors from food insecure regions with strong investment potential such as the Gulf region, China and other Asian markets are directly targeted. In addition, a special budget is released to strengthen the country's economic diplomacy and new Ukrainian Trade Centres are opened in various emerging market hubs to establish direct cooperation with local authorities.

This straightforward and diligently implemented top-down process transforms the agricultural sector into a highly productive and industrialized food value chain. But rather than being the result of an inclusive development process, these measures largely serve as reactive stop-gap activities to combat severe budgetary pressures. The more far-reaching and difficult reforms are eternally deferred under the return of plutocracy that characterized Ukraine's governance model since independence. Half-measures and razor-sharp focus on quick wins in strategic sectors deliver the promised growth, but leave little room for a holistic economic development strategy.

**Deteriorating external conditions create an immediate sense of urgency for limited but targeted reform measures. Top-level actions to support strategic sectors and new trade and investment perspectives lead the economy towards renewed growth, but stop short of**



a comprehensive transformation of the system. Existing structures are perpetuated and small businesses struggle to become part of these new perspectives. The system thus finds a new equilibrium, but fails to undergo fundamental change, which limits its potential in the long term.



Looming large over this development is the gravitational force of old habits. The culture of corruption has penetrated so deep into the minds of bureaucrats, businesses and citizens that it is just too hard to overcome. Together with the pressure of unreasonable expectations, even well-meaning and competent reformers at the top are pulled into this pathway back to the future.

## Implications

This process reinforces the position of vertically integrated national champions that clearly put Ukraine on the map as an indispensable trade partner and a leading global food hub. More than half of this industry's output is produced by large agricultural holdings giving Ukraine unprecedented geopolitical weight in an increasingly food insecure global arena. Although decision-makers pride themselves on achieving high growth rates, the country's human development stagnates as income inequality soars leading to increasing polarization of society as a whole.

The agribusiness sector is heavily branded as the country's flagship sector and its main vector of economic development. The huge focus on channelling investments in this sector bears its fruits and allows its full mechanization with the latest generation of machinery and storage facilities, as well as the systematic use of high quality fertilizers. Those measures put Ukraine on a level playing field of productivity with other world agricultural powerhouses.

Some observers point out the growing corruption and opaque bidding process surrounding the development of this sector. Furthermore, the latest report on Ukraine published by a leading consulting firm warns about the increasing risk of indiscriminately using land lease and bilateral grain deals to plug the fiscal gap, as this cannot be done indefinitely.

In parallel, the focus on large-scale agriculture leaves the rest of the economy in neglect and renders all efforts to improve the business climate nationwide irrelevant. SMEs continue to languish; and dynamic growth of the middle class is nowhere in sight. Despite its fast progress, the surge of the agri-sector fails to deliver a multiplier effect on the rest of the economy.

This is a scenario driven by astute decision-makers who, reacting to external impetus, manage to steady the ship for the time being. However, change is essentially postponed by and in favour of a few powerful groups, remaining a fundamentally top-down process rather than the result of a broad societal effort. Although triggering and driving these transformations, well established interests will soon represent an obstacle to deeper change in the economy, limiting its long-term potential.



# Conclusions: Finding Common Ground for the Way Forward

The analysis presented in this report indicates that Ukraine has the potential to position itself as a key player in tomorrow's global economy. So far, however, Ukraine has largely been a passive and reactive player: growing fast during the global commodities boom of the early 2000s and then contracting even faster during the downturn period. Its current economic fragility has also made it dependent on external assistance, which has been subject to fierce geopolitical manoeuvring between Russia and the European Union.

External pressures aside, Ukraine now stands at a crossroads with respect to the socio-economic model it chooses and the strength of the social contract that it can establish between the government and society. By building a strong and resilient economy based on transparent institutions, as suggested in the Virtuous Circle scenario, Ukraine can be in a position to define its own destiny. The choice is largely up to the main stakeholders in the Ukrainian economy, who need to find common ground for a strong, forward-looking agenda for the country and its place in the wider region.

Deep institutional reforms are the main instruments that Ukrainian stakeholders can use to escape the country's current low equilibrium and kick-start the modernization of the economy. Even while facing the most serious geopolitical confrontation in recent history, Ukraine's capacity to foster strong and agile domestic institutions will define the country's ability to adjust to the changing environment and deliver lasting prosperity to its citizens.

External policy anchors such as the Association Agreement with the European Union can be important catalysts for this institutional reform agenda. Yet, concluding such an agreement cannot in and of itself guarantee successful implementation of reforms unless there is genuine political will and wide-ranging support from all stakeholders. It will also require efforts on all sides to overcome the divisions between Russia and the EU that this process has stirred up and that culminated in the current crisis.

The intent of the Scenarios for Ukraine process was to build momentum behind a constructive society-wide dialogue on Ukraine's economic future, fostering an environment in which these reforms can effectively be implemented.

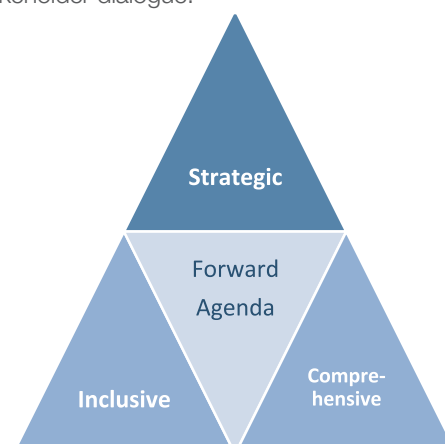
The three scenarios presented in this report describe possible pathways to the country's economic future, one of a fundamental

transformation, one of collapse and one of a new equilibrium within the current system. Each holds important lessons about the long-term imperatives and immediate actions required to ensure a sustainable basis for Ukraine's future prosperity.

Three attributes have characterized the Scenarios for Ukraine process, and could form the basis of a forward-looking agenda that succeeds in finding common ground among all stakeholders, both internal and external.

- 1. Strategic rather than tactical thinking:** Economic reforms need to be conceived with a systemic long-term view of the country's place in the region and its comparative advantage in an evolving global context. While potentially providing the country with short-term benefits, playing external partners against each other is unlikely to provide long-term prosperity for the country or the region.
- 2. Inclusive rather than divisive processes:** Developing this agenda and building the requisite momentum for implementing it will require effective cooperation among stakeholders. Strategies that unite, therefore, need to prevail over actions that deepen divisions.
- 3. Comprehensive rather than piecemeal approach:** The Ukrainian economy is a large and complex ecosystem embedded in a larger regional system, and isolated measures in one part of the system are unlikely to have fundamental effects over the long term.

Following these principles, the World Economic Forum remains committed to supporting Ukraine and acting as an impartial platform for this constructive and forward-looking multistakeholder dialogue.



# Annex: Process and Stakeholder Engagement

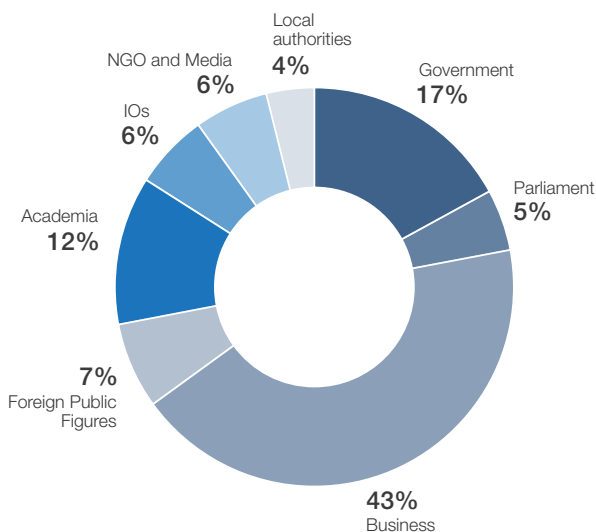
Through its Strategic Foresight practice, the World Economic Forum provides a unique, neutral platform and a powerful process for engaging the country's public and private sector leadership with the international community in a forward-looking strategic dialogue on possible future pathways for the economic development of Ukraine.

The value of this project lies in its participatory nature. It builds on a dedicated 12-month process that involved three distinct phases:

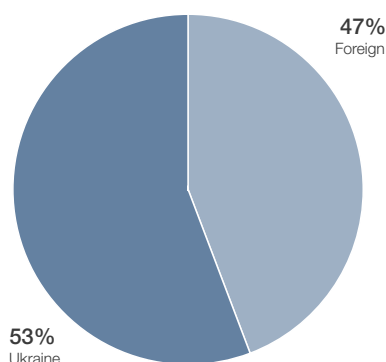
- Exploration and analysis of stakeholders' views, internal challenges and external forces that influence the country's economy.
- Elaboration of different scenarios for the future of Ukraine, exploring different pathways and outcomes that illustrate the opportunities and challenges ahead.
- Discussion of implications of the scenarios for different stakeholders and actions to be taken.

The process engaged more than 300 leaders and decision-makers from different sectors and origins, constituting a real multistakeholder policy dialogue about the future of the Ukrainian economy.

## Stakeholder groups



## Origin



## Milestones

**World Economic Forum Annual Meeting 2013**  
Davos-Klosters, Switzerland, 23-27 January 2013

**Scenario Development Workshops**  
Kyiv, Ukraine, 4 July 2013  
London, United Kingdom, 2 September 2013  
Dnipropetrovsk, Ukraine, 7 October 2013

**World Economic Forum Strategic Dialogue on the Future of Ukraine**  
Kyiv, Ukraine, 5-6 November 2013

**World Economic Forum Summit on the Global Agenda**  
Abu Dhabi, United Arab Emirates, 18-20 November 2013

**World Economic Forum Annual Meeting 2014**  
Davos-Klosters, Switzerland, 22-26 January 2014

## The Value of Scenarios

Scenario thinking is a powerful strategic management tool that can be used in the private, public and non-profit sectors as well as in a multistakeholder context. While scenarios are often used to provide public and private decision-makers with tools to anticipate potential hazards, they have also proven to be a powerful tool for creating opportunities – in the form of new policies, new strategies and the forging of new connections – by freeing thought from the constraints of the past.

Scenarios can enrich learning as well as decision-making at both the country and company level. In particular, they provide leaders with the ability to:

- Enhance a policy's or strategy's robustness by identifying and challenging underlying assumptions and established wisdom.
- Make better strategic decisions by discovering and framing uncertainties, leading to a more informed understanding of the challenges involved with substantial and irreversible commitments, and contributing to strong and pre-emptive governmental or organizational positioning.
- Improve awareness of change by shedding light on the complex interplay of underlying drivers and critical uncertainties, and enhancing sensitivity to weak and early signals of significant changes ahead.
- Increase preparedness and agility for coping with the unexpected by making it possible to visualize possible futures and mentally rehearse responses.
- Facilitate mutual understanding and collaborative action by providing different stakeholders with common languages and concepts in a non-threatening context, thereby opening the space for creating robust, effective and innovative multistakeholder strategic options.



# Annex: References

## Endnotes

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