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Ukraine's Economic Problems and the Possibilities to Increase EU Support for Small and Medium-sized Enterprises

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At the beginning of 2013, the Ukrainian economy will probably enter into recession. In order to encourage economic growth, the Ukrainian leadership is seeking loans from abroad whilst also avoiding the implementation of reforms aimed at the improvement of the country's investment climate. Taking into account the increasingly difficult cooperation of Ukraine's authorities with the European Union, Member States should focus on the support of small and medium-sized enterprises as well as actions that support and the promotion of the benefits of the reforms.

The Worsening Economic Situation of Ukraine. In the last few months, the Ukrainian economy has been seriously suffering. In the third quarter of 2012, the Ukrainian GDP decreased for the first time since 2009. Industrial production and growth of direct foreign investments are also shrinking. There is significant probability that the Ukrainian economy will enter into recession at the beginning of 2013. The basic explanation for the economic problems is the neglect of structural reforms during the independence period. Economic growth and the tax revenues in Ukraine's budget were based on exports of low-processed products from the metallurgic and chemical industries, which are controlled by large enterprises (a third of exports). A worsening situation in the international markets, including a slowdown of exports to the EU, as well as the maintenance of high prices of imported sources of energy—particularly gas, essential for the energy-intensive industries—has adversely affected Ukrainian trade and increased the risk of destabilising public finances.

The worsening economic situation is dangerous for the present leadership as it is largely dependent on a favourable international economic situation, from which the large financial and industrial groups controlling the most important sectors of the country's economy were profiting. Because of political–business connections, the Ukrainian authorities are interested in maintaining their privileged status. This limits the possibilities to improve the economic situation to reforms supporting the development of small and medium-sized enterprises (SME). The Ukrainian government is also unwilling to introduce budget cuts for fear of losing public support. In particular, the state-owned gas and oil company, Naftohaz, whose 2011 deficit accounts for around 30% of the accumulated deficit in Ukraine's state sector, is still subsidised from the budget. By granting these subsidies, the authorities are attempting to preserve Naftohaz's competitive advantage in the export-oriented chemical and metallurgic industries as well as maintain low gas prices for individual recipients. The Ukrainian government is therefore forced to seek external sources of financing current needs, which influences Ukrainian politics towards its key international partners.

External Sources of Financing Ukraine's Current Needs. Although it is one of Ukraine's major international donors, the EU has no instruments to respond to the worsening economic situation of the country. The overall amount of EU support is difficult to estimate since it consists of the scattered actions of Member States and EU institutions. At the EU level, support is planned years in advance and is subject to the implementation of structural reforms. It is also relatively small. The budget of the national programme of the European Neighbourhood and Partnership Instrument for Ukraine for the period 2007–2013 amounts to less than €1 billion. The EU also supports several infrastructure projects in energy and transport through the Neighbourhood Investment Facility (its total contribution is currently less than €20 million). From the point of view of the long-term development of Ukraine, potentially the biggest benefits can be connected with the creation of a deep and comprehensive free trade agreement (DCFTA) under an initialled but as yet unsigned Association Agreement with the EU. Its implementation could become a support tool for the modernisation of the Ukrainian economy through the improvement of the investment climate and the public finance situation and macro-economic stabilisation. The introduction of these reforms remains uncertain. This is demonstrated by the suspension of credit payments (worth around $16 billion) from the International Monetary Fund, agreed in 2010. The reason for this was the failure from the Ukrainian side to implement the terms, namely the introduction of reforms compatible with the EU's expectations, including an end to the subsidy of Naftohaz.

An alternative source of external financial aid is Russia. In 2011 and 2012, the government increased the public debt, allowing Naftohaz to receive loans (altogether worth around $2.5 billion) from Russia's Gazprombank. Furthermore, the Ukrainian government is constantly seeking a change to the 2009 contract on the purchase of Russian gas, which would permit the lowering of gas prices. The Russian leadership does not exclude the possibility of extending further help or lowering gas prices, but conditions it on Ukraine's entrance to its customs union, consisting of Russia, Belarus and Kazakhstan. In the long term, Ukraine's participation in the project would mean an increase in the risk that Russian capital would take over key Ukrainian businesses, necessary reforms would be skipped and, therefore, the country would suffer a drop in competitiveness in world markets. It would also be linked with the risk of neglecting modernisation efforts as well as with difficulties in economic relations with other countries, including the EU.

In 2012, the Ukrainian government intensified its search for new sources of external financing. In August, a credit cooperation agreement with China was initiated. The government allowed an increase in public debt through Naftohaz's loans in the government-controlled China Development Bank. According to media reports, a $3.6 billion debt would be used to modernise four heat-and-power plants by adapting them to use coal instead of gas. These actions were presented by the Ukrainian leadership as efforts to decrease the economy's dependency on gas. The real influence of these investments will, however, only be visible in a few years. Moreover, the terms of the contract with China predict the purchase of Chinese technology, which is associated with a risk of strangling internal production in the long term by subsidising imports.

Conclusions and Recommendations for the European Union. The debts accumulated by the Ukrainian authorities in the last few years are not correlated with a thoughtful strategy for the country's development and economic modernisation. The benefits of these decisions are usually directed to cover immediate needs. This kind of situation cannot be maintained in the long term, as further neglect of basic structural reforms would result in growing difficulties in dealing with already existing or possible new loans. The situation on the international market and its demand for key export products from the Ukrainian economy will largely determine Ukraine's position in international relations in the near future. The Ukrainian authorities are avoiding any explicit declaration on accession to the Russia-Belarus-Kazakhstan customs union, although some information has appeared in the press suggesting such a scenario may be close at hand.

Expecting Ukraine to carry out major reforms in return for financial support, the EU has limited competition vis-à-vis the Russian and Chinese proposals. The EU's long-term comparative advantage consists of the forms of integration offered to Ukraine. The EU and Poland should therefore focus on informative actions, underlining that cooperation with the EU would increase the predictability of the regulatory system, transparency of the tax system, efficiency of the judiciary, and the effectiveness of social control over the management of public funds. They should also note that the infrastructure investments supported by the NIF have little chance of success without the support of the EU.

The EU should also direct its efforts in support of the SME sector in Ukraine. For this purpose, the East-Invest programme, launched in 2011 and aimed at facilitating the exchange of experience between the public and private sectors of the European Union and the Eastern Partnership, should be developed. The EU should consider creating new training and educational programmes promoting entrepreneurship, knowledge of economic basics and the transfer of the practical knowledge necessary for the development of business on the basis of that instrument. These priorities should also be strengthened within the framework of the Polish development assistance. The creation of micro-credit mechanisms for SMEs should be considered. The growth of their importance could become a convincing argument for the government to improve an investment-friendly environment and the modernisation of the economic system.