



BULLETIN

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Modernisation Needs of the Ukrainian Army: Prospects for Its Defence Industry

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The Ukrainian government has significantly accelerated the pace of modernisation of its national army. Such a move will not only provide for better equipping troops fighting in the east, but will contribute to the cessation of the Ukrainian defence industry's dependence on Russian supplies. Potentially, it would also give a significant boost to the state economy. If these effects are to be achieved, the "Development of the National Defence Industry by 2017" plan, adopted by the Ukrainian president Petro Poroshenko in 2014, must be put into action. However, while implementing this strategy Ukraine should focus not only on meeting the immediate needs of its armed forces, but on the initiation of long-term defence industries cooperation (for example, with Poland).

Decades of neglect in the area of economic reforms, as well as ongoing conflict in the east of the country, have had an enormous negative impact on Ukraine's economic performance. There has been a GDP slump, a decline of approximately 6% in the pace of economic growth, the collapse of the hryvnia against the euro and the dollar, and hyperinflation. In April 2015, Ukraine was rated CC (previously it had been CCC-) by Standard and Poor's, which means that its economy is "highly vulnerable." The instability generated by the war also has a negative influence on the climate for foreign investors. The flow of economic aid to the country (mainly loans from the IMF) will help to stave off the most severe effects of the crisis temporarily, but in the long term it is necessary to activate the industries that now have a large industrial base and can become a centrepiece of sustainable economic growth of the state. Among them is the defence sector. In the years preceding the crisis, Ukraine was ranked the eighth largest arms exporter and, according to Congressional Research Service data for the period 2008–2011, it received more than \$4 billion from export.

The State of the Ukrainian Armaments Sector. Despite its huge potential, the Ukrainian defence sector needs a thorough overhaul, an inflow of modern technologies, and increased efficiency. Currently, the domestic industry secures only approximately 30% of the needs of the Ukrainian army (approximately 180,000 soldiers). It is incapable of providing several crucial weapons systems, including armoured infantry, communications, radar systems, anti-tank missiles, drone reconnaissance UAVs, sniper rifles, medical equipment, or individual equipment for soldiers (uniforms, bulletproof vests, helmets and so on). Its exports have also dropped substantially, with revenues from sales abroad shrinking to approximately \$250–300 million in 2014. This is due to the fact that production in the Ukrainian defence companies was seriously dependent on supplies from Russian components (estimated at up to 30,000 various kinds of elements). During Soviet times, when Ukraine was not an independent country, the Ukrainian factories were part of the chain of supply of equipment and weapons in the USSR, where production was dispersed to prevent decoupling of the armaments sector of USSR republics. According to data provided by SIPRI, approximately 60% of production of the USSR was closely connected with plants in Ukraine. In more than 1,800 enterprises in Ukraine, employing approximately 2.7 million employees, ships, rockets, anti-tank missiles and Antonov transport aircraft were among the products.

After the collapse of the USSR, Ukraine inherited this extremely broad foundation for an armaments industry. Over the past two decades, some plants have been restructured, though many of them remain dependent on Russian companies for the supply of various components and parts or servicing. Due to the cessation of orders from Russia,

which was one of the crucial export markets for Ukraine (for example in the space sector, which in 2014 noted a decline of more than 30% in revenues and was forced to suspend some programmes), many of them reduced their activities significantly. This downward trend (it is estimated that approximately 40% of the Ukrainian plants are dependent on imports, mainly in the rocket, aircraft, and engines industries, among others) will deepen even further due to last year's decision of the Ukrainian government to finally halt cooperation with the Russian Federation in the field of armaments cooperation. According to various estimates, it has so far meant a loss of approximately 3.3 billion hryvnia. Ukraine exported, among other things, parts and military electronics components (on-board instruments, electronics, and radio devices) and imported turbine drive systems for ships, aircraft engines and components, parts of cruise missiles, air defence radar components, aircraft engines and their components, parts for missiles, air defence radar units, and more.

The conflict in Ukraine also had a negative effect on other export commitments undertaken in 2008–2013. The government decided that weapons intended for export would be transferred to the Ukrainian army (such weapons included T-64BVI tanks contracted by the Democratic Republic of Congo, and several APCs ordered by Thailand). Due to the annexation of Crimea and the divestment of the local plant by Russia, Ukraine was also unable to meet orders for howitzers for China (the order was finally taken over by Russian arms supplier Rosoboronexport).

Attempts to Reform. Despite these difficulties, the Ukrainian government has adopted a number of solutions that may contribute to better meeting the needs of the Ukrainian army (and the national guard, established in 2014 to protect the state border), and boosting the development of the defence sector. As early as in 2010 a partial consolidation of state-owned enterprises was initiated through the establishment of Ukroboronprom, which currently consists of 130 plants and export companies (for example, Ukrspetsexport), employing a total of approximately 70,000 people (though, due to the ongoing conflict, it lost *de facto* control over a dozen strategic plants in Crimea and in the eastern part of the country). The national development programme adopted in 2014 assumes investments of approximately \$1.3 billion in restructuring the defence industry (approximately 80% of the companies within Ukroboronprom are to be covered by the programme), the acquisition of new technologies, and investment in R&D. This is crucial, as in the domain of cutting edge technologies the Ukrainian defence industry remains far behind the world leaders, and currently has no capabilities to produce high-tech components (microprocessors, microelectronics, and nanotechnologies). Two thirds of the programme is to be financed by the companies themselves (as some have huge assets at their disposal), as well as external investors and banking sector. The programme also envisages the privatisation of 15% of the companies, the restructuring of 60%, and the closure of 5%. The plan also includes the establishment of a national acquisition agency.

In the near future, Ukroboronprom is going to provide the Ukrainian army with approximately 40 tanks and 50 light armoured vehicles (so far, approximately 700 weapons systems units have been modernised and approximately 350 have been created from the scratch). Despite this positive trend, the current challenges facing the Ukrainian army are much more demanding. A rapid pace of reform is also required, taking into consideration the weak conditions of some enterprises (for example, the high accident rate), which also face many problems after losing important markets and the possibility of manufacturing some products.

Prospects for Cooperation with NATO Countries. In order to lessen ties with Russia, the most favourable option would be to establish long-term cooperation first and foremost with NATO partners. Apart from the obvious political benefits to be achieved from this type of cooperation, the Ukrainian enterprises can cooperate with leading international defence industries. The Ukrainian government should, however, avoid the trap of buying “off the shelf” (completed products) since this does not provide the necessary impulse for economic development, which may be gained only by initiating long-term cooperation on the development of joint programmes, assuring transfers of modern technologies, and positioning Ukrainian enterprises as part of the global supply chains. This would strengthen the competitiveness of the Ukrainian defence sector as well as easing companies' ability to enter new export markets and moderate the negative consequences of suspension of cooperation with Russia.

Huge interest in the Ukrainian market flows primarily from U.S. and French companies (some of them have already signed a number of commercial agreements for the supply and modernisation of various equipment and weapons), as well as some Polish companies (for example, Lubawa SA, WB Electronics, and Maskpol). On the Ukrainian side, there is growing interest in cooperation with the Polish defence industry, which presents the possibilities of modernisation of heavy equipment or supplying Ukraine with communications equipment, much needed logistics, optoelectronics and the like. Among others, the aviation sector is particularly promising here, as the Ukrainian Motor Sich's proposal to supply engines for Sokol helicopters or assemble them in its plants, or the possible transfer of production of some versions of the particularly successful Antonov transport aircraft (which has been used widely in EU and NATO operations), could provide Ukraine with the opportunity to have its aircraft certified in the EU area and ease its entry into European markets.

To achieve a position as a serious partner for Western industries, the current Ukrainian government must, however, make a serious attempt to improve the damaged image of Ukrainian industry, which is affected by a high level of corruption, a lack of transparency, the supply of arms to embargoed countries (as disclosed by Wikileaks), and a certain level of disorganisation in state-owned Ukroboronprom (as recently as 2014 there had been several changes in the management of the company).