ECONOMIC CONNECTIVITY IN UKRAINE

A REGIONAL FOCUS

A survey of enterprises across Ukraine

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CASE UKRAINE

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ECONOMIC CONNECTIVITY OF UKRAINE: A REGIONAL FOCUS

A. Executive summary

The Report "Economic Connectivity of Ukraine" examines how the on-going armed conflict in the East of Ukraine, the annexation of Crimea by the Russian Federation, and the overall political tensions in Europe have affected trade relations and the business climate of Ukraine. The report takes a company's perspective to review in detail 1) internal connectivity between Ukrainian territories, and especially with Crimea and areas of the Donbas not under Ukraine's control; and 2) external connectivity with Ukraine's main trade partners including Russia and the European Union (EU).

Internal connectivity:

Disrupted internal economic connectivity has depressed Ukraine's economic output: many respondents reported that they stopped trading with the non-government-controlled Donbas. The Ukrainian government has restricted trade, making it practically impossible to trade officially with these territories. Economic activities in the region are down due to severely damaged or destroyed production facilities and economic infrastructure. The conflict has caused distorted production chains with the rest of Ukraine in key sectors like metallurgy, machinery and electricity production, resulting in shortages of raw materials.

The annexation of Crimea affected Ukraine's economy less since Crimea had contributed less to Ukrainian GDP before annexation. What is more, Ukraine has enacted a trade embargo for Crimea starting only in January 2016, i.e. after the survey had been finished. While the trade with Crimea was still legally possible throughout the survey period companies indicated that it had become more problematic due to the sealing off of the administrative boundary line and Crimea's de facto joining of Russia's regulatory framework.

Trade restrictions are encouraging illegal activities and semi-legal trade schemes.

Despite the newly created dividing lines and restricted trade within Ukraine, businesses continue to trade across the contact line between government- and non-government-controlled territories in the Donbas. However, the restrictions create more opportunities for illegal activities including bribery and smuggling. Bribes translate into higher prices on Ukrainian products which are passed to the uncontrolled territories. Those maladies mainly reflect on small and medium-sized companies, while large companies tend to have better means to overcome current restrictions.

Businesses in areas controlled by the "DPR" and "LPR", and in Crimea are not allowed to engage in the international trade. Even Russian companies cannot legally trade with the areas controlled by the "DPR" and "LPR". There is no access to the international banking system in any of these areas. Despite these limitations there are semi-legal systems operating there to ensure international trade and payments: Businesses working in areas controlled by the "DPR" and "LPR" are registering with Russian non-banking credit unions and working with brokering companies in South Ossetia to gain access to the global market. Crimean business also works through brokering companies registered in Russia.

Restricted trade with Ukraine is forcing the non-government-controlled territories in the Donbas and Crimea to expand economic connectivity with Russia. With trade restrictions imposed by Ukraine, businesses in non-government-controlled territories are relying more on supplies from Russia. They are replacing Ukrainian products with their Russian equivalents. Closer economic ties with Russian business lead to further disintegration of traditional connectivity in the region. Similarly, businesses in Crimea reported that it is easier for them to work with Russian companies and many are expanding into the Russian market.

Ukraine's decaying infrastructure has been further damaged by the conflict reducing economic connectivity and business opportunities. Roads, railways and the electricity network near the conflict zone have been ruined by fighting. The roads in neighboring regions suffered from damage caused by transporting military equipment to the conflict areas.

Internal economic connectivity within Ukraine is increasing as businesses are replacing lost markets in the Donbas and Crimea. Businesses reported looking for internal replacement markets for the Donbas and Crimea. New links between businesses in government-controlled territories of the Donbas have been established with clients in western and central Ukraine.

External connectivity:

Businesses across Ukraine experienced a decline in sales with Russia and the EEU: The negative trend in trade with Russia started even before the outbreak of the conflict as Ukrainian businesses started trading more with EU and Asian countries. During 2013-2014 the trend accelerated with informal Russian trade bans on food products and difficulties accessing the Russian market.

Russian economic decline and sanctions on the EU has decreased trade with Ukraine: the decline in economic activities and decreased consumer consumption in Russia have decreased trade between Ukraine and Russia. In addition, Russian sanctions of EU exports have decreased business for Ukraine's brokering and logistics companies traditionally working on Russian market.

Ukrainian businesses are poorly prepared for DCFTA implementation: Attitudes and opinions on EU integration and benefits of the DCFTA are mixed: many businesses simply do not understand what it means for their enterprises. Only a few businesses reported getting specific EU certification or exploring EU markets for potential trade.

It will take time for Ukraine to benefit from DCFTA: None of the respondents reported benefiting from the unilateral removal of the trade barriers by the EU. Due to low awareness about the opportunities offered by the DCFTA and poor access to additional financing Ukrainian businesses will hardly be able to benefit shortly from removed trade barriers.

The internal regulatory environment is limiting opportunities for trade: businesses reported inconsistent customs procedures that created limitations. The delay at customs, need for excessive bureaucratic procedures and expectation of bribes limited opportunities for expanding into new markets. In addition, specific sectors reported that Ukraine's certification system is inconsistent with the EU's, making it more difficult to access the EU market.

B. Overview of the study

Ukraine has changed rapidly since Russia's annexation of Crimea and the outbreak of fighting in the Donbas. The destruction of infrastructure, new dividing lines and the closing of the Russian market, while the EU market has opened, have all permanently changed Ukraine's economy. This study is unique, as it pays tribute to Ukraine's economic diversity by focusing on several of its regions, while also taking an industry perspective by conducting interviews with local large and medium-sized private enterprises about how their businesses have changed their operations in 2014-2015 in comparison with pre-conflict period. The focus of this report is on how enterprises are dealing with the country's evolving political, social, economic and security dynamics and how that is changing the national economy.

The aim of the study is to share information about local economic conditions that will aid the Ukrainian government, international donors, and the OSCE in improving Ukraine's economy.

The following sections will first give an overview over the methodology employed and then summarize the main findings across Ukraine for changes in trade dynamics and the business environment. The annex to this summary report presents the detailed findings per region.

Analytical Framework

"Economic Connectivity" means trade and economic exchange between different political entities. Hence, this report focuses on the contextual factors that are enabling or hindering trade and economic exchange between different territories in Ukraine and between Ukraine and the rest of the world. This study focuses on conflict-related aspects, yet economic connectivity can also be influenced by the institutional framework and the actions of authorities, or even broader macroeconomic trends. Specifically, the report looks at economic connectivity at two levels: 1) internal connectivity, including with Crimea and the non-government-controlled Donbas; 2) external connectivity, focusing on Russia and the EU.

The study is organized by region to present the economic situation on the local level and show how it is shaping the national economic picture. Ukraine's regions have different key export markets, leaning towards Russia and the Eurasian Economic Union (EEU), or the EU. Prior the conflict those economic orientations fed into the appeal in different regions of the two integration projects. This report looks at how those economic orientations have been affected by changes in the political context.

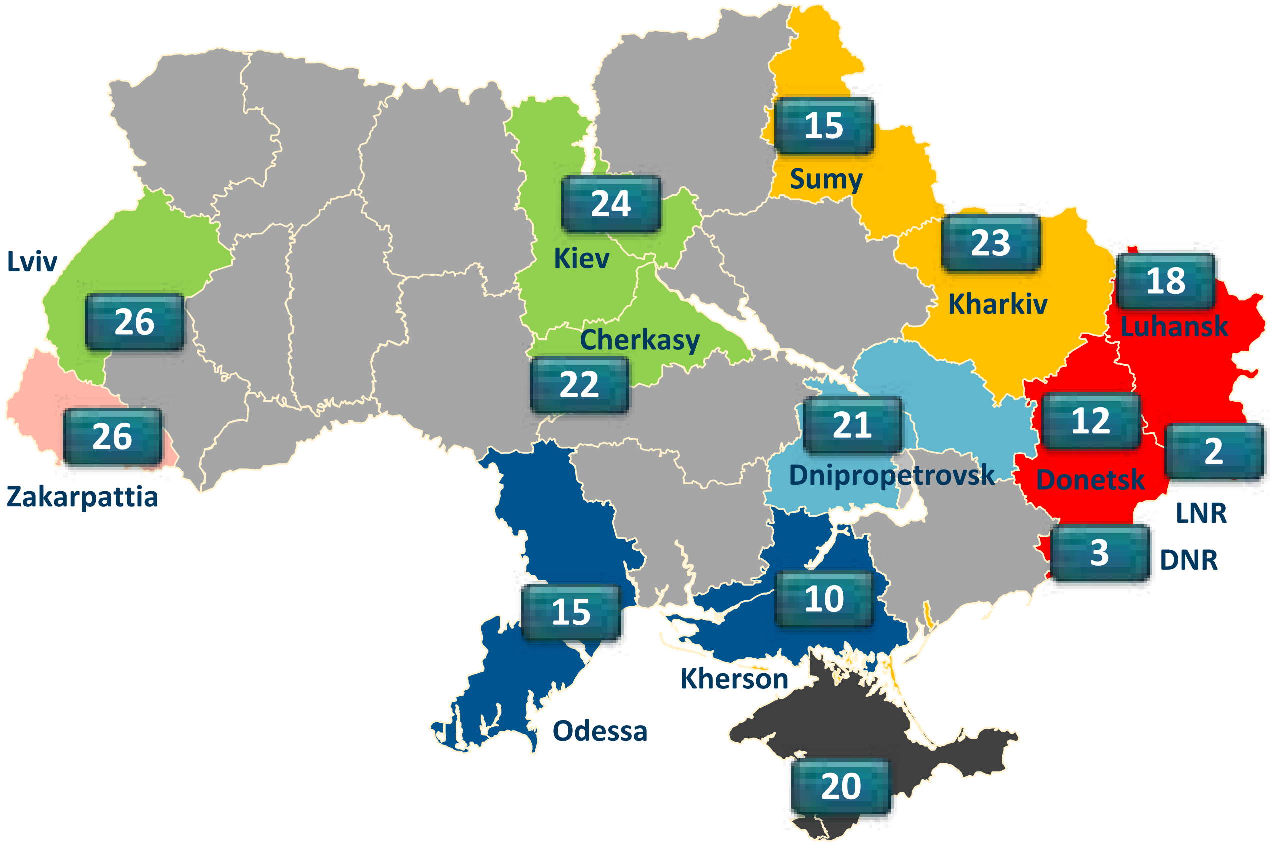
Methodology

To ascertain the effect of the security situation on economic actors the research group surveyed large and medium enterprises in the 14 selected regions shown below. From July to September 2015, 237 face-to-face interviews were conducted with businesses.

To qualify for participation in the survey businesses had to employ over 20 people, belong to one of the primary economic sectors identified for each oblast and could not be state-owned. Interviews were held with companies' senior managers and lasted approximately 1 hour. The research team also conducted interviews with representatives of oblast administrations, and in some cases representatives of the oblast capital's local government, as well as the regional chambers of commerce and industry.

For sampling, the research group identified 7-10 sectors that contribute most to the economy of each target oblast, after which medium and large enterprises in each industry were identified along with their ownership. If the enterprise was not fully state owned it was included in the target sample.

The security situation made some respondents wary of participation and others cautious in answering questions. Respondents were often distrustful of interviewers despite letters of support, and questioned the purpose of the



research, fearing that the results might be used against them by government agencies, separatist groups, army recruiters, competitors or political parties. Even usually simple questions had to be verified, as some companies do not employ all of their personnel legally and thus hide their real employment numbers. In areas close to the conflict zone and the non-government-controlled territories in the Donbas interviewers had issues finding contact information for enterprises.

Main research findings

External Trade

Main trade trends during 2014-9M2015

Ukraine's goods exports dropped by -13.5% year on year (yoy), while imports of goods collapsed by -28.2% yoy in 2014. Exports suffered because of hostilities in the industrial and export-oriented Donbas region, downward correction of world commodity prices and deterioration of trade with Russia. In particular, hostilities in Donbas caused significant damage to infrastructure and production equipment, loss of control over a number of industrial enterprises and transportation routes, and disruptions in production chains in major export industries such as metallurgy and machine building.

At the same time, export performance was aided by the better access to the EU market, a high agricultural harvest and Ukraine's currency depreciation. Import activities contracted due to decreasing economic activity, weakening domestic demand and lower energy production. Overall, the deepest contraction of Ukraine's trade was observed in the second half of 2014 and the first half of 2015, before it slowed in the third quarter of 2015.

Ukraine's top exports have changed over the last two years. Agriculture has become the most significant export accounting for 36.2% in 9M2015. IT and telecom services was the only service category that revealed growth in 2014; its share in total Ukraine export of services grew steadily to 15.8% in 9M2015. Exports of machinery equipment and transport vehicles suffered the most from deteriorating trade relations with Russia. Service exports experienced a considerable slowdown largely due to lower demand for transport services, material resource processing and business services.

Table 1

Ukraine's geographic structure of merchandise exports and imports, 2012-9M2015[1]

	2012		2013		2014[2]		9M2015[3]	
	Billion, USD	Share, %	Billion USD	Share, %	Billion USD	Share, %	Billion USD	Share, %
				Exports of goods				
EU-28	17.1	24.9	16.8	26.5	17.0	31.5	9.2	32.9
EEU	22.5	32.7	19.3	30.6	12.7	23.5	4.9	17.3
Asia	17.7	25.7	16.8	26.6	15.4	28.5	9.4	33.3
Africa	5.6	8.2	5.1	8.0	5.1	9.5	2.8	9.9
America	2.6	3.8	2.2	3.4	1.4	2.5	0.6	2.2
Other countries	3.3	4.7	3.1	5.0	2.4	4.5	1.3	4.5
Total	**68.8**	**100.0**	**63.3**	**100.0**	**53.9**	**100.0**	**28.1**	**100.0**
				Imports of goods				
EU-28	26.2	31.0	27.0	35.1	21.1	38.7	11.1	40.7
EEU	34.0	40.1	27.5	35.8	17.1	31.4	7.5	27.4
Asia	17.1	20.2	15.2	19.8	10.8	19.9	5.2	19.0
Africa	0.9	1.0	0.7	1.0	0.7	1.2	0.5	1.7
America	4.4	5.2	4.3	5.6	3.0	5.6	1.7	6.2
Other countries	2.0	2.4	2.1	2.7	1.7	3.2	1.4	5.1
Total	**84.7**	**100.0**	**77.0**	**100.0**	**54.4**	**100.0**	**27.4**	**100.0**

Half of the businesses surveyed were engaged in international trade. Medium-sized businesses usually trade internationally through brokers to ease the burden of dealing with customs. Respondents reported internal barriers that limit trade. Most cited was the elimination of preferential customs processing through the authorized economic operator status. Respondents reported that limitations on currency exchange have also restricted trade. Customs further complicates the process by keeping imported supplies at the border for months.

The current conflict has caused a steep decline in trade with Russia, Crimea and the non-government-controlled Donbas. The shift has caused businesses to look for replacement markets abroad. Though businesses are optimistic about the EU Association Agreement, few have a concrete plan of how to take advantage of it. As a result, most businesses have focused on expanding on the internal market, and to a lesser extent moving into the markets of Moldova, Kazakhstan, Asia, Middle East, and the US.

[1] Foreign Trade in Goods of Ukraine during 9 months of 2015 (2015, November 16). *Express Editions*, 512/0/08 (2.vn-15).

[2] *Data for 2014 exclude the territory of the Autonomous Republic of Crimea and Sevastopol.*

[3] *Data for 9M2015 exclude the territory of the Autonomous Republic of Crimea, Sevastopol and the zone of the antiterrorist operation.*

Trade with Russia

As has already been indicated above, trade with Russia and EEU has declined. Exports to Russia dropped by -33.7% yoy in 2014 and then halved in the first nine months of 2015 due to decreased access to the Russian market. As a result, Russia's share of Ukraine's total merchandise exports contracted significantly to 12.8% in 9M2015. The most affected commodity groups included railway locomotives and cars, mechanical machines, electrical machines, paper and paperboard, ferrous metals, milk and milk products. Imports from Russia shrank too – mainly due to declining supplies of energy resources. As a result, Russia's share in Ukraine's imports more than halved from 30.5% in 2013 to 13.2% in 9M2015. At the same time, Russia's share of Ukraine's service exports (mainly gas pipeline transport services) stayed at about 30% during this period.

Russia effectively closed its market to Ukrainian goods. Russia implemented trade restrictions on Ukrainian products, including complicated customs procedures, problems with access to public procurement, import bans, due to issues with technical barriers to trade (TBT), and sanitary and phytosanitary standards (SPS). In particular, TBT and SPS related import restrictions were applied to railcars, confectionery, dairy products, alcohol products, juices, vegetables, poultry, sunflower seeds and soybeans. Russia launched these trade restrictions in July and August 2013 and gradually intensified them in 2014. Ukraine responded by introducing limitations on deliveries of military and dual-purpose equipment to Russia. In 2015, trade tensions between Russia and Ukraine intensified as Ukraine banned Russian airlines from using its airspace. Ukrainian producers highly dependent on the Russian market (such as railcars and locomotives, cars and dairy producers) lost their main destination market and were unable to quickly reallocate their external sales to other markets, resulting in a drastic drop in their exports and production. From January 2016, Ukraine lost its duty-free access to the Russian market with Russia suspending the CIS Free Trade Agreement for Ukraine.

Businesses reported several reasons for the decline in trade with Russia. Some respondents reported their sales declined before the conflict due to increased competition from China. Others reported their sales dropped off after Russia instituted informal bans on their goods. Foodstuff producers from Sumy and Kherson oblasts reported not being able to export their goods to Russia because of these bans.

Part of the decline in sales is because of the decline of the Russian economy since the conflict began. The marked decline in the price of oil and the connected loss in value of the Russian ruble resulted in decreasing consumer purchasing power, decreasing imports from Ukraine and elsewhere.

Russian sanctions on the EU have also hurt trade relations between the two countries even though Ukraine is not a member of the EU. Russia implemented sanctions banning imports of certain goods from the EU. Part of that trade went through Ukrainian brokers and logistic companies and as the volume had decreased those sectors have been hurt.

In addition, political polarization has also led to Ukrainian companies choosing no longer to do business with Russian companies and vice versa.

Trade with European Union

Ukraine signed the EU Association Agreement in summer 2014 expecting to implement it in 2015. The Association Agreement includes a Deep and Comprehensive Free Trade Agreement (DCFTA) that provides for the progressive removal of customs tariffs and trade quotas, and for the harmonization of the legislative framework. In response to the security, political and economic crisis in Ukraine, the EU unilaterally removed trade barriers for Ukrainian businesses until the end of 2015. To guarantee Ukraine's access to the CIS market under the CIS Free

Trade Agreement, the EU postponed implementation of the DCFTA until January 2016, while conducting negotiations with Russia and Ukraine. The DCFTA is being provisionally applied since January 2016.

The market opening resulted in a stabilization of exports to the EU in absolute terms, in comparison to a decline with regard to all other markets. In relative terms, Ukraine's trade flows with the EU went up considerably in 2014, slowing down throughout 2015 due to unfavorable conditions.

This aggregate data is reflected in the responses to our survey: Despite the removal of barriers trade with the EU has not changed for most respondents. Oblasts closer to the EU are more connected to the EU market. Almost half of respondents in Zakarpattia Oblast and 40% in Lviv Oblast import from EU countries. The Donetsk, Dnipropetrovsk, Kyiv, Sumy, Kharkiv Kherson and Cherkasy oblasts are less engaged in trade with EU. Those who traded with EU member states continue to in similar volumes. None of the respondents reported benefiting from the unilateral removal of EU tariffs on Ukrainian products.

While the majority of businesses are optimistic about the DCFTA, many admit that they do not know what it will mean for their businesses. Most respondents have little knowledge about the DCFTA beyond what is available in the mass media. As a result, their main concerns are increased competitiveness on the internal market, and inability to meet EU standards required for entering the EU market. Businesses with EU market experience mentioned few trade barriers connected to standards and certification. Many reported they did not have the funds to explore entering the EU market.

Other Countries

Asia became Ukraine's most important destination market in 2015 (mainly grain, sunflower oils, ores and metals). Exports to Asia also revealed negative growth during this period but at a slower pace than for other regions. Asia's share in Ukraine's merchandise imports stayed almost unchanged (19%).

Many respondents are exploring new directions in trade. Kharkiv- and Dnipropetrovsk based machinery producers reported replacing Russian sales with Asian sales. Some respondents, however, also reported that competition from Chinese companies made it difficult to enter Asian and Middle Eastern markets. Businesses have also established contacts with Kazakhstan and Brazil, and are exploring US, Canadian and Australian markets.

New internal dividing lines

Severe disruptions in the Donbas

Donetsk and Luhansk oblasts have lost their leading role as exporters. Before hostilities in eastern Ukraine Donetsk and Luhansk oblasts were leaders in Ukraine's foreign trade together accounting for about 25.6% of total merchandise exports in 2013. In 9M2015 that share decreased to 10.5%. Now the top exporting regions are Kyiv City with a 22.1% share of merchandise exports in 9M2015 and Dnipropetrovsk Oblast with a 17.8% share[4].

The World Bank estimates that territory not under Ukrainian control in the Donetsk and Luhansk oblasts accounted for 14.4% of Ukrainian industrial production and 6% of its GDP[5]. The regional economic structure is dominated by coal, metallurgy, coke, chemical and machine-building enterprises (producing general machinery, mining equipment, machinery and equipment for the metallurgy and chemical industries, transportation equipment, locomotives and rail cars). An overwhelming amount of Ukraine's

[4] Foreign Trade in Goods of Ukraine during 9 months of 2015 (2015, November 16). Express Editions, 512/0/08 (2.vn-15).

[5] Ukraine Recovery and Peacebuilding Assessment. Analysis of crisis impacts and needs in Eastern Ukraine, Volume II: http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/06/11/090224b082f1bea0/2_0/Rendered/PDF/Full0component0reports.pdf

coal production comes from these two regions and is an important input for the steel industry and electricity generation. These areas also hold key pieces of energy infrastructure such as the the Starobeshevskaya and Zuevskaya thermal power plants. The "DPR" has access to the Sea of Azov; however, the local port's capacities are insufficient to service regional industry.

Economic activity in the region was severely disrupted and precipitously declined due to damage to production facilities and economic infrastructure (most notably the railway connections and electricity supply); distorted production chains with the rest of Ukraine ("coal-coke-metal" and "coal-electricity" links) resulting in raw materials and equipment supply shortages, and logistics problems. Most large enterprises operating in the area either closed their businesses or did not operate at a full capacity during 2014 and the beginning of 2015.

There is no reliable data on the economic situation in the so-called Donetsk People's Republic ("DPR") and Luhansk People's Republic ("LPR"). According to the "DPR"'s own estimates, regional industry is functioning at 30% of pre-conflict levels, and retail trade had declined by about 50% as of February-March 2015[6]. Industry in areas controlled by the "LPR" has witnessed an even steeper decline. According to the 2015 recovery plan of "DPR", agriculture was expected to reach 85% of its 2014 level and industrial output 30% of its previous level. Companies from the extractive industry are expected to reach 35.7% of their capacity, while the manufacturing industry is anticipated to reach only 2.7% of their previous potential capacity. The volume of wholesale and retail trade is around 91% of their 2014 levels, while sales for transportation services, postal and courier services were estimated to reach near 80%.

Before the conflict, 45% of respondents traded with areas of the Donbas currently not under Ukrainian government control. The majority of businesses reported lost markets in these areas and broken ties with suppliers there. For the majority of respondents these lost markets constituted 15% of their sales in 2013. Due to its geographic proximity, government-controlled Donetsk and Luhansk oblast are much more connected to non-government-controlled territories of the Donbas and the average sales that went to these territories constituted around 30%.

Before the outbreak of the conflict, many businesses in government-controlled areas relied on supplies and raw materials from areas currently not under Ukrainian control. Those respondents reported on average that 27% of their supplies had been coming from non-government-controlled Donbas. While Donetsk and Luhansk oblast had on average around 58% of supplies coming from the non-government-controlled areas, the Kharkiv and Sumy machinery industry also had an extensive connection with the suppliers from this area.

In June 2015, Ukraine's government officially banned trade with the non-government-controlled territories. The majority of respondents reported terminating trade with clients and partners from these areas. The only legal trade from Donbas territories is coal and coal products shipped via railroad. Despite the ban, some companies continue trading illegally, usually paying bribes at Ukrainian checkpoints. Suppliers that continue to operate in "DPR" and "LPR" have legally registered their businesses in Ukrainian controlled areas, or have their branches in other oblasts that officially agree to contracts and conduct trade.

Some businesses have registered with the de facto authorities in non-Ukrainian controlled areas. A mid-sized Ukrainian retail business reported obtaining "DPR" and "LPR" registration to be able to do business there, but also reported that it is easier for them to deliver products from Russia than from Ukraine.

Respondents reported extensive corruption at the contact line, causing goods to be significant-

[6] (2015, May 12) Retrieved February 28, 2016 from http://ua.112.ua/statji/proekt-dnr-pidsumky-roku-nezalezhnosti-227829.html

ly more expensive in the non-government-controlled Donbas.

The Ukrainian energy sector has been badly hurt by the breakdown in trade. Respondents from Donetsk and Kharkiv oblasts reported that they relied up to 80% on coal from Donbas and as a result of the conflict had to decrease their output and look for alternative energy sources. Machine manufacturing, chemical and metallurgic industries also depend on supplies from non-government-controlled territories and territories that are close to the contact line, like Kramatorsk and Mariupol.

With the ban on trade from the Ukrainian side, more and more businesses in the non-government-controlled Donbas are building stronger trade relations with Russia. Small and medium businesses were heavily dependent on the delivery of goods by road now restricted by the blockade. Smuggling is flourishing and the high bribes that smugglers pay at checkpoints make goods more expensive.

Large businesses continue their operations despite the blockade and companies like Metinvest could even increase their sales to Europe and North America. Despite the ban for trade across the contact line, goods continue to travel across. The coal extracted in Krasnodon (currently controlled by the "LPR") is delivered to the Avdeevka Chemical Plant in Ukrainian controlled territory. Then as charred coal, it is transported to Yenakievo Metallurgic Plant (currently "DPR") where metal is produced. After that, it is transported via the Azov Sea to the West.

Crimea: minor impact

Crimea only accounted for 3% of Ukraine's GDP, 2% of production and contributed 1.4% to merchandise export supplies in 2013. The annexation of Crimea thus resulted in much smaller economic losses than the loss of control over areas of the Donbas.

According to official Crimean statistics, regional output dropped by -9.9% in 2014 before recovering by 8.8% in 2015. Before annexation, the Crimean market was mainly oriented towards Russia and the EEU with those markets making up about 35% of total sales (the EU accounted for about 20% and Asian markets for 20%).

In 2014 trade between Ukraine and Crimea did not stop. Ukraine continued to supply Crimea with electricity and food products. Nonetheless, Crimean and Ukrainian statistics differ for 2014 and 2015. According to Crimean statistics[7], exports from Crimea to Ukraine grew from USD 3.5 mln in 2014 to USD 19.9 mln in 9M2015, while imports were USD 2.6 mln in 2014 and USD 40.9 mln in 9M2015. However, according to the State Fiscal Service of Ukraine, Ukraine supplied Crimea with goods worth USD 654.6 mln in 9M2015, with mainland Ukraine importing USD 8 mln in goods from Crimea in 1Q2105[8].

Before the conflict, around 40% of respondents in the survey traded with Crimea with on average 8% of sales coming from the region and 5% of supplies. Kherson Oblast businesses bordering Crimea lost about 30% of their sales and 30% of their supplies. The majority of businesses reported losing markets in these areas and broken ties with suppliers there.

The sealing of the administrative boundary line and international sanctions create significant problems for business in Crimea, as they are unable to carry out official trade and make international payments. In this environment, businesses are building stronger economic ties with Russia. Respondents reported both new contracts for selling their services to Russia and more supplies and goods come from Russia. The majority of respondents refuse to trade with Ukraine. For companies aiming to sell beyond Crimea, the Russian market is an attractive alternative to the Ukrainian market as it is larger and now easier to access.

[7] (2015, June 23), http://crimea.gks.ru/wps/wcm/connect/rosstat_ts/crimea/ru/statistics/foreign_trade/
[8] Foreign Trade in Goods of Ukraine during 9 months of 2015 (2015, November 16). Express Editions, 512/0/08 (2.vn-15)

The companies engaged in international trade are mainly wholesalers and retailers. The majority of trade from Crimea goes to Russia and Ukraine, and trade to Crimea comes from Ukraine, Russia, Turkey and China. The agricultural companies report that they used to sell their products through traders to Europe, Turkey and Arab countries, which is not happening anymore. Similarly, the construction materials company that imported supplies from Europe via Ukraine, now uses only Russian and Turkish supplies imported via Russia. However, the change of political relationship between Russia and Turkey at the end of 2015 is likely to further limit the Turkish supplies to Crimea market.

Business environment

Conflict-related change to the business environment

Businesses in the conflict-affected areas of Donetsk and Luhansk oblasts have lost their assets and staff, while businesses in the rest of Ukraine have also suffered. The majority of respondents attributed economic decline to political instability and fluctuation of the Hryvnia. Internal consumption has declined aided by a lack of access to the non-government-controlled Donbas and Crimea.

Simultaneously, credit sources have dried up. A quarter of respondents reported being refused credit over the last twelve months with many reporting they did not even bother applying for loans. Respondents reported that due to the conflict, banks' lending rates are extremely high, and in territories close to the conflict areas reach 30%. Many businesses do not have the necessary collateral and once refused have a black mark on future applications. The banking, real estate and construction sectors suffer the most because their services are directly connected to securing financing. Real estate deals are undermined by the lack of consumer loans, and construction companies by the lack of financing for large construction projects.

Finding and retaining qualified personnel has become more difficult due to the conflict. With the economy declining employers are not able to make salaries match inflation and the rising exchange rate. Businesses requiring special technical skills, such as machine manufacturing or the energy sector, are especially vulnerable to personnel turnover because extensive training has to be done before replacement. To cut labor costs businesses have laid off personnel, introduced short working weeks and cut staff wages. Costs have also been driven up by the need to provide security. Businesses reported employees being killed in the conflict and others resigning during times of active fighting.

Internally displaced people (IDPs) have expanded labor pools in Ukrainian-controlled areas, but mainly for less skilled jobs.

Conscription is also creating difficulties with qualified staff being drafted into the army. Companies must continue to pay for drafted employees and find temporary replacements. The draft is managed by official employment records, making many not want to be officially employed. Many businesses reported that young men wanted to be employed unofficially to avoid conscription. Qualified personnel meanwhile are looking for jobs abroad.

Medium-sized businesses are more vulnerable to changes in the business environment, but they are also more flexible. They have limited access to credit and finance and reported that high taxes mean they have limited capital, but they are also more able to avoid taxes and regulatory limitations.

Decline in business profitability varies by sector. Some machinery producers are struggling after losing markets in Russia and the non-government-controlled territories. The textile industry faces a decline in the production of local raw materials like wool, cotton and linen, forcing them to import. The banking sector reported cutting their operations due to the poor economy. Exporters of foreign cars to Russia reported losses due to the decline in demand there. Logistics and transportation companies are suffering from decreased economic connectivity. Sanctions on trade with Russia meanwhile have cut the need to transport goods.

Some economic areas are brighter. Agriculture, and IT and telecommunication companies are able to maintain their profitability. Food processing businesses suffered after losing markets in uncontrolled territories and Russia, but have reoriented sales to other parts of Ukraine.

Challenges of the regulatory framework

Ukraine's post-Maidan governments have pushed for reforms, including the simplification of regulations for businesses, minimizing corruption and implement austerity measures as per IMF requirements. Parliament has adopted numerous changes to tax legislation and various regulatory acts. The regulatory changes made the regulatory framework less stable and led to gaps in the implementation process. Businesses reported specific regulations causing difficulties:

- VAT Refund: the changes to the tax code adopted in July 2014 and enforced in 2015 introduced a new electronic system of VAT administration that significantly altered the procedures for VAT refunds. Businesses reported that tax refunds were slow and inconsistent, with delays leading to capital shortages. Some businesses reported that during the transfer to the electronic system money disappeared from their accounts.
- Limits on foreign currency: to stabilize the Hryvnia the National Bank of Ukraine introduced restrictions on currency exchange in 2015. Businesses engaged in export and import reported that the mandatory exchange of 75% of income in foreign currency caused them to suffer major losses. Large traders in Donetsk, Kharkiv, Kyiv, Sumy and Cherkasy oblasts reported losing significant sums especially when the exchange rate was fluctuating in February and March.
- Ban on trade with the non-government-controlled territories: Starting on June 16, 2015 trade with the non-government-controlled territories became more difficult. In accordance with new rules there is a ban on transporting goods to the non-government-controlled territories from the rest of Ukraine. This has complicated the activities of businesses operating in Donetsk and Luhansk oblasts highly interconnected with the non-government-controlled territories. Despite the official ban, unofficial trade continues through corruption schemes at checkpoints.
- High payroll taxes: In 2015 the payroll tax for employees increased from 17% to 20%. The military tax of 1.5% introduced in 2014 was extended for 2015. Other taxes include 3.6% paid to the State Pension Fund by employees and 22.2% paid to the State Pension Fund by employers. Nearly half of salaries go towards taxes. As a result medium sized businesses often pay workers off the books in order to avoid the tax burden.
- Non-systemic state policy for key sectors: Respondents mentioned that government policies lack a strategic vision for key sectors' economic development. Businesses stated that a comprehensive strategy for the development of the key sectors is needed and should support export oriented and high value-added industries.
- Custom code changes: authorized economic operator status was abolished when the customs code was changed in 2012. That status previously provided preferences in simplified customs procedures, priority customs inspection and exemption from the requirement of guarantees for transit of goods.

Sector specific regulations: As the study focused on the key industries and sectors in each region, the specific regulatory challenges were discovered.

Lack of implementation

Respondents reported that the new legislation created inconsistencies that implementing agencies manipulate. They said there has been little information about what the changes mean, leaving businesses to try and figure it out themselves. They considered regulating bodies to be more interested in charging businesses fines for not following procedures and exhorting bribes than explaining the new procedures. Respon-

Sector	Policy area	Problems for business
Agriculture	Issuing of second export certificate during grain transportation while changing the vehicle	Delay in export of grain
	Excessive fees for subsoil land rights usage, which equals 55% of the value of land	Disincentive for investors
Coal	Licensing of coal exports leads to 100% testing of all kinds of coal for export	takes 10 days and delays export by 12 days
Construction	Construction permits delayed by months	Leads to delays in the project development
E-commerce	Absence of e-commerce regulations	Complicates the operations in this areas
Media	Russian content ban	Media providers that purchased Russian content are experiencing losses
Timber	Moratorium on export of timber	Prohibits export of wood from Carpathians for the next 10 years
Wine	Licensing fees for wineries	Too expensive for small wineries giving them no legal ways to sell their product

dents reported that legal cases against tax authorities took years. It turned out that large businesses more readily use legal means to protect their rights as they have the funds to pay for legal services. Medium-sized businesses do not have these resources and as a result face greater pressure to resolve disputes by paying bribes.

Businesses have seen little improvement in the work of government agencies whether tax agencies, ecological departments or the fire department. Despite the moratorium on tax audits for 2014 and 2015, many businesses reported that they went through audits. Half of respondents who went through tax audits in the last year reported they were expected to pay bribes. Nearly 40% of respondents reported that they were expected to pay bribes during interactions with controlling or regulating bodies.

Businesses interact with tax authorities the most. They found tax officials to have the least clear procedures with little information available and constant changes. Customs services often cause delays for exports and imports. Respondents reported unclear and non-transparent customs value assignments meant to increase import fees, expectation of bribes, excessive licenses requirements and delays causing losses.

Nonetheless, the regulatory framework implementation varies across Ukraine's regions. While Zakarpattia businesses reported enormous corruption and little recent improvement, Luhansk Oblast businesses reported officials were exhorting fewer bribes due to the conflict. At the same time, Luhansk businesses face armed inspection. Corruption is a major concern in Odessa Oblast, but unlike other oblasts, there is high expectation for change.

Challenges to Business Connectivity

The conflict has affected the internal and external economic connectivity of businesses. The ban on trade with the non-government-controlled territories in the Donbas and Crimea has limited business and forced enterprises to find ways around restrictions. Official trade with the non-government-controlled Donbas Oblast is only possible by rail, which is mainly used for coal deliveries. Middle-sized businesses continue to trade illegally, but risks increase the price of goods delivered to the non-government-controlled territories and Crimea.

Fighting has taken a heavy toll on infrastructure already in poor condition. Artillery has destroyed roads and railway stations. Oblasts near the conflict zone, like Kharkiv and Dnipropetrovsk oblasts, have witnessed deteriorating road conditions due to heavy military vehicles using their roads to reach the conflict zone.

Businesses throughout Ukraine suffer from limited electricity supplies, which are mainly due to outdated electricity infrastructure. Also, ruined internal connectivity with the non-government-controlled territories explains part of the shortages. Businesses in Zakarpattia, Kyiv, Lviv, Odessa and Kharkiv have all experienced electricity shortages.

Connectivity has suffered unevenly throughout Ukraine. Machinery producers, traditionally located in eastern Ukraine, are more dependent on producers near or beyond the contact line.

The conflict has also limited external connectivity by making it difficult to establish partnerships with international companies. Potential partners from Asia or the Middle East often have doubts about the ability of Ukrainian businesses to deliver on contracts because of the conflict. International lending is no longer open to Ukrainian businesses due to the high risks associated with the conflict.

Business environment in the non-government-controlled territories of the Donbas:

In areas controlled by the "DPR" and "LPR" businesses are struggling to survive under conditions of armed conflict. The new institutions, including "ministries", "banking institutions", "tax" and "security agencies", have been established, but their responsibilities are ambiguous and their work unclear. Rules are applied inconsistently and enforcement depends on businesses' relationships with key figures in the "DPR" and "LPR". SMEs are more vulnerable and are often forced to register and pay taxes using physical threats, kidnapping and actions taken by military officials. Large businesses like Metinvest and DTEK that control key sectors like electricity and coal, and employ large numbers of people are able to negotiate. They preserve their Ukrainian registration and invest in local infrastructure instead of paying taxes.

The new "Ministry of the Income and Tax Collection" in the "DPR" did not provide the list of registered companies to interviewers, but in personal conversations confirmed that at least half of the businesses are not operating. This was also the impression of interviewers as they attempted to contact businesses. Most of those still operating registered from March to April 2014 in the "DPR" and are paying taxes into the "DPR" budget, often operating under double registration in Ukraine and the non-government-controlled territories. Ukrainian businesses that are also registered in non-government-controlled territories could be prosecuted for supporting terrorism by paying taxes into the "DPR" or "LPR" budget.

A semi-legal banking system operates in the "DPR", enabling businesses to trade with other countries, using the Russian ruble as the main currency. Companies that register in the "DPR" open an account in the "Central Republican Bank" and then register with Russian non-banking credit organizations. Russian companies cannot legally have contracts with "DPR" companies, but work through accounts of non-banking credit organizations in Russia and brokering companies in South Ossetia.

Crimea business environment

Russian annexation of Crimea has significantly changed its business climate. The sealing of the administrative boundary line between Crimea and Kherson and sanctions on air and marine transportation have limited the trade routes local businesses can use. The main route to Crimea is via the Kerch Strait ferry. Ferries are dependent on weather conditions and during storms the delivery of goods is delayed. Logistics companies are expanding their storage capacities to account for breakdowns in delivery, but require additional funds.

New barriers to trade with Ukraine have devastated business relations. Adjusting to the Russian regulatory system has also created obstacles for businesses. More restrictive, the Russian regulatory system limits business opportunities in Crimea.

Due to sanctions, there is no international banking system in Crimea, significantly limiting international trade. There are semi-legal ways to make international payments, either through international money transfer systems or through Russian accounts, which are more expensive and time consuming.

Expectations for the future

Respondents' expectations for the future of the Ukrainian economy are connected to how the conflict develops. Many believed Ukraine had reached its economic nadir and expected growth or stagnation, but also believed intensified fighting could further worsen the economic situation. Businesses have not seen positive economic effects from promised reforms. They considered authorities to be slow in implementing new laws, and corruption to remain prominent. They stated that without change in these factors they expected Ukraine to remain uncompetitive on the global market and primarily remain a source of cheap labor and raw materials.

Expectations for respondents' own oblasts were linked to geography. The respondents from the regions near the fighting, Donetsk, Luhansk, Dnipropetrovsk and Kharkiv oblasts, are very pessimistic about economic prospects for their regions. Respondents in western Ukraine, Zakarpattia and Lviv oblasts, are optimistic about the economic development for their regions. They expected increased investment from the West as a result of the Association Agreement with the EU.

Kyiv Oblast respondents also had a more positive view for their region's economic situation than for the country as a whole due to its status as a center of business in the country. Odesa Oblast respondents too had a more positive view of their region's economy.

Respondents were also optimistic about the development of specific sectors they believed could expand into EU, US, Middle Eastern and Kazakhstani markets. These sectors include IT, agriculture, machinery production, extractive industries, food processing, and retail and wholesale.

Conclusions and outlook

By conducting in-depth interviews with over 230 enterprises across Ukraine, this study argues that the on-going armed conflict and the broader tensions have strong effects on Ukraine's economy. In the whole of Ukraine, the conflict is present in the business environment via macroeconomic instability – mainly high inflation, fluctuations in the exchange rate, as well as lack of credit. Macroeconomic uncertainty also contributes to policy uncertainty, as lawmakers are pressed to find solutions for propping up state coffers. Rapid deterioration of infrastructure and the lack of skilled personnel are also corollaries of the on-going conflict. With regard to external trade, Russia's new formal and informal barriers lead to further economic stress on certain regions, while the EU market is still inaccessible for most producers. Naturally, regions close to the armed conflict and the new dividing lines are even more affected – not only by the volatile security situation and the destruction of production facilities, but also by policies such as restrictive regulations on trade.

Yet the study also reveals a number of uncertainties in the business environment that are unrelated to the conflict situation. This suggests that improvements can be made in spite of the conflict. Those include arbitrary decisions by state institutions, difficult and costly judicial procedures that result in ineffective protection of businesses against unlawful decisions, as well as frequent changes in the legislative framework. Also, those changes and their implementation are often not well communicated to the business community. Last but not least, the study suggests that information and knowledge about access to new markets is often lacking.

Initial findings of this study were discussed at a **workshop in Kyiv** in November 2015, with a view to formulating a way forward for Ukraine. The workshop was hosted by the Embassy of Switzerland in Kyiv.

Participants stressed the possible **role of business in rebuilding trust** across the contact line. Rebuilding economic ties could therefore be seen as a confidence-building measure that could hamper a new escalation of the conflict. Participants noted that the more connections there are on the ground, the more difficult it would get to restart conflict. At the same time, the official blockade of trade was identified as giving rise to contraband and corruption schemes. Participants noted that this issue needed to be solved quickly, as vested interests would grow stronger and stronger. Yet, high resistance in Ukrainian society against a reestablishment of connectivity with the separatist-held regions was seen as a major obstacle in re-establishing trade ties. It was therefore noted that it would be necessary to promote the publicity of the work of the Trilateral Contact Group in society, as well as to develop an "ideology of small steps" that would explain how each step fits into a broader picture of reconciliation. The necessity to explaining the Minsk agreements to politics and society and of finding people in Ukraine who support the implementation of these agreements was noted by several participants as an urgent task.

The high level of interconnectedness of the **infrastructure** across the contact line was noted as one prerequisite for greater cooperation. It was also noted that this offers the underpinning of reconciliation in small steps. Restoration of water infrastructure was identified as one issue where cooperation is functioning well on both sides of the contact line. The same was said to be true for the restoration of electricity, gas, and railway infrastructure.

Concerning the future rebuilding of the Donbas economy it was noted that many of the **industries** (coal-steel) were **not competitive** globally and therefore should not be rebuilt. Only those that proved to have a competitive advantage should be given the go-ahead. This presupposes a long-term diversification strategy. Therefore, the loss of the Donbas was not seen as a paramount problem for the economy of Ukraine by some participants.

Concerning relations of **Ukraine with the EU** it was noted that they are an asset and should be used more actively for diversification of markets. With one third currently going to the EU market there was still potential for development. As the EU is a difficult market, assistance to get on this market would be needed. Several participants claimed that it would be very difficult for UA to enter especially the core EU markets, where even several new EU countries were experiencing problems. Rather than aiming for the core EU market, UA should rather take the path of Balkan markets, to which it was similar, and aim at integration with neighbors (Romania, Moldova, Poland…). Also, participants agreed that the attraction of **FDI** was key and noted problems in this area. Here, one participant proposed that UA's goal should be to move into the existing value chain of established European brands. Others cautioned that attraction of FDI was far more difficult now than it had been for CEE economies in the past. After the financial crisis, risk capital would be more regulated and hence appetite to invest was low.

With its comprehensive findings the study provides a solid basis for action – for Ukraine, third states and actors, as well as for donors and the international community.

Donetsk Oblast
(Government-controlled)

Located in eastern Ukraine and bordering Russia, the Donetsk Oblast is located in the industrial heartland of the country. In the Soviet period, the oblast was known for coal mining and metallurgy and it continued to be a center for those industries in post-Soviet Ukraine. In 2014 the Donetsk Oblast and Donetsk City in particular, became centers of fighting. As elsewhere in Ukraine, Donetsk Oblast infrastructure was badly in need of repair even before fighting began, but artillery bombardments and military clashes have further damaged infrastructure. The most famously example is the new terminal at the Donetsk airport built for the EURO 2012 soccer championship, which fighting has rendered useless. The contact line has cut off businesses from one another, breaking old trade relationships as centers of the oblast's economy, like Donetsk City, now fall outside of Ukrainian government control. With valuable coal and coking plants in Donetsk Oblast, DTEK and others have struggled to protect workers' safety while trying to keep their operations running. With the future of the economy closely linked to a permanent cessation of fighting, the situation remains unstable with businesses struggling to adapt to new realities.

To better evaluate the region's economy, industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, six sectors were the most prominent:

Donetsk Oblast	Metallurgy coal mining industry machine building electricity power generation food industry transport services (sea port in Mariupol, rail) wholesale and retail trade

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Economic Overview

Donetsk Oblast is directly involved in the military conflict in the Donbas and has suffered considerable economic losses. Before the military conflict in the Donbas, Donetsk Oblast generated 10.8% of Ukraine's GDP (2013) and was the biggest region in terms of industrial production (16.3%) and export supplies (19.6%). Since then Donetsk Oblast's share of the economy has contracted considerably: industrial production fell to 15.1% (2014) and 11.5% (1H2015); merchandise exports to 15.6% (2014) and 9.9% (1H2015). 10.1% of Ukraine's total retail trade took place in Donetsk Oblast in 2013 and fell to 7.3% in 2014 and then to 3.3% in 1H2015.

As a result of the conflict, Donetsk Oblast lost control over a part of its territory. Data for Donetsk Oblast for 2014 and 2015 excludes the part of the region not under government control. The most important sectors include (2013): the extractive industry (13.0%), the manufacturing industry (18.8%), wholesale and retail (16.8%), transport (10.4%), electricity, gas, steam and air conditioning supply (5.1%). Regional manufacturing specializes primarily in metallurgical production (ferrous metals, articles, pipes), machine building (machinery, mining equipment, machinery and equipment for metallurgy and chemical industry, handling and transport equipment, locomotives and rail cars), the food industry, coke and refined petroleum products and chemical the industry (fertilizers, ammonia, urea, nitric acid, ammonium nitrate).

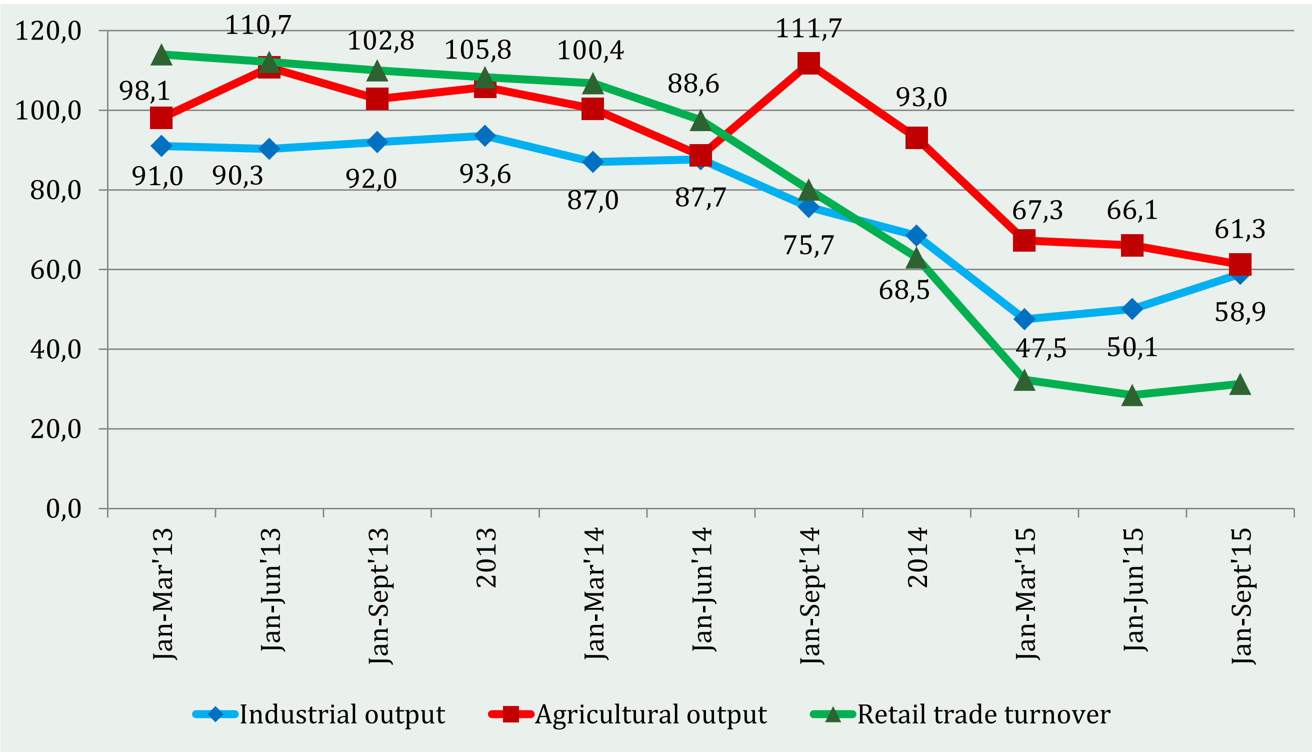
Donetsk industry suffered a huge -31.5% yoy drop in 2014 and further -49.9% yoy drop in 1H2015 due to the loss of control over parts in the Donbas, destruction of infrastructure (railway connections, electricity and water supply, etc.) and economic links, shortages of raw material supplies and weakening external demand on major commodity exports (Table 1). In particular, traditional production chains "coal-coke-metal" and "coal-electricity" were distorted in the core industries of the region. Machine-building and chemical industry observed the strongest declines (by more than -40% yoy each in 2014, and by -43% yoy and -75% yoy respectively in 1H2015) as they were in areas near Donetsk City not controlled by the Ukrainian government. As a result the leading chemical enterprise of the Donetsk Oblast, Stirol Concern PJSC (80% of regional chemical output), is not included in Ukrainian recording.

Metallurgy (about 40% of industrial output) is the leading sector in the oblast and experienced a significant decline (-27.7% yoy in 2014 and -41.2% yoy in 1H2015). The metallurgical complex was hit hard by the disruption of production links, logistics problems and shortages of crucial inputs. Steel plants located in government-controlled territory experienced shortages of coal supplies, which previously came from Donbas mines, and had to import coal. Similarly steel enterprises in non-government-controlled areas lacked iron ore, which previously came from the Dnipropetrovsk Oblast. The second-largest industry was mining (about 15% of industrial output), which shrank by a third in 2014 and by almost -60% yoy in 1H2015. According to the Ukrainian government, 115 out of 150 coal mines in Donetsk and Luhansk oblasts are located in non-government-controlled areas[1]. The situation in the Donbas significantly affected the entire Ukrainian electricity industry because Ukraine lost control over all mines producing anthracite coal, which was used by half of Ukrainian thermal power plants.

The average unemployment rate of the working age population in the region went up from 8.2% of the economically active population of relevant age in 2013 to 11.3% in 2014, and to 14.1% in 1H2015. Consumer prices went up by 22.0% in 2014 and by 38.4% during January-June 2015. Retail trade in the region fell by -38.8% yoy in 2014 and by -71.5% yoy in 1H2015.[2]

Figure 1

Indices of industrial production, agricultural production and retail trade in Donetsk Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine[3]
Note: Data for 2014-2015 exclude areas beyond the control of the Ukrainian government.

[1] Government of Ukraine (2015, June 1). Kremlin's Black Book: Russian War against Ukraine. Retrieved March 12, 2016, from http://www.kmu.gov.ua/control/en/publish/article?art_id=247956386

[2] Donetsk Oblst department of Statistics. (n.d.). Statistical information on Donetsk Oblast. Retrieved March 12, 2016, from http://www.donetskstat.gov.ua/statinform1/index.php

[3] Here and in other oblast chapters: Retrieved March 12, 2016, from http://www.ukrstat.gov.ua/

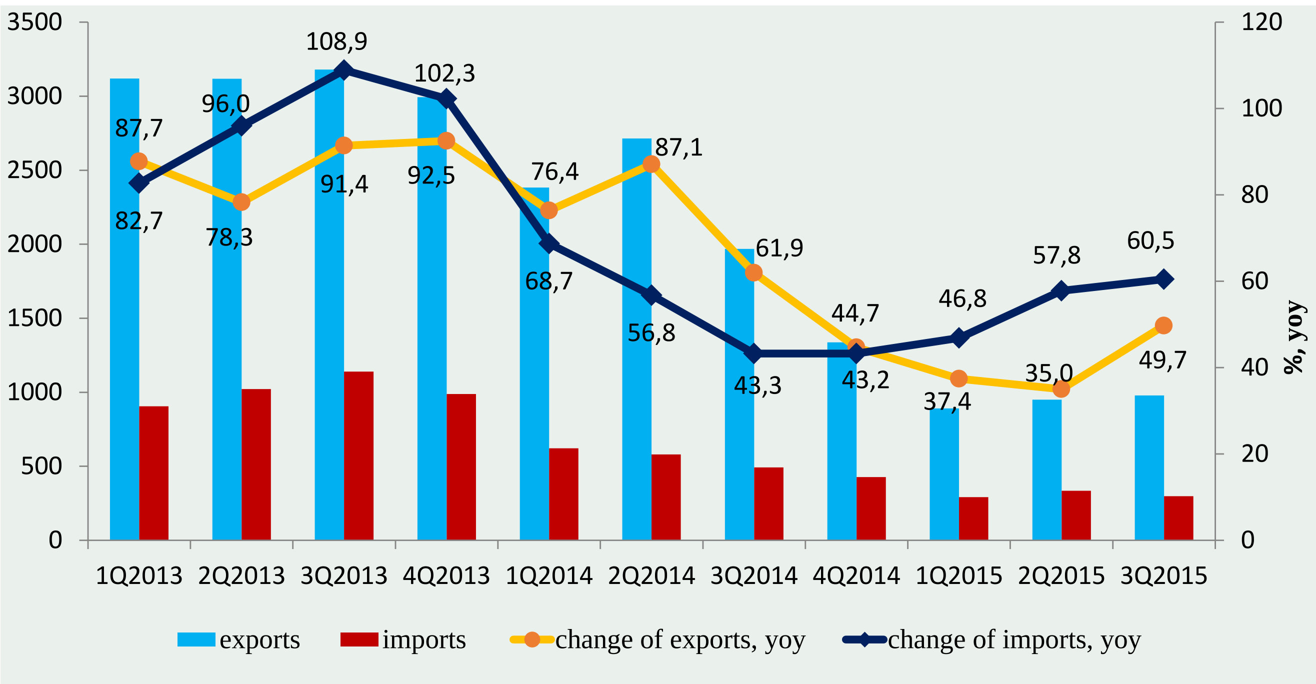
Trade Overview[4]

Donetsk Oblast's foreign trade was badly affected by hostilities on its territory, the continuous decline in world commodity prices and Russian market trade restrictions (especially on machine-building exports). As a result, exports of goods shrank by -32.3% yoy in 2014 and -63.9% yoy in 1H2015 (Figure 2). Imports of goods almost halved in 2014 (down by -47.7% yoy), and then continued to fall by -47.9% yoy in 1H2015. The largest contribution to the drop of merchandise exports came from declining supplies to the EEU market that was the major destination of regional exports in 2013 (about 30% of regional exports). Supplies to the EEU market fell by -55.6% yoy in 2014, depressing the EEU share to 19.2% in regional export supplies in 2014 and to 17.8% in 1H2015.

EU and Asian markets were also important markets for Donetsk Oblast exports (accounting for 25.7% and 26.9% of all supplies in 2013). Export flows to these destinations also decreased but at a slower rate (by -17.6% yoy and -32% yoy respectively in 2014). As a result, the EU share expanded to 31.3% in 2014, and this trend continued in 2015 (about 47% of regional exports supplies in 1H2015 went to the EU). Exports of chemicals and vehicles/transport equipment (railway locomotives) almost stopped in 2014 and 1H2015 (down by -81.7% yoy and -88.1% yoy respectively in 2014) (Table 3). Exports of metals and metal components decreased by -19.5% yoy in 2014 and then by -60.1% in 1H2015. However, metals became the overwhelming part (83.4%) of regional exports in 1H2015 (versus 64.2% in 2013) as other commodity exports collapsed. Service exports went down by a quarter in 2014 and -16.3% yoy in 1H2015, attributed to the fall in material resource processing and business and transport services.

Figure 2

Dynamics of exports and imports of goods in Donetsk Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine
Note: Data for 2014-2015 excludes areas beyond the control of the Ukrainian government

[4] Here and in other oblast chapters, the data used from Foreign Trade in Goods of Ukraine during 9 months of 2015 (2015, November 16). Express Editions, 512/0/08 (2.vn-15).

Survey

There were 12 interviews conducted in Donetsk Oblast. Due to the proximity of the conflict zone businesses were cautious and afraid of reprisals. Businesses that still have some connections with the non-government-controlled territories of the Donbas are especially cautious as their activities are outlawed by the trade with those areas.

Business climate

Political instability is one of the most often named problems affecting business. Other major concerns were the absence of a properly functioning judiciary, low demand on the internal market, access to credit and growing production costs. Donetsk businesses also listed as major concerns problems linked to the current conflict, like the confiscation of assets, threat of military action and barriers to trade with the non-government-controlled territories. Large businesses are particularly concerned by these threats as many still have assets in non-government-controlled areas.

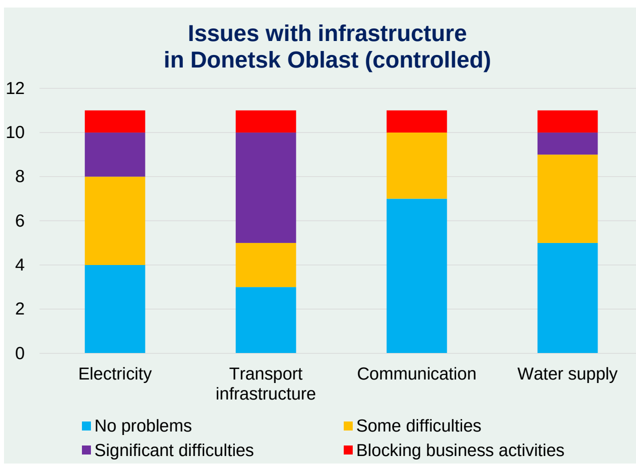
All businesses suffered because of fighting. This results in the closure of branches, losses of property, interrupted business contact and problems with infrastructure. "There is a need to control security on the territory of Ukraine. We have had seven people die and eight injured in our company as a result of military actions," one respondent reported. Some companies' losses due to fighting are estimated to be in the millions of dollars. "Donbas is fully isolated now. We can't bring anything in or out. We have 37,000 workers there and we can't even pay their salaries," said the same respondent.

Five of the large enterprises surveyed represent DTEK group, and are part of the large industry cycle, including coal extraction, energy production and provision, water supply and oil production. The group operates throughout Ukraine and has large coal-mining and energy operations in non-government-controlled areas. DTEK represents one of the most important industries for eastern Ukraine. In addition to the views of DTEK, this section includes opinions from metallurgic and machinery producers, a food processing company and a water supplier.

Infrastructure

Damage to railways in fighting affected the coal industry's delivery of coal to thermal electric stations. The train station in non-government-controlled Debaltseve is now operating at a lower capacity and is unable to deliver coal to Pridenprovska and Kryvyi Rih Thermal Electric Stations. When transporting coal, trains are often fired upon, further damaging the railways. DTEK is investing its own resources to repair the railways and provide fuel. "It is like a pri-

Number of responses by sector, Donetsk oblast (government-controlled)	
Energy, gas, water supply	5
Food processing	2
Extractive industry	1
Wholesale	1
Retail	1
Transportation	1
Hotel and restaurants	1
Metallurgy	1
Machinery production	1



vate-owned railways system now," one respondent said. Due to the limited capacity of the railways there are 2 mln tons of coal in separatist controlled areas that can't be sent to the rest of Ukraine.

Though transport by truck is possible, companies are often unwilling to operate near the front and the price for delivery has increased.

There has also been a significant loss of power lines during the conflict. DTEK reported losing electricity infrastructure and struggling to keep the system operational.

Internal regulatory environment

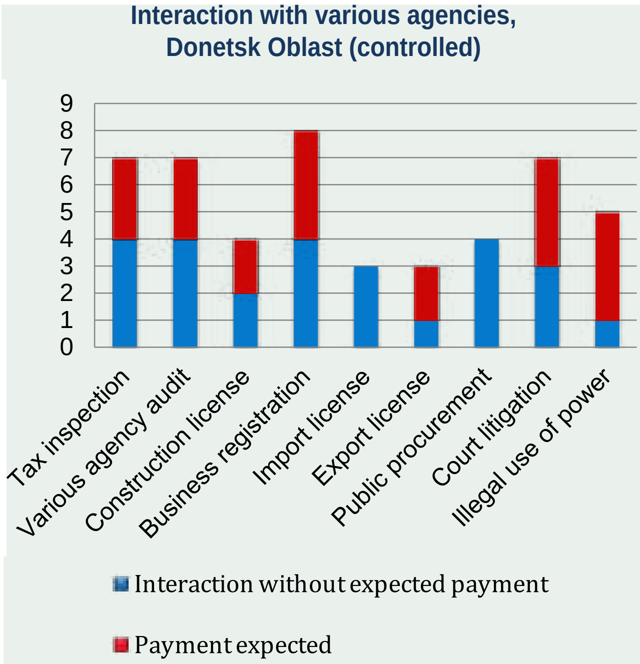
Energy production, specifically gas and coal, is a major part of the oblast's economy and as a result respondents focused on the overregulation of the energy market. Respondents raised issues of nontransparent pricing and export limitations they believed were politically motivated.

Companies that have assets on both sides of the contact line reported on the difficulties they faced as a result of a Ukrainian trade ban on non-government controlled areas of the Donbas. Simultaneously, they faced difficulties operating in the separatist control zone where respondents said Russian legislation is applied and payments is made in Russian rubles.

As a result of a recent law banning communist names and symbols, businesses with Soviet names or brands will have to change them. For example, Artemivsk champagne is named after the city of Artemivsk, which is named after a famous Bovlshevik. The new law required that both the city and the champagne to be renamed. Changing well-known brands risks doing further damage to sales at an already difficult time.

Businesses also mentioned the need to improve the rule of law by cracking down on corruption and to depoliticize prosecution.

Restrictions on currency exchange were also a major concern. They make it difficult to keep capital in foreign currency and to exchange hryvnia for foreign currency, hurting businesses-by making it difficult to restock imported supplies.



Taxation Officials

Despite the tax audit moratorium, seven companies reported being audited in the last year. In three cases bribes were expected from the companies. Middle size businesses are more vulnerable to changes in tax administration. They lack information about changing tax procedures and report that tax inspectors don't provide them with the necessary information about changes.

Access to financing/capital

Five out of eight respondents reported being refused credit over the past year. Respondents blamed the National Bank of Ukraine, which stopped credit lines to areas close to the conflict zone and increased the interest rate from 14% to 28%. Being in a high-risk ATO territory is one of the main reason for refusal of bank loans. The lack of access to credit meant they had to stop investment projects. Two out of 5 companies reported they were not able to buy supplies or equipment, could not launch a new product or service or had to close some of their branches and production facilities. One respondent said that because of the absence of additional financing, the company could not enter new markets to replace lost markets and had to lay off staff.

Changes in business profitability

Unlike most oblasts in Ukraine, Donetsk Oblast has had to deal with losses due to active fighting. Since 2014, DTEK has spent over UAH 100 million dealing with damage from hostilities. A DTEK electric sub-station built for Euro 2012 near the Donetsk airport, for example, was completely destroyed.

Labor force

With companies struggling to survive they are unable to increase salaries to meet price inflation, creating higher turnover of qualified employees as they search for better paid jobs elsewhere. The economic recession and large number of IDPs has greatly increased the number of people looking for work and the salaries they are willing to accept, but not addressed the issue of a shortage of trained workers that existed before the crisis and has worsened since.

The current conflict also requires companies to provide security measures for their workers. One company reported that seven people died and eight were injured while working in areas near fighting. Another company reported that after a shooting in the city of Kurahovo around 15 employees there resigned.

The drafting of employees into the armed forces has also created problems. One DTEK enterprise reported that 80 of their workers were drafted, and another reported 2,500 being drafted (DTEK has 128,000 employees in total). They reported that individuals with specialized experience were drafted, making them difficult to replace.

Trade climate

Only four of the 12 companies interviewed in Donetsk Oblast exported. Large enterprises working in the coal, energy production, metallurgy and food processing sectors are the main exporters. The four large enterprises interviewed are importers, these include energy companies, a food processing company, and a metallurgical company. The medium sized businesses were not engaged in import or export.

Exports are generally low with the internal market making up on average 76% of the companies' total sales. The two companies that export to Russia export 20% and 7% of their goods to that market respectively. The second largest export market is the EU, where four companies exported between 4% and 20% of their production. The average share of exports to the EU and Russia is almost the same, but more companies were engaged in trade with the EU than Russia.

As a result of the weak hryvnia imports were low, with only one company importing from Russia, one from the EU and one from other countries.

Out of all sales in 2013, the average percent of the customers in Crimea was 8% to 15%, and from what is now non-government-controlled Donbas from 8 % to 40%. One retailer reported that in 2013 most of their sales were to what are now non-government controlled areas of the Donbas. The Donetsk Oblast energy sector relied on non-government-controlled Donbas for 50% to 70% of their supplies. Supply from Crimea was about 2% to 3%.

International trade

Exporters must deal with barriers. The Cabinet of Ministers limited coal and electricity exports to make up for shortages within the country. For an electricity producer this meant possibly losing a license to export to Poland, which they spent a year trying to obtain. The license is automatically canceled if there are no exports within 6 months.

There are mixed assessments of the EU Association Agreement implementation and what it will mean for the each sector. The representatives of metallurgic and food processing industry expect increased competition, but the energy sector welcomes EU integration hoping for new transparent market regulations. The trade breakdown with Russia has mainly affected the food processing and the metallurgic industries, and they are now looking to expand into markets such as China.

Trade with non-goverment-controlled territory

The food processing company reported a -40% loss of internal sales caused by lost access to the uncontrolled territories. They are now trying to re-focus sales to western Ukraine and exports.

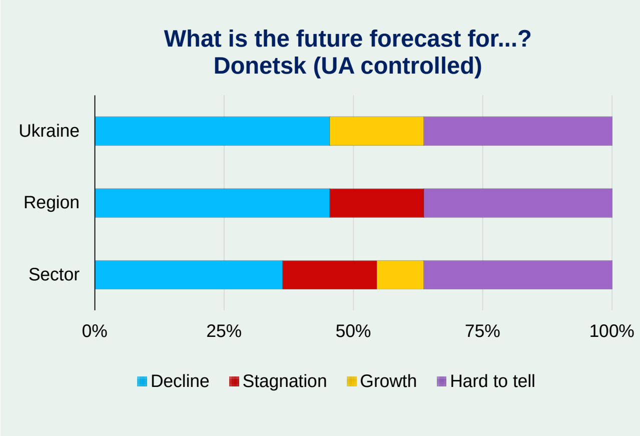
The energy company reported losing control of the energy station they used to supply Crimea with electricity. They also reported a -60% decline in coal production in the Donbas. They reported that these losses were so huge it is extremely difficult to make up for them.

The majority of the suppliers of the energy companies are located in the ATO zone and Crimea. Contact with most Crimean companies was lost, but many of the suppliers and partners have re-registered in the territories controlled by Ukraine. Meanwhile Ukrainian companies have registered in areas controlled by the "DPR" in order to continue business operations there.

While medium sized business is not engaged in the international trade they are actively trading with the non-government-controlled territory. One retailer trades on both sides of the contact line and thus registered with the "DPR". However, they cannot deliver their products from the Ukrainian side and have to deliver from Russia. Their sales are a fifth of what they were. Other businesses have cut business ties with the uncontrolled territories completely and had to replace suppliers and customers with those in Ukrainian controlled areas.

Future potential

Donetsk Oblast businesses are pessimistic about the economic future of the oblast. While some respondents are positive about developments in their respective sectors, none had an optimistic forecast for Donetsk Oblast. Those who were optimistic about Ukraine's overall economic future believed that Ukraine was at the bottom of its economic fall and should begin to show economic growth again. Those who were pessimistic saw fighting drawn out, continuing to sap the country's resources. Respondents were skeptical that Donetsk Oblast would be able to rebuild its infrastructure anytime soon and believed the economy would continue to struggle.



DTEK companies were optimistic concerning their operations, believing that as one of the main industries in Ukraine they would eventually be able to recover.

Conclusion

Donetsk Oblast is the center of the conflict and part of the oblast continues to not be under Ukrainian control. The part of the oblast now under the control of the so-called "DPR" hosts large enterprises of the key industries like coal extraction, metallurgy and machinery. Due to the conflict, enterprises have lost their assets and the infrastructure between government-controlled and non-government-controlled territory is ruined. The major production chain of the "coal-coke-metal" and "coal-electricity" are ruined. While some coal is brought from the non-control territory, the limited capacity of the main infrastructure hubs prevents further transport.

With the traditional basis of the oblast's economy broken, an economic recovery would require tremendous investment to rebuild infrastructure, provide badly needed credit to businesses and encourage new economic models. Until the situation in the oblast becomes more stable, however, businesses do not expect a recovery, and an influx of the necessary volume of capital is unlikely.

Luhansk Oblast
(Government-controlled)

Luhansk Oblast is Ukraine's eastern most region and a traditional economic bridge between Ukraine and Russia. A center of Soviet heavy industry, links with Russia continued to be strong during the post-Soviet period. Currently the loss of control of approximately one third of the oblasts territory including Luhansk City has sent the region's economy into disarray. As the front has shifted and transport infrastructure has been damaged by fighting, traditional trading and supply routes for businesses have become unreliable or closed.

As part of Ukraine's rustbelt, Luhansk Oblast was already experiencing economic decline before the conflict began. Fighting and difficulties trading with Russia have since accelerated and exacerbated that decline. As one of two Ukrainian regions where fighting actively takes place, businesses struggle to anticipate their economic environment and investors are uneager to be exposed to such instabilities.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 7 sectors were the most prominent:

Luhansk Oblast (Ukrainian State Controlled)	coal mining industry
	chemical and oil refining industry
	metallurgy
	machine building
	production of construction materials
	food industry
	wholesale and retail trade

An overview of the specific characteristics and dynamics of the regional economy follows to provide context for the qualitative information in the survey section.

Economic Overview[5]

Before the armed conflict in the Donbas, the Luhansk Oblast accounted for 3.6% of Ukraine's overall GDP (2013), 5.4% of its industrial output and 5.6% of its merchandise export supplies. The Luhansk Oblast economy nearly collapsed over the course of 2014 and 2015, resulting in its overall share of the country's industrial production falling to 3.9% in 2014 and 1.2% in the first half of 2015. Merchandise exports were similarly affected as the oblast's share fell from 3.5% in 2014 to 0.3% by mid-way through 2015, as well as with its retail trade, which dropped from 4.2% in 2013 to 2.4% in 2014 and to 0.9% in the first half of 2015.

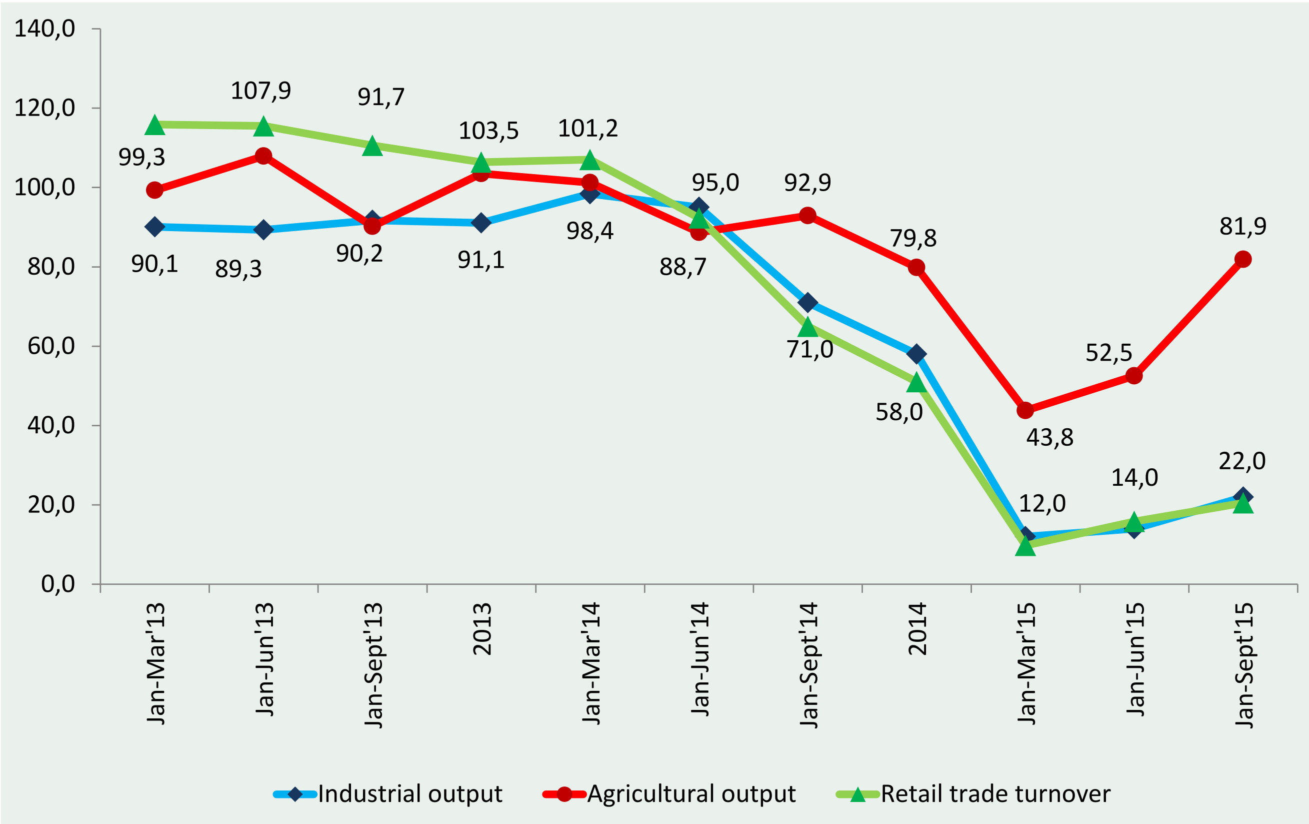
The Luhansk Oblast's manufacturing industry specializes primarily in metallurgical production (ferrous metals, pipes), machine building (railway locomotives and cars, transport equipment, electric equipment, etc.), coke and refined petroleum products, and the chemical industry (production of synthetic ammonia, ammoniac saltpeter, carbamide, etc.).

Industrial production in the oblast has witnessed a precipitous decline since 2012, dropping by -8.9% in 2013. In particular, all major industrial sectors in the oblast in 2013 decreased their output (with the exception of wood product manufacturers, paper production and printing service providers) due in part to a decline in global commodity prices, but also drastically lower demand from their primary market – the Russian Federation. Russia has gradually implemented

[5] The data for the Luhansk Oblast for 2014 and 2015 exclude information from the areas not under the Ukrainian state's control. According to the State Statistics Service of Ukraine, this data may yet be further updated, as oblast data for 2014 is still not complete at the time of this report's writing. The regional gross value-added used in this section were largely created with reference to the following sectors (2013): extractive industry (largely coal) (13.5%), manufacturing industry (20.9%), agriculture (6.9%), wholesale and retail (10.6%), transport (7.7%).

Figure 1

Indices of industrial production, agricultural production and retail trade in Luhansk Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine.

an import substitution policy since 2008, which since 2013 has increasingly affected the oblast's railway locomotives and car manufacturers.

The military conflict in eastern Ukraine has caused an acceleration of the region's economic decline, whether as a result of raw material supply shortages, damage done to industrial facilities and infrastructure, or disrupted production chains. A significant number of the oblast's large enterprises in the metallurgy, machine-building, chemical and mining industries are located within the non-government-controlled territories. That has caused an industrial collapse in the oblast, which dropped -42% in 2014 and -86% in the first half of 2015. Other export oriented and Russian market-dependent enterprises in areas under the Ukrainian state's control (particularly machine-building enterprises) have been hurt by the deep disruption of their economic and production ties.

The average unemployment rate of working age individuals in the region grew from 6.7% in 2013 to 11.8% in 2014, stumbling even further to 16.6% in the first half of 2015.

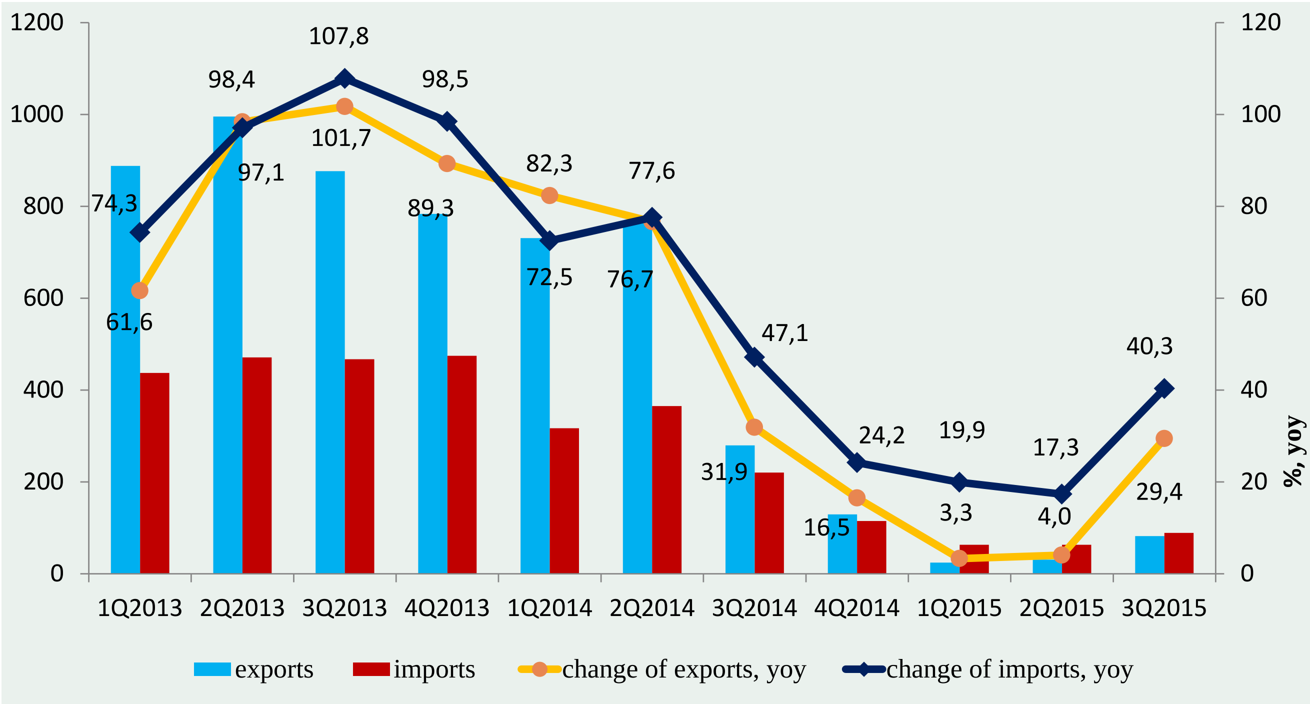
Trade Overview

As a result of the armed conflict in the region, the oblast's merchandise exports nearly halved in 2014, falling -46.3%, and almost ceased to exist by mid-2015, having been hit by a -96.3% decline. Goods imports fell -45% in 2014 and dropped -81.5% by the first half of 2015. The oblast's exports, which have traditionally been highly concentrated on the Russian and EEU markets (accounting for about about 65% of regional exports) from 2012-2014, saw the share of exports heading to these markets fall to 40% as access became increasingly restricted.

Exports to the EEU fell -46.5% from 2013 to 2014. The share of the oblast's exports to the

Figure 2

Dynamics of exports and imports of goods in Luhansk Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine
Note: Data for 2014-2015 excludes area beyond the control of the Ukrainian government.

EU, however, gradually rose from 27% in 2012 to 37% in 2013 and reached 46% in 2014.

However, the rise in exports to the EU and other markets were not enough to compensate for the losses incurred in exports to the EEU market. All major commodity exports from the Luhansk Oblast slid in 2014 and the first half of 2015, with the most noticeable declines in chemicals, vehicles/transport equipment (especially railway locomotives) and machinery/electrical equipment. Service exports, which are primarily associated with transportation services and material resource processing, were in ruins by the second half of 2014, having fallen -93.3%.

Survey

While the survey's preliminary screening identified 47 businesses that fit the sample matching criteria for the survey, only 18 interviews with business and one with a representative of the local oblast administration were recorded. The low response level was due to a mixture of factors, including the timing of the survey (the summer holiday season) as well as the reluctance of local businesses to be interviewed.

Businesses in the government-controlled regions of the Luhansk Oblast were cautious when providing responses that might be deemed critical of the local authorities. This was particularly true for the large enterprise interviewed, as they generally refused to provide any information that might be deemed critical of the authorities.

Interviews were conducted in key sectors for Luhansk oblast including wholesale and retail, furniture and wood making, machine manufacturing, among other industries. The interviews covered 1 large enterprise and 18 medium enterprises.

Number of responses by sector, Luhansk Oblast	
Wholesale and Retail Industry	5
Wood and Furniture Production	4
Machine Manufacturing	3
Food Processing	2
Other (Construction Materials)	2
Gas, Water, and Electricity Production	1
Chemical and Oil Reprocessing	1
Other	1

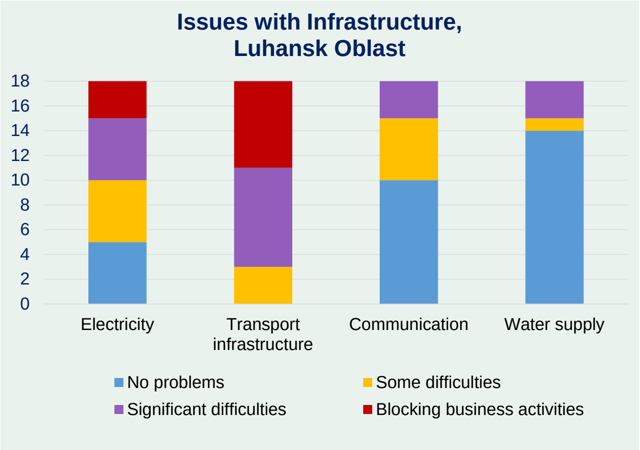
Business climate

Businesses in the Luhansk Oblast are facing multiple challenges due to the conflict in their region. Medium sized businesses pointed to the state of the region's transportation infrastructure, which was already in poor condition before the conflict in the Donbas began, as being a major obstacle to doing business. Both large and medium sized enterprises were highly concerned about the region's political stability and the difficulties they face in paying taxes during a deep regional economic depression.

In addition to political instability, growing production costs were cited as one of the most serious challenges to business over the past 12 months. The lack of access to new markets and low demand domestically were significant factors that have changed the way businesses function and are planning their future.

Infrastructure

Half of the medium sized enterprise respondents reported regular issues with electricity, which over the past 12 months has gone out for long stretches as a result of fighting and destruction of parts of the electrical grid. The sole large enterprise surveyed did not indicate that there were issues with the regions' general infrastructure, despite regular media reports of significant and prolonged power outages and water shortages.

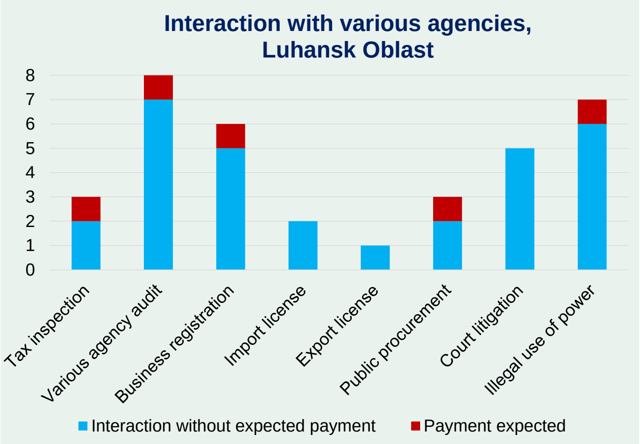


Medium sized businesses cited the poor state of the roads in the region as a major obstacle and expense they had to regularly contend with. Two businesses reported setting aside money in an account for the costs associated with repairing their vehicles after deliveries runs, as their vehicles regularly break down due to the state of the roads.

They also reported long delays at military checkpoints situated on government-controlled territory throughout the oblast. One respondent indicated that the checkpoint system was very poorly organized.

Internal regulatory environment

Two businesses cited a new requirement that businesses use cash registers as having hurt their sales. They stated smaller businesses that used to purchase goods from them have stopped altogether because they cannot afford to purchase a cash register, much less pay the monthly service fee.



Access to financing/capital

Of the two businesses that reported seeking credit for maintaining their operations, neither was successful. Both companies said they had enough collateral to receive a loan, but the interest rate of 30% stopped them from applying. One respondent noted that even if they were willing to pay the high interest rate, their location near the demarcation line between the non-government-controlled and Ukrainian government-controlled territories would be too big of a risk for any bank.

Changes in business profitability

Some of the larger company's main clients are still located in Russia and, according to them, sanctions and general economic difficulties have created delays in payment and led to numerous contracts being cancelled. However, the company had other clients outside of Russia that substituted demand, with overall demand for their products remaining relatively stable over the past 12 months.

Medium sized enterprises said demand for their goods fell because regional customers closed, or were located on territory not controlled by the Ukrainian government that they couldn't do business with. They also reported not being able to deliver to government-controlled territory near or along the line of demarcation, where various volunteer battalions and formal military detachments were posted. According to respondents, members of these groups would enter a town or village and, in many instances, immediately try to establish control over everything entering or departing. Medium sized businesses reported that bribes were necessary to get to their destinations and had become prohibitively expensive, cutting off access to markets.

Labor force

The large enterprise reported significant difficulty recruiting new qualified employees. They also reported releasing between 5%-20% of their workforce due to the poor financial state of the company.

Seven of seventeen medium sized enterprises reported having considerable difficulty finding qualified personnel for their businesses. This phenomenon was most prevalent among companies working in machine manufacturing, and the wholesale and retail industry.

Only three businesses reported being able to maintain roughly same number of employees over the past 12 months. A majority of medium sized businesses reported releasing over 20% of their employees.

Trade Climate

International trade

The sole large enterprise surveyed reported that they continued to work with clients from Russia, Kazakhstan and Uzbekistan, with Russia continuing to account for 70% of the company's exports.

The same business also stated that they were seeking new markets in south-east Asia, but cited the local standards in the region as being difficult for their company to adapt to. They had found some success using French intermediary company to export their goods to Iraq, and are currently seeking a partner to do the same in the EU. Previously, they had several contracts with companies in Estonia and Lithuania, and remained optimistic that their position would improve.

Nearly half of the medium sized businesses interviewed reported losing all of their former exports to and imports from Russia. Four companies, working in the food processing and machine manufacturing industries, suffered losses so great they were on the verge of closing. One company from wholesale and retail reported that they had tried to import goods from Russia, but were unable to due to a secret ban in Russia on exporting the goods in question to Ukraine.

Six respondents viewed the opening of the EU market through the Deep and Comprehensive Free Trade Agreement as a positive development, though they had no plans to try to export their goods to the EU. Six companies viewed closer economic integration with the EU as something that could negatively impact their business. Both the optimists and pessimists cited higher standards and more competition as factors that concerned them.

Trade with non-government-controlled territory

Only three of the medium sized enterprises had previously done business with Crimea, which amounted to less than 5% of their overall domestic trade, but there were only three companies that had not traded domestically throughout the Luhansk and Donetsk oblasts.

In total, twelve medium sized enterprises reported having lost a majority of their clients in both non-government-controlled and government-controlled areas. Two companies from the machine manufacturing industry reported they had lost nearly 70% of their domestic trade market due to the armed conflict. A wholesale and retail company and a gas, water, and electricity service provider reported similar losses.

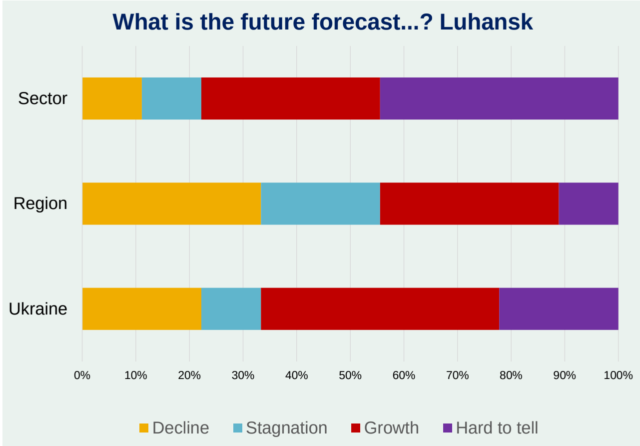
While nearly all of medium sized enterprises reported looking for new markets domestically, of those who had lost business domestically in the region, none reported finding a new market.

Future potential

Only half of the companies interviewed were willing to share their thoughts about the future.

In their responses to what they believed would be the state of the Ukrainian economy in the coming 1-2 years, four companies thought the country as a whole would experience economic growth. Each respondent used the term “we hope” when qualifying their forecast for the Ukrainian economy. One company from the machine manufacturing industry stated that the national economy had yet to hit its low point. In describing why they believed the economy would be stagnate in 1-2 years time, another respondent stated that the current government’s misguided policies would not lead Ukraine out of its recession. No policies in particular were identified.

As a region, respondents stated that they could only “hope” that the economy would grow and it would only grow if Ukraine’s economy as a whole improved. Companies that believed that the regional economy would continue to decline cited the unlikelihood of the conflict in the



region ending in the near future, and the collapsing infrastructure as reasons why they did not expect the situation to improve.

On a sector-by-sector basis, there was similarly little optimism about the future. Respondents who forecasted their sector returning to growth could not provide any reasons, instead simply expressing their hopes that it would. Among uncertain respondents, three had plans to make their businesses more profitable, but much depended on whether the conflict would end.

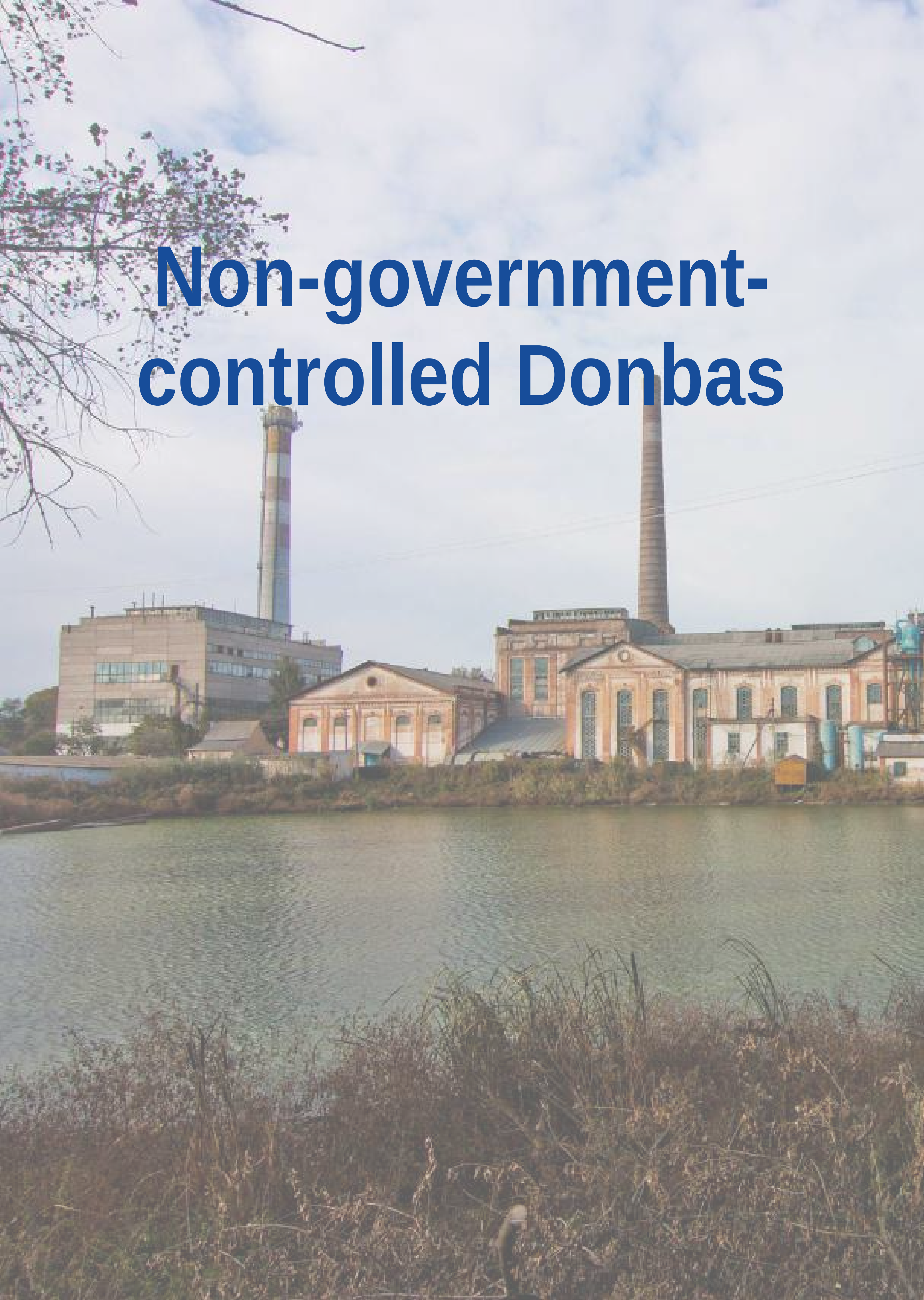
Conclusion

The Luhansk Oblast is one of the Ukrainian oblasts most affected by the armed conflict in eastern Ukraine. While the one large sized enterprise seemed to be in a good position to recover, they are an outlier for the oblast and in no way represent the general economic trends in the region or their sector.

The region’s domestic and international economic connectivity has been damaged to the point of near complete disconnect. The previous reliance on trade with Russia has caused many production chains to be completely severed by the current conflict.

Medium sized enterprises are mainly concerned with surviving the current dire economic climate. For now businesses are trying to find new domestic clients and suppliers in order to continue to operate. The specialization of the region’s economy, however, limits alternatives. Few businesses had plans for how to move forward, and without a long-term stabilization of the security situation and influx of capital to rebuild these situation is unlikely to change.

Non-government-controlled Donbas



The self-proclaimed so-called "Donetsk People's Republic" ("DPR") and "Luhansk People's Republic" ("LPR") control about one-third of the Donetsk and Luhansk oblasts' territory (3% of the territory of Ukraine), and half of those oblasts' population. The "DPR" and "LPR" control major urban areas and industrial agglomerations in the Donetsk and Luhansk oblasts, including Donetsk, Horlivka, Makiivka, Yenakiieve, Torez, Shakhtarsk, and Luhansk. According to "DPR" and "LPR" statistics, around 2.3 million people live in the "DPR" and 1.5 million in the "LPR" (as of September 1, 2015). These areas are economically important for the Donbas as a region and the country as a whole, as they have important economic ties to the rest of Ukraine.

According to World Bank estimates, the areas not under Ukrainian government control (in both oblasts) are estimated to account for 14.4% of Ukraine's industrial production and 6% of its GDP.[6] The regional economic structure is dominated by coal, metallurgy, coke, chemical and machine-building enterprises (producing general machinery, mining equipment, machinery and equipment for the metallurgy and chemical industries, transportation equipment, locomotives and rail cars). An overwhelming amount of Ukraine's coal production comes from these two regions and it is an important input for the steel industry and electricity generation. The region also contains several key objects of the energy infrastructure of the Donbas, including the Starobeshevskaya and Zuevskaya thermal power plants. The "DPR" has access to the Azov Sea, however, the local port's capacities are insufficient to service regional industry.

Economic activity in the region was severely disrupted and precipitously declined due to damaged or destroyed production facilities and economic infrastructure (most notably the railway connections and electricity supply); broken production chains with the rest of Ukraine ("coal-coke-metal" and "coal-electricity" links) resulting in raw materials and equipment supply shortages, and logistics problems. Other issues included labor shortages due to large scale out migration, a suspended banking system, lack of investment and low consumer spending. Local small and medium-sized businesses have suffered the most from the changes that have taken place since 2014. A large number of large enterprises operating in the area have either closed their business or were not operating at a full capacity from 2014 to the beginning of 2015.[7]

Several key industries have experienced significant difficulties. Below is an overview of some of the more prominent sectors:

- Metallurgy and coke industry. The Donetsk Metalworks and Donetsk Electro-metallurgical Plant, Enakiev Metalwork Plant, Stakhaniv Ferroalloy Plant (20% of Ukraine's gross ferroalloy production), Alchevsk Iron & Steel Works (13% of Ukraine's gross iron and steel production) have all suspended their operations. Horlivka Chemical Recovery Plant, Yasynivka Chemical Recovery Plant, Enakievskiy Coke-Chemical Plant, Makiyv Coke all had key assets damaged as a result of the armed conflict and difficulty securing coal. Coke factories in the conflict zone were working at 30-40% of capacity.
- Chemical industry. Since May 2014, Stirol Concern has not been operating (production of ammonia, urea, nitric acid, ammonium nitrate has stopped). Given the potential dangers from a renewed armed conflict and damage to the chemical plant, the company is not likely to start operating again until they have assessed that there is no danger to their operations.
- Machine manufacturing. Donetskhormash, Donetsk Power, the Research Institute of Complex Automation in Donetsk, Stakhanov Wagon Works are all out of service. Horlivka

[6] Ukraine Recovery and Peacebuilding Assessment. Analysis of crisis impacts and needs in Eastern Ukraine, Volume II: http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2015/06/11/090224b082f1bea0/2_0/Rendered/PDF/Full0component0reports.pdf

[7] Government of Ukraine (2015, June 1). Kremlin's Black Book: Russian War against Ukraine. Retrieved March 12, 2016, from http://www.kmu.gov.ua/control/en/publish/article?art_id=247956386

Machine Builder, Novohorlivsk Machine Works, Yasynuvata Machine Works have also suspended their production activities. According to the “DPR” administration, as of April 2015 machine-building enterprises were working at 20-25% of their production capacity.[8]

- Coal industry: 70% of coal mines have stopped or suspended their operations due to electricity shortages, flooding and explosions related to fighting.[9]

There are no reliable statistics on the economic situation in the “DPR” and “LPR”. According to the “DPR”’s own estimates, regional industry was functioning at 30% of pre-conflict levels, and retail trade declined by about 50% as of February-March 2015.[10] The “LPR”’s industry has witnessed an even steeper decline. According to the official program of recovery and development of the economy and social sphere of the “DPR” in 2015, agricultural output is forecasted to reach 85% of the level it had in 2014 and industrial output should reach about 30% of its previous potential. Companies from the extractive industry are expected to reach 35.7% of their capacity, while the manufacturing industry is anticipated to reach only 2.7% of their previous potential capacity. The volume of wholesale and retail trade is around 91% of their 2014 levels, while sales for transportation services, postal and courier services were estimated to reach near 80%.

Taking into account all of these factors, industry is expected to witness negative dynamics in 2015 (-70% drop from the previous year), with the manufacturing industry taking the largest hit with a -97.3% annual decline. Even with a ceasefire, the recovery of the “DPR” and “LPR”’s economies is very slow. In September 2015, a secretary of the “DPR”’s “Security Council”, Alexander Khodakovsky, confirmed that prices are as much as three times what they were before the conflict began.[11]

Neither of the self-proclaimed breakaway “republics” are economically self-sufficient. As of December 2014, both territories have been under a de facto Ukrainian economic blockade (Ukraine imposed a transportation blockade on the region and a pass permit regime in the area of hostilities.). In addition to the banking system being shutdown, Ukraine has also suspended social welfare benefits and payments in areas outside of government control. The Donbas also struggles with food and water shortages.

The “DPR” and “LPR” authorities have faced a host of problems, from a massive outflow of capital, rising unemployment, cash shortages, and the rise of criminal and semi-legal economic activities (e.g. bartering, smuggling of scrap metal and coal to Ukraine and Russia, counterfeit goods production, etc.). Local businesses have suffered from an unstable and unpredictable business environment, open banditry, and shortages of electricity, raw materials and equipment. They are often expected to pay taxes and/or make unofficial payments to both Ukraine and the local de-facto authorities.

To cope with constant currency shortages, in March 2015, the “DPR” and “LPR” authorities introduced a multi-currency zone in which the ruble, hryvnia, euro and U.S. dollar were used. Then the “republics” began to reorient them-

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[8] Occupants of "DPR" has stolen billions from Donbas: Statistics of fake republic. (2015, July 20). Retrieved March 12, 2016, from http://pravda.dn.ua/details/255497/

[9] ADAROV, A., ASTROV, V., HAVLIK, P., HUNYA, G., LANDESMANN, M., & PODKAMINER, L. (2015, April 15). How to Stabilise the Economy of Ukraine (Background study). Retrieved March 12, 2016, from The Vienna Institute for International Economic Studies website: http://wiiw.ac.at/how-to-stabilise-the-economy-of-ukraine-dlp-3562.pdf

[10] Bezsonova, I. (2015, May 12). Project "DPR": Summary of the Year of Independence. Retrieved March 12, 2016, from http://ua.112.ua/statji/proekt-dnr-pidsumky-roku-nezalezhnosti-227829.html

[11] Kravchenko, S. (2015, September 16). The Central Bank With No Currency, No Interest Rates, But ATMs. Retrieved March 12, 2016, from http://www.bloomberg.com/news/articles/2015-09-15/the-central-bank-with-no-currency-no-interest-rates-but-atms

selves towards the ruble. According to the "central bank" of the "DPR", rubles accounted for 90% of the local currency stock in the "DPR" as of September 2015.

Neither of the two unrecognized "republics" had an officially approved state budget and their funds are allocated on a short-term basis. They need at least 55.2 billion rubles ($947 million) annually to pay pensions and social benefits, however their coffers do not possess the necessary funds.[12] According to the "DPR" administration, Russia transfers 2.5 billion rubles ($37 million) for pensions every month in the "DPR". Financial assistance from Russia was estimated by "DPR" official Alexander Khodakovsky to account for up to about 70% of the "DPR"'s budget.[13]

In addition to this, they both generate revenue by taxing businesses. In the "LPR" businesses pay between 3-8% of their turnover, and in the "DPR" businesses can choose to pay 2% of their turnover or 20% of their net profit. The income tax rate has been set at 13%. Entrepreneurs have to buy patents at a fixed rate on a monthly basis in order to obtain the right to engage in certain types of commercial activities.

As of February 2015, the "DPR" and "LPR" have been receiving natural gas and electricity directly from Russia. Ukraine has terminated financial agreements with the energy distributors located in the uncontrolled territories. According to the Ukrainian government, the "DPR" and "LPR" were both disconnected from the Ukrainian power grid in May 2015.

Companies in the "DPR" and "LPR" are unable to legally trade outside of the regions controlled by the separatist administrations without holding some registration in Ukraine, including with the Russian Federation. This is a consequence of the fact that they are formally a part of Ukraine and not recognized by any state. A majority of large companies physically located in the "DPR" and "LPR" are registered in the territories under Ukrainian government control, which they do in order to be able to export their goods to Ukraine and to other countries.

Russian goods are regularly imported by local entrepreneurs who have accounts in the republics' "central banks", which allow an importer to pay Russian suppliers through a Russia-based credit union or through a bank in South Ossetia.

Survey

Interviewers were able to collect only five full interviews, three from the "DPR" and two from the "LPR". In addition to the full survey, interviewers spoke to two more businesses who decided not to participate but provided information about the business environment. Notes from their conversations are used in this report too.

In order to conduct interviews interviewers contacted "authorities" in the self-proclaimed so-called Donetsk People's Republic and Luhansk People's Republic. Upon arrival to "DPR", the interviewers registered in the press center, received contacts of all "ministries", and verified the survey form with the "legal department". The interviewers submitted a formal request to the "Ministry of Information" for the contacts of registered companies, but were told the information was classified.

Despite registration with "DPR" "authorities", interviewers were detained twice. One interviewer was detained for 4 hours at a checkpoint when he was crossing the contact line. After a phone call, the interviewer was released. After twenty days in the "DPR" an interviewer received a call asking for a meeting with representatives of "authorities". During the meeting the interviewer was accused of espionage and was interrogated for a few hours. Next day, at the end of the second day of interrogation, they released the interviewer after her contacts called the local "Ministry of State Security (MGB)". The same interviewers contacted the "LPR"

[12] The strained economic situation in the Donbass. (2015, June 18). Retrieved March 12, 2016, from http://in.rbth.com/world/2015/06/18/the_strained_economic_situation_in_the_donbass_43737

[13] Tumakova, I. (2015, September 8). Interview with Alexander Khodakovskiy. Retrieved March 12, 2016, from http://www.fontanka.ru/2015/09/07/163/

"government" and while they did not deny them entry to the "LPR", the local security services ("LPR" "MGB") made it clear they were against interviews being conducted there.

There is little cooperation between the "DPR" and "LPR" governments, but the business and trade environments are very similar. Due to the small number of surveys and the similarity of the regions, the data is presented in one chapter. The report below specifies when there are differences between two regions.

Business climate

Businesses are struggling to survive under current conditions. While the "Ministry of Incomes and Tax Collection" did not provide the list of the "registered" companies, in personal conversations they confirmed that at least half of the businesses are not in operation. Those still operating registered from March to April 2014 in the "DPR" and are paying the taxes into the "DPR" budget.

This is confirmed in local stores where receipts are provided under new names and registration, and interview with local businesses.

A number of famous Donetsk food producers continue their operations, having "registered" in the "DPR". The director of such a firm said there is criminal investigation against him in Ukraine for supporting terrorists because he "registered" the company in the "DPR".

Respondents stated that business was complicated by difficulties bringing goods over the contact line, new barriers with Ukrainian controlled territory, the threat of military action and absence of an independent judiciary.

Attacks on businesses are common. Separatists reportedly destroyed a chicken processing facility in Makeevka capable of meeting the needs of the entire "DPR". The director of the company was abducted but later released. Electricity producers are forced to incur debts and continue to produce electricity under physical threat to the company managers. There are also many incidents of stolen property and equipment.

Infrastructure

The contact line limits the transportation of goods and with the recent blockade, crossing the contact line has become even more difficult. As a result companies cannot deliver their products across the line. Roads and communication infrastructure have been ruined by fighting. Large enterprises continue using railways to deliver their goods.

Internal regulatory environment

The internal regulatory environment of the "DPR" and "LPR" remains unclear. The new "ministries" and regulating bodies' responsibility are ambiguous and their work is barely visible. The small and medium enterprises have double "registration" in government-controlled territories and in the "DPR". Companies like Metinvest and DTEK are able to operate exclusively with Ukrainian registration.

The local "legislation" does not apply equally to all companies and higher level agreements with the "DPR" leadership can influence implementation.

The "DPR" tax rates according to interviewees were: 20% for private entrepreneurs; VAT is 13%; for the employees who earn under UAH 10,000 the tax is 13% and for those who earn more it is 20%. The "custom fee" for "imported" goods is 2%.

In comparison with the "DPR", the "LPR" usually follows Ukrainian law. A new set of rules and regulations were put together, but there is no elected council to approve them. Registration of businesses in the "LPR" is similarly enforced and large enterprises do not plan to re-register. The tax rate in the "LPR" is much lower than in Ukraine and there are two levels of taxation – "state" and local.

There are nine taxes on business – income tax, tax on turnover, excise tax, tax on extraction of natural resources and an ecological tax. There is no VAT tax and some industries pay a preferential rate of 2% for machinery, coal extraction and processing and agriculture sectors. The export fee from the “LPR” is 3% and private entrepreneurs pay only UAH 300. Personal income tax is 13%.

Key positions in the “DPR” government are held by individuals without much experience. Ministries are not aware of their responsibilities or information they collect. The appointment of ministers is based on the loyalty to their superiors rather than on any professional qualities. While coordination of the ministries on specific areas like economic development would be expected, no coordination mechanisms exist and most of the issues are solved by personal telephone calls. A notable exception is the individual responsible for communal services in Donetsk City.

Many regulatory bodies simply do not exist in “DPR” as most professionals left for Ukraine. The respondents report low capacity of the “regulatory agencies”. Interviewees mainly interacted with the local “Administration”, “Ministry of Coal Production”, “Ministry of Economic Development”, “Ministry of Fuel and Energy”, the “Tax Agency”, the “Sanitary and Epidemiology Agency”, the fire department, the “People’s Militia” of the “DPR”, the “Military Administration” and the “Social Security Service”.

Taxation officials

The companies that continue working with Ukrainian registration are experiencing pressure from local “tax authorities”, “ministries” and other authorities. Only large companies are able to stand against such pressure, others prefer to register and pay taxes to local authorities. In cases of refusal to register there are often physical attacks on companies’ senior management. A chicken farm and an electric power station were both reported to have been attacked.

Licenses, permits and certificates

Companies that re-registered in the “DPR” and “LPR” have difficulties conducting international trade, but there are schemes using non-banking credit organizations based in South Ossetia and Russia. To ensure that companies are aware how to avoid sanctions and limitations on trade, the “DPR” government conducts seminars on existing schemes, and paid consultations are provided to entrepreneurs. Respondents reported that receiving an “export license” takes 25 days, and an “import license” from 6 to 25 days.

Access to financing/capital

A banking system operates in the “DPR” and enables business to trade with other countries. Companies registered in the “DPR” open accounts at Central Republican Bank and then register with Russian Non-banking Credit Organization. While Russian companies cannot legally have contracts with “DPR” companies, they can work with a non-banking credit organization accounts and brokering companies in South Ossetia.

Trade climate

Small and medium businesses have been hurt by Ukrainian restrictions on trade that have made it more difficult to get goods across the contact line. As a result of the restrictive practices, businesses have switched to importing Russian goods. The restrictions have also increased smuggling and the bribes paid at checkpoints have increased goods’ prices.

Respondents reported the cost of bribes for bringing different goods across the contact line: for one live pig UAH – 1,000; for one truckload of food – UAH 100,000, for a small “Gazel” car – UAH 50,000, for truckload of medicine – UAH 6 mln.

Large businesses continue to operate despite the blockade and Metinvest could even increase sales to Europe and North America. The Metinvest’s branch in Yenakievo continues to operate. Often companies are not able to deliver their products to Ukraine and as a result are looking to export to other countries.

Strategic supplies, however, continue to be transported across the line. The coal extracted in Krasnodon (currently “LPR”) is delivered to the Avdeevka Chemical Plant (Ukrainian control). There it is turned into charred coal and transported to Yenakievo Metallurgic Plant (currently

“DPR”) where metal is produced. Then that metal is transported via the Azov Sea to the west. There was a breakdown in the delivery of coal to Avdeevka in the beginning of the year, but after negotiations work was resumed. The Avdeevka coke plant receives 10% of its coal from Krasnodon.

Conclusion

Ukraine’s blockade, restrictions on business by the new separatists leadership and damage to infrastructure from fighting have drastically hurt the non-government-controlled territories’ connectivity. Though businesses have registered in both Ukraine and the “DPR” and “LPR” in order to keep operating, and pay bribes at checkpoints to be able to move good across the contact line, it has placed a considerable stress on business and driven up costs.

The economic blockade has pushed the remaining businesses in the non-control led territories to establish partnerships with Russian businesses and find substitute Russian products. Cut off from the Ukrainian banking system, businesses similarly use Russian financial institutions as replacements.

The situation for large enterprises is better as they are able to keep functioning on both sides of the contact line, keeping their Ukrainian registration while paying to repair infrastructure in the non-government-controlled territories, but without registering or paying taxes there. Because of the importance of their industries to the Ukrainian economy, they are able to more freely move their goods across the contact line.

Despite the tremendous amount of physical and economic damage that has crippled connectivity, there was no discernible plan from the new separatist authorities for restoring it.

Kherson Oblast

Kherson Oblast is located in southern Ukraine and borders on Crimea to the south. Since Russia seized control of Crimea, Kherson Oblast's southern administrative border has become a de facto international border. It's important geographic position has made Kherson Oblast the staging ground for a Crimean Tatar and Right Sector organized economic blockade of Crimea, and where power lines into Crimea were downed, temporarily cutting off the supply of electricity to the peninsula. These events showed continued areas of Crimean dependence on Ukraine, but at times placed the future of the Kherson Oblast in question with some experts speculating Russian President Vladimir Putin could try and build a "land bridge" from Russia to Crimea via the Kherson Oblast.

The conflict has cut off Kherson Oblast from previously important trade partners in Crimea and the neighboring Donetsk Oblast. Access to the Russian market has also become restricted. In response to these changes some of the oblast's businesses have faired better than others in adapting. The sunflower oil business with low production costs thanks to weak hryvnia and strong demand in Europe has done well, but the machine building industry, dependent on countries using Soviet legacy systems, has not found a replacement for the Russian market. There continues to be tremendous pressure to find new markets and adapt to economic changes.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 5 sectors were the most prominent:

Kherson Oblast	agriculture food industry machine building industry light industry real estate

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Economic Overview

The Kherson Oblast accounts for 1.4% of Ukraine's overall GDP (2013), and just 1.1% of its industrial output (2014) and 0.7% of total merchandise exports (2014). Agriculture is the oblast's most valuable sector in terms of both the workforce it employs and its value added, accounting for 27% of the value of goods and services produced in the oblast in 2013. The agricultural sector primarily produces grains, sugar beets, sunflower seeds, potatoes as well as other traditional goods like dairy products, meat and eggs. Other major contributors to the oblast's GDP include wholesale and retail (11.6%), manufacturing (11.2%), education related services (9.5%) and real estate (8.5%).

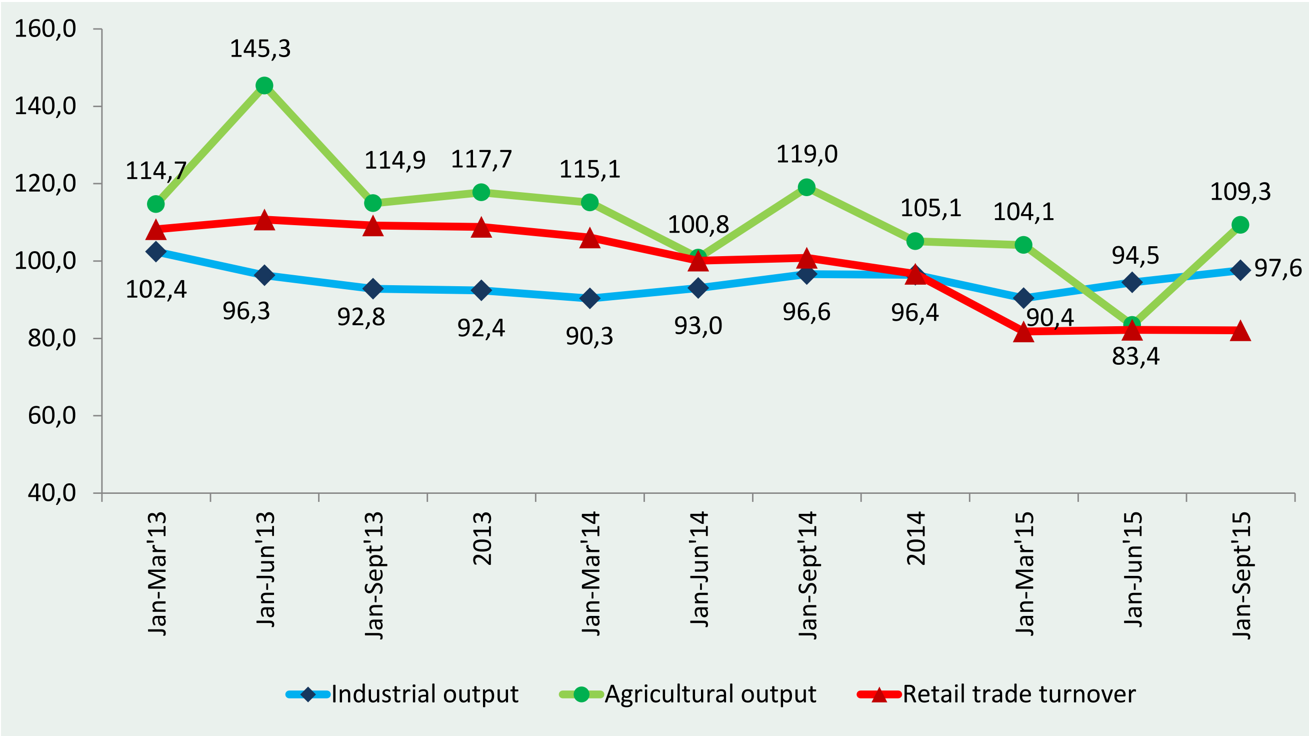
The Kherson Oblast's industrial sector consists of a well-developed food industry, machine-building manufacturing, a paper production and printing industry and non-metallic mineral manufacturers. The food industry processes a variety of products, including sunflower oil, flour, wine, seafood and has several food canning facilities. Its machine manufacturers typically produce inputs that are part of a larger production chain, including specialized electronic devices for larger electronics, instruments and spare parts for industry and stand alone electronic machines.

The oblast's industrial output exhibited signs of general decline from 2013 to mid-2015 and is highly dependent on the performance of its food and machine-building industries. Food production, which fell -10.6% in 2013, rebounded in 2014 with 15.3% growth, thanks largely to a bumper harvest year for sunflower seeds and, subsequently, a higher volume of sunflower oil production. Sunflower oil is a significant contributor to the region's economy, accounting for roughly 40% of the oblast's total food output.

The oblast's other major sector, machine building, witnessed its share of regional production drop from 12.1% in 2013 to 7.3% in 2014, falling even further to 3.5% by the first half of 2015.

Figure 1.

Indices of industrial production, agricultural production and retail trade in Kherson Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

As around 65% of their goods are made for export, half of which were originally destined for the Russian market, the formal and informal measures applied by the international community, Ukraine and the Russian Federation as a result of the armed conflict in the Donbas and the annexation of Crimea hit machine building in the Kherson Oblast particularly hard.

The oblast's metallic mineral manufacturers' traditional domestic market in Crimea also shrank as a consequence of the peninsula's annexation.

Despite the economic downturn in the region, the average unemployment rate for able-bodied individuals in the oblast grew only slightly from 9.1% in 2013 to 10.2% in 2014, inching up to 10.4% by mid-2015.

Trade Overview

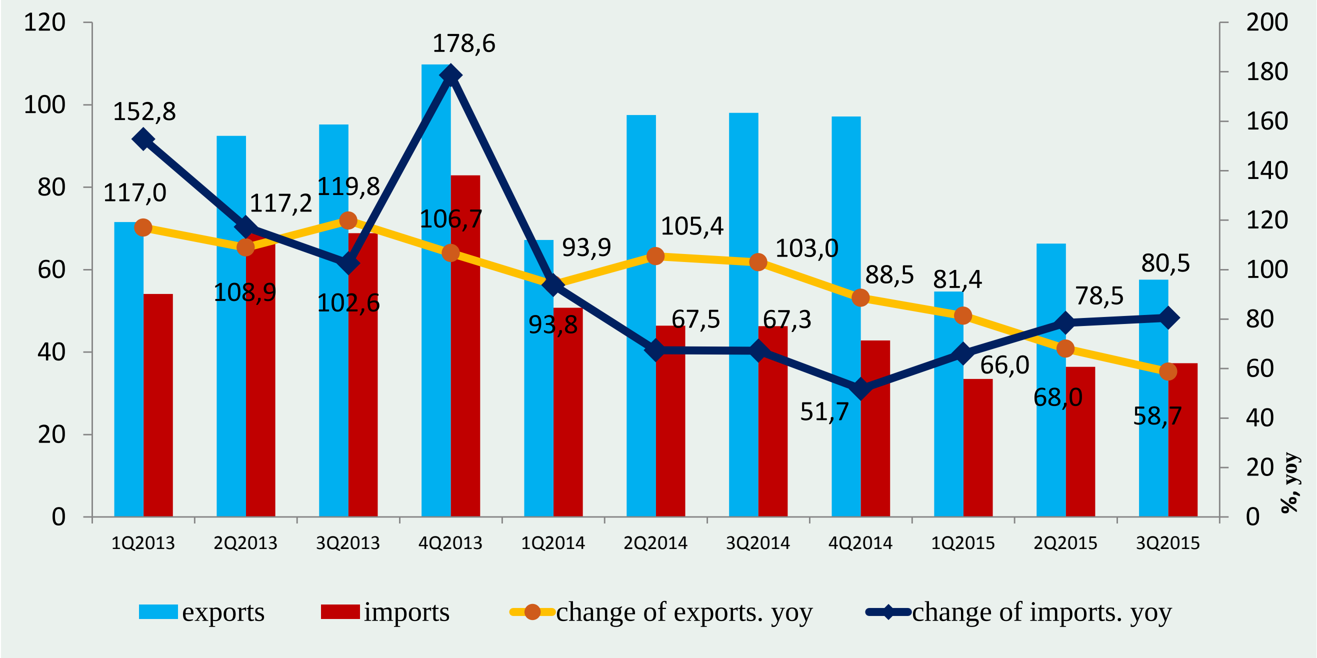
The oblast's merchandise exports and imports continued to fall throughout 2014, a trend that did not abate in the first half of 2015, though imports declined at a slower rate. The EU became a major destination for the oblast's exports in 2014, accounting for 36.7% of its overall volume, with Asian markets following closely behind with 30% of its overall outbound trade. Over the course of 2014, exports to the EU grew an impressive 32.9% and to Asia 56.2%.

Exports to the EEU declined by a drastic -47%, with the overall share of the oblast's exports destined for the EEU contracting from 41.1% in 2013 to 22.3% in 2014. The EEU market accounted for only 14.4% of Kherson Oblast's total exports in the first half of 2015, demonstrating a continuous shift in exporter preferences as informal and formal restrictions further contract their export market in the economic bloc.

A strong harvest and improved access to EU markets, in large part due to one-way preferential trade measures instituted by the EU, boosted regional agricultural exports. Agriculture and food products are the oblast's primary exports, accounting for 66.4% of its overall exports in 2014. Of its total exports, grains and sunflower oil are the staple crops in the oblast and con-

Figure 2

Dynamics of exports and imports of goods in Kherson Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

tribute to 33% of its agricultural exports, while pre-prepared foodstuffs and animal-based products account for a combined 27.3% of its outward bound goods. Exports of vegetables and vegetable-based products, which are more oriented towards the EU and Asian markets, grew in 2014 as a result of a strong grain harvest and subsequently fell -27.5% in the first half of 2015.

Restrictions on Russian and EEU market access drove regional exports and production downwards, particularly its export-oriented transportation equipment and machinery sectors that traditionally rely on these markets. Losing their positions as some of the oblast's major exporters, vehicle and transportation equipment exports witnessed a dramatic drop in exports in 2014 and the first half of 2015, falling -75.2% initially and a further -47%. Consequentially, service exports also fell, particularly repair and maintenance services as well as business services.

Survey

A preliminary screening identified 38 businesses matching the survey's sampling criteria, but only 10 businesses and one representative of the Kherson Oblast Administration agreed to take part in the survey. Due in part to the timing of the fieldwork, conducted during the summer holiday season, there were complications in reaching out to potential respondents. The agricultural sector was heavily engaged in seasonal work at the time. Participants were guarded in their responses to anything related to neighboring Crimea or corruption.

The interviews were conducted in key sectors for Kherson Oblast including agriculture, food

Number of responses by sector, Kherson Oblast	
Food processing	3
Retail	2
Agriculture and forestry	1
Machinery production	1
Chemical and oil	1
Wholesale	1
Hotel and restaurants	1
Real estate	1
Machinery production	1

processing, retail and wholesale, machinery production and chemical and oil manufacturing. The interviews covered 4 large enterprises and 6 smaller enterprises.

Business climate

Around half of large and medium sized enterprises reported concerns about the impact of low domestic demand and political instability on business. Over half of each group cited growing production costs as an issue negatively affecting the oblast's business climate. Large businesses also cited lack of access to financing as hurting growth.

Drop in domestic demand over the past year dominated medium sized enterprises' concerns and was a pressing issue for a majority of the large enterprises. Besides the threat of renewed fighting in the east and southeast of the country, enterprises also cited trade barriers with Crimea and the Donbas as negatively affecting their businesses.

Infrastructure

75% of large enterprises surveyed and all but one medium sized enterprise identified the oblast's transportation infrastructure as a considerable obstacle to doing business. Respondents specifically identified the oblast's decaying roads. Costs associated with transporting their goods, such as vehicle repair and low fuel economy, continue to grow as conditions deteriorate each year. Several medium sized businesses also noted that the state of roadways was not confined to the oblast, but extended throughout Ukraine and hampered their ability to receive supplies from or ship goods to countries like Moldova, Lithuania and Russia.

Internal regulatory environment

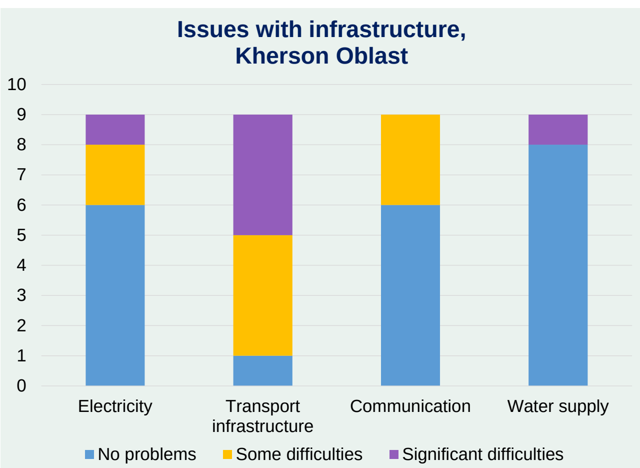
Business is also struggling with constant changes to laws affecting them. Two companies complained about not receiving a refund of VAT as required by law. The electronic administration of VAT, introduced in February, has not been implemented effectively, delaying VAT refunds since May, hurting business profitability.

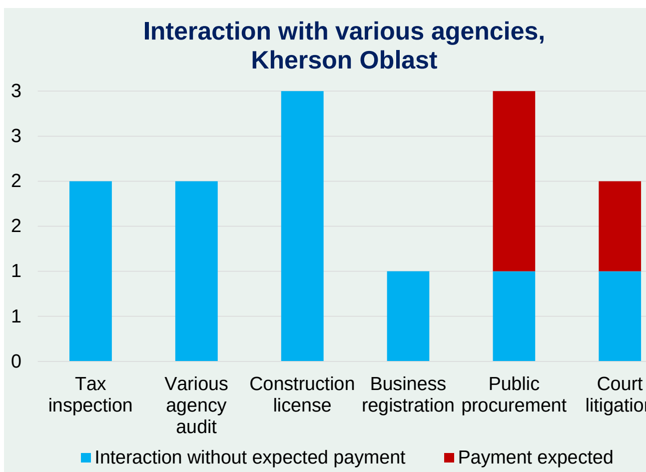
Large and medium sized enterprises reported that they did not receive their VAT refunds from the tax authorities. Kherson's large businesses noted the poorly administered electronic VAT administration system as one source of the problem. Businesses cited these issues and inconsistencies in the VAT system as factors that limited their ability to function as it restricted the funds their businesses had access to.

Large enterprises stated much needed to be done to create a growth-enabling environment for investors and exporters. Medium sized businesses reported on Ukrainian authorities failure to recognize many EU licenses and certificates, requiring double certification to reapply within Ukraine.

Relationship with Tax officials

Business in the Kherson Oblast reported dealing with the taxation authorities more often than any other state agency, despite the recently imposed tax moratorium. In their dealings with tax officials, they cited considerable difficulty in





communicating with them to clarify any questions or issues they have, such as navigating the complex series of procedures to pay taxes. Though the sheer volume of inspections had decreased, medium sized business said they were still regularly fined for supposed errors in their tax audits. According to several large enterprises, the practice of requesting bribes in exchange for the dismissal of penalties remains a common practice. One large business even reported that officials produced falsified documents for them at their request in exchange for a bribe.

Licenses, permits, certificates and court rulings

Businesses in the construction industry reported excessively long waiting periods, ranging from 60 to 90 days, to receive building permits. One large enterprise said that they entered a local bid to secure a government contract, though soon learned that the authorities required a bribe for the contract and related permits. According to one enterprise, a court official expected payment for a ruling in their favor.

Access to financing/capital

Three enterprises, two large and one medium sized, reported applying for credit from local banks but later declining to take the loan due to high interest rates. As a consequence of their inability to secure additional financing, each business stopped their respective investment projects and did not foresee their companies growing.

Changes in business profitability

While growing production costs affected the profitability of all the enterprises surveyed, businesses cited gradually declining consumer demand and purchasing power as some of the most significant challenges they faced. Some companies, like medium sized retailers, developed a strategy of targeting the lower end market to improve sales, though reported meager results due to the overall economic climate.

Other obstacles to returning to higher profit margins were cited by importers from the medium sized business community who explained that while higher taxes are imposed on imports, they are unable to raise their own prices because fewer customers would purchase them.

Labor force

Internally displaced persons (IDPs) became an important part of the oblast's workforce, with large enterprises surveyed reporting hiring over 100 IDPs in the past 12 months. Both large and medium sized enterprises reported that they replaced employees who were drafted into the Ukrainian military with IPDs, though large businesses struggled to find qualified individuals with the necessary technical skills to work on their machinery, which is often outdated. They pointed to the retirement of a generation of skilled workers as their main staffing problem. Medium sized enterprises cited an under-qualified young workforce as a larger obstacle in securing the personnel they need.

One medium size enterprises reported that since the government required them to register the ages of employees for military service, employees refused to provide them with the required documents.

Trade Climate

International Trade

Five out of 10 Kherson businesses export, where four export directly and one business through brokers. Three Kherson businesses import directly. On average around 25% of export sales goes to the EU, mainly in the food processing and packaging sectors. The second most popular market is EEU countries with one business exporting half of their food products to these countries. Only 10% of agricultural and machinery exports go to Russia. The three companies that import directly from abroad operate in the food processing, machine production and package producing sectors. One of the companies reported that 100% of their supplies comes from abroad including countries like India, Saudi Arabia and the US.

Large businesses have negative expectations for the Association Agreement with the EU, though they noted not understanding how it would affect business. In contrast, medium sized enterprises hold a generally positive view of the Association Agreement, but cited concerns about their ability to compete with EU companies. They hope a simplified system of documentation for the EU that will make it easier for them to do business in general.

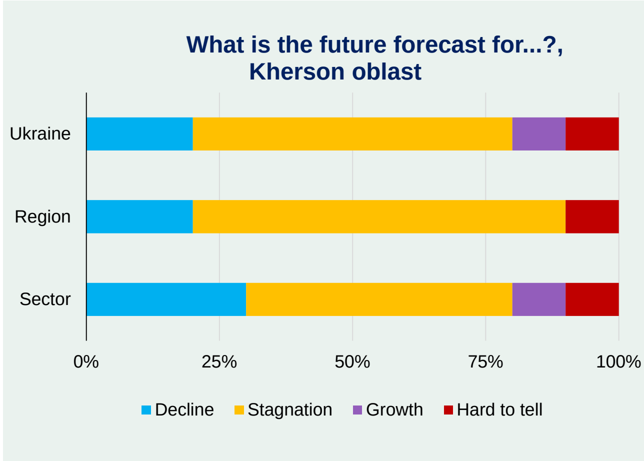
There were no significant changes in international sales distribution reported by the respondents, but the lower demand on the local market has influenced internal sales. Restricted access to the Russian market affected sales of both large and medium sized enterprises in the food processing industry. Food processing companies stated that despite these losses, they were able to find and develop new domestic markets to substitute for the Russian market. Prior to the outbreak of the conflict in the Donbas and the annexation of Crimea another large business reported leaving the Russian market due to rising customs duties.

Trade with the Donbas and Crimea

Five companies reported that in 2013 they had clients in the Donbas with the average percentage of sales ranging from 7-30%. Four companies had sales in Crimea ranging from 10-45%. Four companies reported having had important suppliers in the Donbas with 3-30% of supplies coming from the territories not under Ukrainian government-control at the time of the survey. Three companies reported ties to suppliers in Crimea in 2013, where 70% of one retail business' goods came from, the others had 3% and 13% coming from non-government-controlled territories respectively.

Most business reported decline in domestic sales due to the conflict, but there are growing areas. Demand for medical goods related to combat injuries increased with volunteer battalions buying them in large quantities. The real estate broker also had increased business from finding apartments for IDPs and the border control department, which relocated from Crimea to Kherson.

A majority of businesses that historically relied on Crimean and Donbas markets, either for exports or supplies, reported abandoning those



markets. Four large business said they discov-ered substitute markets elsewhere in Ukraine for their goods and no longer conducted business with either regions. A medium sized business in the food processing industry even successfully transformed their operations to begin self-producing the inputs they previously ordered from Crimea. Other enterprises said they maintained ties with their partners in Crimea, but they stopped buying supplies due to the higher costs associated with goods coming from the peninsula. The sole real estate company interviewed cited complex new regulations and difficulty adjusting to the recently introduced Russian ruble as creating new obstacles for their remaining operations in Crimea.

Future potential

Kherson businesses largely believe that the economic climate will remain stagnate due to the continuous threat of armed conflict in the Donbas. They reported seeing little progress with reform and, consequently, few improvements in the business environment. They believed without those changes much needed investment was unlikely. However, there is some optimism amongst respondents. Several said they saw potential for their goods in several foreign markets, particularly in the EU, India, China and even the EEU, though in order to be truly competitive they said they needed to modernize their production facilities to bring them in line with the market and global standards.

Conclusion

The Kherson Oblast's economic connectivity suffers most from its separation from both the Donbas, Crimea and Russia. Some export industries, like vehicle part manufacturers, have lost their position in Russian production chains. Others, like food processing companies, lost traditional domestic markets due to the armed conflict in the Donbas and annexation of Crimea.

While some sectors like machine building struggle to find markets to substitute those they lost in Russia, agricultural and some food processing companies have already shifted their focus towards new domestic and foreign markets with some success. Machine building, on the other hand, is unlikely to find many new clients on foreign markets and only limited success on the domestic market.

Both grains and sunflower oil, two of the oblast's most prominent exports, are subject to global market prices and are set to remain important exports. Increased trade with the EU and further integration with the European market will further aid them.

Access to new markets, especially the EU, is viewed positively if a company believes it can compete. However, many companies that could export to the EU are unclear on what the precise standards are, how to secure the necessary licenses and permits, or whom to advertise to.

Autonomous Republic of Crimea

Located in southern Ukraine, the Autonomous Republic of Crimea together with city of Sevastopol make up the Crimean peninsula. Russia seized control of both Ukrainian territories in March 2014, annexing them and applying Russian law there. Ukraine considers the territories to be illegally occupied by Russia, and Western countries have sanctioned trade with the peninsula in response. Annexation has increased connectivity with Russia, but decreased it with all other countries and Ukraine as international flights to Crimea's airports and international shipments to its harbors have stopped. Ukraine continues to control the only overland route to Crimea and be the main source of water and electricity, but trade has drastically decreased and the organization of blockades of the peninsula have made the shipment of goods and the supplying of electricity more erratic.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 5 sectors were the most prominent:

Crimea	recreation and tourism
	chemical industry
	extractive industry
	wholesale and retail trade
	transport

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Economy

As part of Ukraine in 2013 the Autonomous Republic of Crimea accounted for 3.0% of Ukraine's GDP, 2.0% of industrial production, 1.4% of merchandise export supplies and 4.6% of total retail trade. Due to Crimea's small contribution to national GDP and foreign trade, Russia's annexation of the peninsula in 2014 entailed much smaller economic losses for Ukraine than the military conflict in the Donbas.

The most important sectors in regional gross value-added creation included (2013): agriculture (8.6%), the manufacturing industry (7.9%), wholesale and retail (20.4%), transport (10.8%), and medical treatment services (8.3%). The regional manufacturing industry specializes primarily in food production (alcoholic beverages, meat products, butter, dairy products, cheeses, oil, groats and flour and tobacco wares), machine-building (shipbuilding, machinery) and the chemical industry. The chemical industry is mainly comprised of two enterprises - Crimean TITAN and the Crimean Soda Plant (calcium soda, synthetic detergents and chemical detergents, polymeric pipes for gas pipelines' underground gaskets). Services also play a major role in the economy – transport (mainly sea ports and railway transport) and the resort-tourist sphere. The largest exporters include the Crimean Soda Plant, Crimean TITAN, Bromine, Selma Firm, Soyuz-Viktan and Massandra. Crimea also has gas and oil off-shore deposits (an estimated, 6% of Ukraine's gas and 16% of its oil deposits are located in Crimea, though recovery is expensive due to geological challenges).

According to official Crimean statistics, regional industrial output dropped by -9.9% yoy in 2014 and then recovered by 8.8% yoy in 1H2015. Manufacturing industries observed the strongest declines during 2014, especially the food industry (-21.6% yoy in 2014), machine building (-17.1% yoy in 2014) and chemicals (-16.4% yoy in 2014). At the same time, the extractive industry continued growing (largely due to extraction of crude oil and natural gas) though at a slower rate (7.2% yoy in 2014 vs 23.7% yoy in 2013). Regional agriculture suffered most from shortages of water and electricity after annexation – its output were up by only 0.7% yoy in 2014 and then dropped dramatically by -18.4% yoy in 1H2015. The regional transport sector was hit the most due to disruption of economic links with Ukraine. The amount of cargo transportations by the regional transport sector dropped by -32.1% yoy in 2014, mostly due to contraction of railway (-41.5% yoy) and automobile (-37.5% yoy) cargo transportation (while the amount of cargo transported through the sea ports increased by 36.9% yoy in 2014[14]).

The economic performance of Crimean enterprises after the annexation of Crimea was affected most by the following factors:

- Infrastructure problems and high dependence on Ukraine: Crimea is experiencing water and electricity supply shortages and cuts since it is reliant on Ukraine for 85% of its water supply and for 83% of its electricity demand.
- Transport isolation: suspended railway and land connections between Ukraine and Crimea restricted the movement and economic activity of Crimean enterprises. Since all land routes go through Ukraine, connections with Russia are mainly via sea. Ukraine also suspended transit cargo transportation through the Crimean ports. From the point of view of international law Crimean ports continue to be under the jurisdiction of Ukraine. Ukraine has closed them to international navigation.
- Disruption of production links and chains with Ukrainian enterprises, most notably concerning machine-building and defense industry related products.
- Western economic sanctions that include embargoes on trading with and investing in Crimea, make the overall investment climate in Crimea highly unfavorable. Western businesses significantly reduced or discontinued trading with the peninsula to avoid penalties. Crimea has rapidly lost its traditional suppliers of raw materials and existing markets for its goods (except the EEU market).

Meanwhile the Russian government has been massively subsidizing the region - 125 bn Russian rubles ($2 bn) were spent in 2014 and a minimum of 100 bn rubles ($1.7 bn) is expected to be allocated to Crimea in 2015.[15] The local government has been allowed to retain its VAT profits that in Russia are normally transferred to the federal budget. Since January 2015, Russia established a free economic zone in Crimea with tax preferences and other advantages (income and property tax benefits and the right to duty-free import of imported goods, components and equipment) that will be in place for the next 25 years.

Table 1

Industrial output structure and percentage change during 2013-9M2015

<table>
<tr><th rowspan="2"></th><th colspan="2">2013</th><th colspan="2">2014*</th><th colspan="2">9M2015*</th></tr>
<tr><th>Share in total output</th><th>Change of index, % yoy</th><th>Share in total output</th><th>Change of index, % yoy</th><th>Share in total output</th><th>Change of index, % yoy</th></tr>
<tr><td>Extractive industry</td><td>5.9</td><td>23.7</td><td>n/a</td><td>7.2</td><td>n/a</td><td>6.3</td></tr>
<tr><td>Food industry</td><td>27.9</td><td>-6.1</td><td>n/a</td><td>-21.6</td><td rowspan="4">Manufacturing/processing industries</td><td rowspan="4">5.2</td></tr>
<tr><td>Chemical industry</td><td>13.4</td><td>-5.2</td><td>n/a</td><td>-16.4</td></tr>
<tr><td>Machine building</td><td>10.8</td><td>3.8</td><td>n/a</td><td>-17.1</td></tr>
<tr><td>Manufacture of plastics & rubber; other non-metallic mineral products</td><td>4.6</td><td>13.8</td><td>n/a</td><td>-31.3</td></tr>
<tr><td>Electricity, gas, steam and air conditioning supply</td><td>29.9</td><td>-2.8</td><td>n/a</td><td>-16.1</td><td>n/a</td><td>21.4</td></tr>
<tr><td>Total industrial output</td><td>100.0</td><td>0.8</td><td>100.0</td><td>-9.9</td><td>100.0</td><td>12.3</td></tr>
</table>

Source: 2013 - Department of Statistics in the AR of Crimea, 2014, 2015 - Local Body of the Federal State Statistics Service for the Republic of Crimea.
*Note: * Local Body of the Federal State Statistics Service for the Republic of Crimea does not specify data for different manufacturing/processing industries[16]. Data for 2015 may be updated.*

[14] http://gosstat.crimea.ru/ukotran1.php#_van
[15] http://www.ng.ru/economics/2015-03-19/1_crimea.html
[16] http://crimea.gks.ru/wps/wcm/connect/rosstat_ts/crimea/ru/statistics/enterprises/production/

According to the Local Department of Federal State Statistics Service for the Republic of Crimea, the registered unemployment rate amounted to 1.0% of economically active population in 1H2015. Consumer prices went up by 42.5% in 2014 and by 18.5% during January-June 2015.

Before annexation, the Crimean merchandise trade was already oriented towards the Russian/EEU market. The EEU's share of Crimea's goods exports was 35-40% in recent years. The EU accounted for 20% of export supplies, while Asian markets (a major destination for chemicals and grains) – for 13-20%. The commodity structure of the regional exports traditionally consisted of prepared foods (alcoholic beverages, etc.) and vegetable products, chemicals, mineral fuels, machinery and ships. Service exports usually contributed a significant part to total exports. Service exports were mainly transport (sea port) and tourism services. In 2013, Crimea exported $904.9 mln in goods and $521.7 mln in services, and imported $1143.9 mln in goods and $75.9 mln in services.

After annexation, the Crimean statistical service recorded trade volumes with Ukraine as foreign trade while trade with Russia is no longer reported as foreign (in 2013 Russia accounted for 26.5% of Crimea's exports). That is why the data on foreign trade for 2013 and 2014-1H2015 are not directly comparable. According to the regional statistics, Crimea generated $147.9 mln in exported goods and $47.6 mln in exported services from April-December 2014 – a drastic decline of export income as compared to 2013 (this data did not include EEU countries). Regional imports of goods and services amounted to $84.2 mln and $26 mln respectively from April-December 2014. According to the regional statistical service, the volume of exports to the EU fell to $17.4 mln from April-December 2014 versus $171.4 mln in 2013. Due to EU sanctions, Crimea goods can only be exported to the EU with Ukrainian certificates.

In 2014, trade between Ukraine and Crimea did not cease even during political and economic conflict. Ukraine supplied Crimea with electricity and food products. Currently, trade between Ukraine and Crimea is conducted under the free economic zone regime that came into force on September 27, 2014 according to the Law of Ukraine "On Establishing Free Economic Zone in Crimea" and "Specifics of Economic Activity on the Temporarily Occupied Territory of Ukraine." Under these laws the moving of goods and services across the administrative boundary became export or import of goods and services subject to customs clearance. There is a huge difference in regard to bilateral trade flows recorded by Crimean and Ukrainian statistical bodies in 2014 and 2015. According to the Crimean statistics, exports from Crimea to Ukraine amounted to $3.5 mln in 2014 and $5.6 mln in 1Q2015, while imports were $2.6 mln in 2014 and $4.4 mln in 1Q2015. However, according to the State Fiscal Service of Ukraine, Ukraine supplied Crimea with goods worth $235.7 mln in 1Q2015, and imported from Crimea goods worth $8 mln in 1Q2105.[17] On January 17, 2016 Ukraine introduced trade restrictions with Crimea that will limit further trade.

Survey Results

From July to August 2015 20 interviews conducted in conducted in Crimea in Sevastopol, Simferopol, Feodosia, Alushta and in two rural locations in Saki and Cheromorkiy rayons.

Number of responses by sector, Autonomous Republic of Crimea	
Wholesale and retail	10
Tourism and recreation	5
Agriculture	3
Transportation	2

Access to businesses in Crimea was complicated by businesses' lack of trust concerning the interviews' purposes and the funding of the survey. Some did not want to participate in a project funded by organizations that did not officially recognize Crimea joining the Russian Federation. Others feared negative consequences from

17 http://www.eurointegration.com.ua/experts/2015/05/29/ 7034276/

local law enforcement for engaging in such interviews. The larger the enterprise was the more difficult it was to get access to them and their answers were mainly evasive.

Most respondents felt uncomfortable talking about changes in the business operating environment and about the relationship with the new government. Most respondents reported stopping business relations with Ukraine. Because of unpredictable political decisions and international sanctions, respondents found it hard to make forecasts about the future.

Business climate (current status, changes experienced)

De facto joining Russia has significantly changed the business climate. As part of Ukraine, Crimea had close connections with mainland Ukraine, with deliveries coming via land and Ukraine's ports. The sealing of the administrative boundary line and sanctions on air and marine transportation have limited businesses' transportation options. The regulatory framework has also drastically changed, and businesses have had to adjust to new rules and procedures for their operations. Russia has more internal regulations and a more complicated system for businesses. Due to sanctions there is no international banking system in Crimea, limiting international trade. Additionally, there is no clarity in the division of authority and governance systems. For example, the Sevastopol Administration and its City Council often make contradicting decisions concerning what businesses must do.

Infrastructure (transportation, electricity, water etc.)

A bridge is planned to be built from Russia to Crimea over the Kerch Strait, but for now the main route is by ferry. Ferries are dependent on the weather conditions, and due to storms the delivery of the goods is often delayed. As a result, logistic companies are expanding storage facilities to be able to store more products. However, this will not solve the issue fully and requires increased turnover from companies. A respondent working in the tourism noted that reliance on air transport has overstretched airport infrastructure, requiring expansion.

Internal regulatory environment

The application of Russian law in Crimea had created major challenges for businesses. Respondents reported that Russian regulations are much more complicated and have different procedures for employment, business registration and operation. For example, hotels have to inform the Migration Service about visitors within three days and there are huge lines in the responsible department offices as a result. For employment under Ukrainian law, transportation companies had private entrepreneur agreements where individual drivers were responsible for their registration and taxes. Now, companies have to register each driver and car and report for them.

Businesses reported having to complete enormous amounts of paperwork, and difficulties getting permits and registration. Businesses in Crimea most often interact with the ministry responsible for their sector, the local tax inspection authority, and the pension fund. The agencies that have the most influence on business include the local tax inspection agency and the pension fund agency.

While there is a moratorium on business audits in Crimea during the transition period, eight businesses had to register business activities with officials. Respondents did not report that they were expected to pay bribes during any encounter with government agencies. Some businesses said that despite the bureaucracy of Russian legislation, it works better than Ukrainian legislation and that there is more overnight and no low level corruption.

Taxation officials

Tax offices are full of new staff unfamiliar with Russian tax law. Companies reported they do not provide information or advice and that the only way to learn about new regulations is through special seminars organized by the tax agency. The lack of knowledge about new rules leads to fines businesses have to pay. Respondents said that tax officials no longer take bribes, but are very strict concerning regulations.

Licenses, permits and certificates

Respondents reported long waits to register businesses under Russian law. Now they say the situation has stabilized, but that lack of information about the rules and procedures is creating challenges for business operation.

Access to financing/capital

Western sanction have kept the banking system in Crimea from being fully operational. It is possible to make semi-legal international payments via Russian accounts, which makes money transfers more expensive and time consuming. Agriculture, however, has benefited from the ability to receive loans from the Rosleasing, the state company that supports farmers. A respondent reported that he could replace 70% of his equipment thanks to a loan from this company. At the same time another farmer says that he cannot cope with the requirement of having to pay 20% of the loan as part of the first installment. Under Russian legislation farmers also qualify for other subsidies.

Changes in business profitability

Most businesses are suffering as a result of exchange rate fluctuation and the related increase in prices, but specifics vary by sector. The tourism sector reported that they have significantly fewer clients and are bearing losses. The agricultural business reported increased prices for fuel, water and electricity, but said grain traders won't increase the price they pay for wheat.

Labor force

The majority of respondents did not report problems finding personnel. Two companies reported employing IDPs from Donetsk and Luhansk oblasts. Hiring IDPs, however, requires filing paperwork with the Migration Services and as a result most businesses prefer to hire local personnel.

Trade climate

Six out of 20 respondents sell their products beyond Crimea's borders, four of them are doing this directly and two through brokers. They are wholesalers and retailers of Crimean products such as Crimean tea and cosmetics. Only one company sent goods to Ukraine, making up 20% its sales. Six companies exported to Russia, making up on average 31% of their sales.

Seven out of 20 respondents bring in supplies from outside of Crimea. The main direction for supplies is from Russia, Turkey, China, Uzbekistan and Ukraine. Two companies both brought in and sent out supplies. Wholesale and retail traders received supplies from Ukraine, Russia, Turkey and China. Construction businesses received supplies mainly from Russia and Turkey.

Opportunities and barriers (market access)

The sealing of the administrative boundary line and international sanctions create significant problems for business. In this environment, businesses are building stronger economic ties with Russia. Four respondents reported having new contracts with Russia, and two reported more supplies and goods going to and coming from Russia. The majority of respondents stopped selling to Ukraine and ended all contracts with Ukrainian providers. For those looking to sell their goods outside of Crimea, the Russian market is an attractive alternative to Ukraine, as the market is bigger and easier to access. One respondent reported previously trying to trade with Russia, but the border and customs regulations made the process too complicated. Now they say the market is more accessible.

The agricultural companies reported that though their grain used to be exported to the EU, Turkey and Arab countries it no longer is. Similarly, a company producing construction materials used to import supplies from the EU via Ukraine, but now only uses Russian and Turkish supplies.

Future potential

There is not much optimism for the future of the Crimean economy. Some see it as a "dump" that needs investments that no one has. There is hope that if a bridge to Russia is completed it could improve the economic situation. Some respondents are optimistic and hope that if sanctions are removed it will encourage investment.

Respondents are more optimistic about their own sectors. The respondent working in agriculture believed that Russian preferential treatment for agriculture would encourage development. All respondents were planning to expand their activities and enter new markets, focusing on Russia.

Conclusion

Since annexation, Russian law has been applied in Crimea, creating difficulties for businesses. Businesses used to operating under Ukrainian law have had to adjust to a more restrictive system, but one where regulatory officials do not engage in petty corruption.

Crimea's connectivity has been hurt by being cut off from Ukraine, which it had a stronger geographic connection to. Water and electricity both predominantly came from mainland Ukraine, and the only roads to the peninsula are also from mainland Ukraine. Completion of a planned bridge between Russia and Crimea would improve some economic connectivity, but given the high construction costs of the bridge and the current economic crisis in Russia it seems unlikely to be completed in the nearest future. As a result, businesses are dependent on the delivery of goods by ferries traveling across the Kerch Strait, which are unreliable due to weather conditions.

While sanctions have hindered access to international markets, annexation has removed all barriers to the Russian market. With most other trade avenues blocked or significantly complicated, Crimea will continue to orient towards the Russian market.

Dnipropetrovsk Oblast

Despite its location not far from the front in the Donbas, since the outbreak of hostilities Dnipropetrovsk Oblast has made a reputation for itself as a cornerstone of stability in left bank Ukraine. A center for military, and especially rocket production, in the Soviet Union, Dnipropetrovsk Oblast continued to be a key manufacturing center for the Russian military complex in the post-Soviet era. With new restrictions from both the Ukrainian and Russian sides cutting off military and other exports to Russia, recession has cut deep into the oblast's economy. As its well established industry tries to re-orient towards other markets and make up for lost supply in the Donbas, the Dnipropetrovsk Oblast faces the daunting challenge of adapting its comparatively developed economy to the new political realities.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 8 sectors were the most prominent:

Dnipropetrovsk Oblast	Metallurgy
	extractive industry (iron ore)
	chemical industry
	machine building
	electricity power generation
	food industry
	Transport
	wholesale and retail trade

This overview of specific capabilities and problems facing the regional economy provides context for the qualitative information found in the survey section.

Economic Overview

The Dnipropetrovsk Oblast is one of Ukraine's leading industrial regions, accounting for 10% of the country's GDP (2013) and nearly 20% of its industrial output (ranking first in 2014) and 16% of the nation's merchandise exports (second after Kyiv City). 9% of of all retail turnover was conducted in the Dnipropetrovsk Oblast in 2014. The top value-added contributors to the oblast's GDP are found in its extractive industries (mostly iron ore) 23.3%, manufacturing 17.7%, wholesale and retail 12.9%, transportation services 6.9% and agriculture 6.4%.

The economy of the Dnipropetrovsk Oblast has been seriously affected by the armed conflict in the region. Highly integrated with neighboring Donbas, local industries were hit hard by the break-up of interregional ties and the destruction of production capacity and transport infrastructure in the war-torn east.

The regional economy is highly export-oriented and natural resource dependent, making it extremely vulnerable to price fluctuations in its outputs like metal and natural resource inputs. Domestic metal producers, in particular, have faced shrinking demand on both the Russian and broader Asian market.

Several major sectors of industrial production show a marked decline in output, leading to an overall dip in industrial output of -7.5% in 2014 and -10.9% in the first half of 2015. The most notable decline was seen in machine-building, suffering a -35.1% decline in 2014 and a -23% decline in in the first half of 2015. Machine-building with Russia as its primary export market has faced difficulties as a result of the conflict in eastern Ukraine and the annexation of Crimea. Specifically, bans on sensitive exports and restricted market access to Russia forced the oblast to cut ties with the Russian military industrial complex's production chain that it was long a part of.

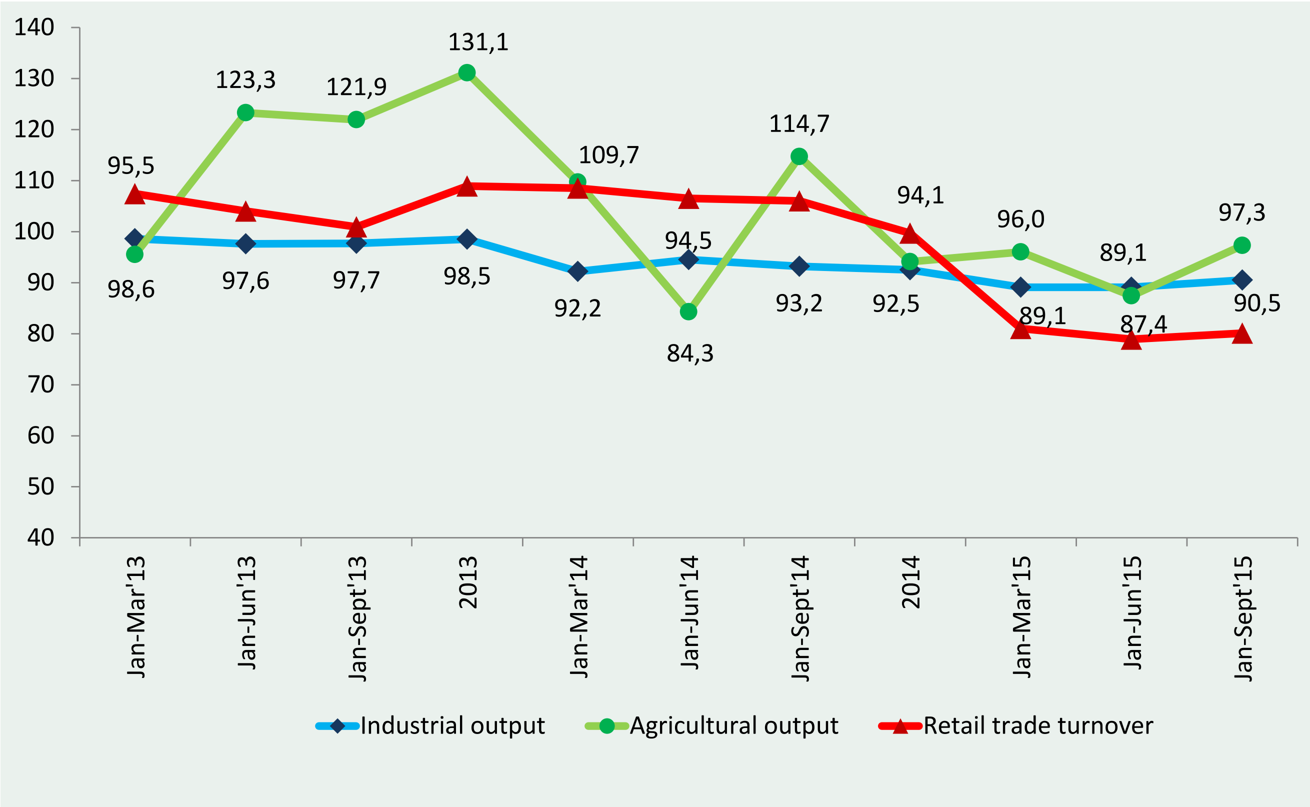
As a result of economic slowdown, the average unemployment rate for working age individuals in the oblast climbed from 6.8% in 2013, to 8.3% in 2014, before falling to 6.9% in the first half of 2015.

Trade Overview

The Dnipropetrovsk Oblast's overall share in Ukraine's exports dropped from 7.9% in 2013 to 5.1% in 2014, falling further to 2.9% in the first half of 2015. As a result of the economic crisis

Figure 1

Indices of industrial production, agricultural production and retail trade in Dnipropetrovsk Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

and armed conflict in the Donbas, the oblast's foreign trade dropped -10.5% and its imports by -16.2% in 2014. Merchandise exports were hit even harder in 2015, dropping -16.2% in the first quarter of the year and a staggering -31.6% in the second quarter.

Whereas overall exports to the EU saw a slight decline in 2014 (-2.9%), the proportion of the oblast's merchandise exports to the EU grew from 18.5% in 2013 to 20% in 2014.

The oblast's exports to the EEU witnessed the most dramatic level of decline over the course of 2013 to 2014, dropping -26%. This stark decline is part of a trend since 2012 when EEU exports were 33.7% of the oblast's exports. In 2013, the EEU accounted for only 29.3% of the oblast's overall exports, sliding to 24.3% in 2014. In first half of 2015, overall exports to the EEU dropped to 14.9% of the oblast's total regional exports (12.5% went to Russia).

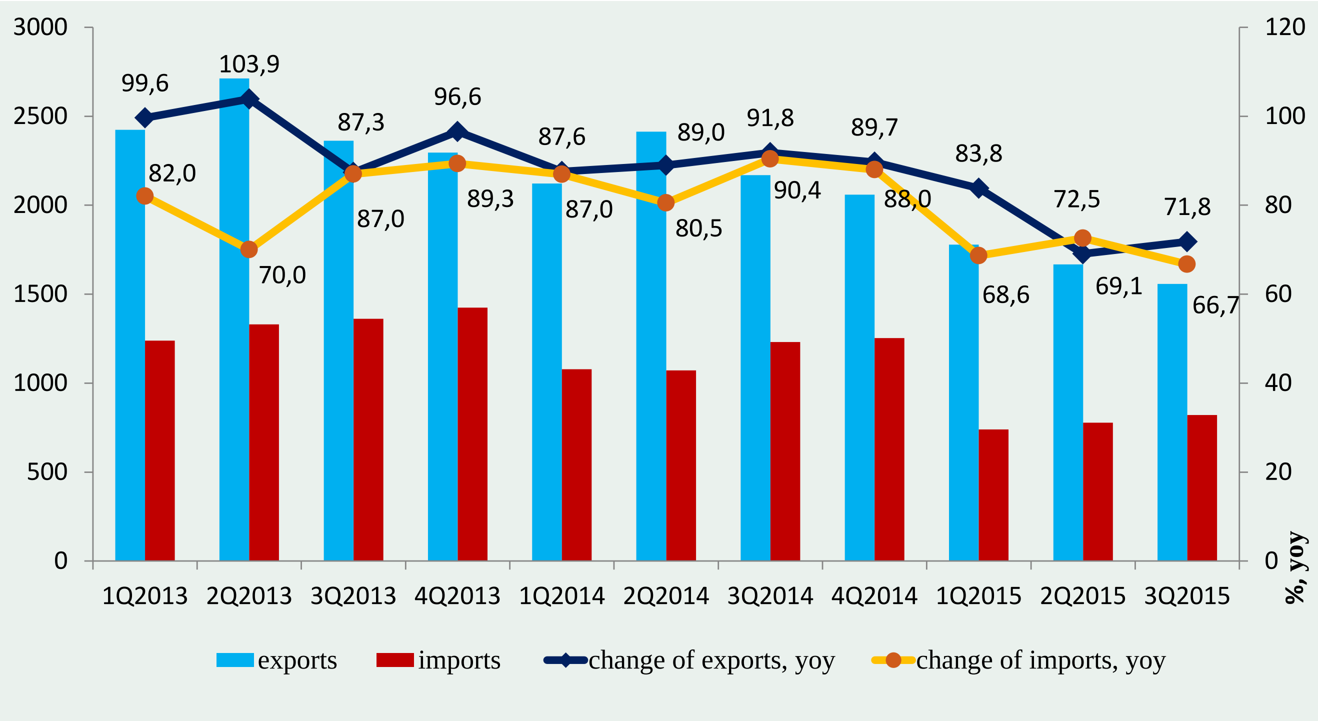
Asia accounted for 37.5% of the oblast's exports in 2014 (mainly metal and agricultural goods), and also declined, though only by -7.2% since 2013.

The oblast's transport equipment and machinery/electrical equipment manufacturing declined the most, by -40% and -60% respectively in the first half of 2015. Both are highly dependent on the Russian market. Other major exports from the oblast – particularly metal and ores – have more diversified markets making them less dependent on Russia.

The most successful exports in 2014 were agricultural and food goods, but their dynamics turned negative in 1H2015 (exports of prepared foods fell by -27.4% in 1H2015). Service exports experienced an even stronger slowdown (-30.6% yoy in 2014 and -42.8% yoy in 1H2015) largely due to a 40% decline of exports in financial services (accounting for almost a half of total exported services).

Figure 2

Dynamics of exports and imports of goods in Dnipropetrovsk Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Survey

21 interviews were conducted with Dnipropetrovsk Oblast businesses, as well as two additional interviews with local government representatives – one from the Oblast

Administration and one from Dnipropetrovsk City Council. There were no major obstacles in obtaining interviews with respondents from the target sectors and in the local government and representatives were generally open about their views.

Number of responses by sector, Dnipropetrovsk Oblast	
Construction	4
Wholesale and Retail	4
Metallurgy	3
Chemical Industry	3
Electronics	3
Agriculture	2
Finance	1
IT	1

The interviews were conducted in the Dnipropetrovsk Oblast's key sectors: metallurgy, chemical production, construction, electronics and wholesale and retail. The interviews covered both large and medium sized enterprises.

Business climate

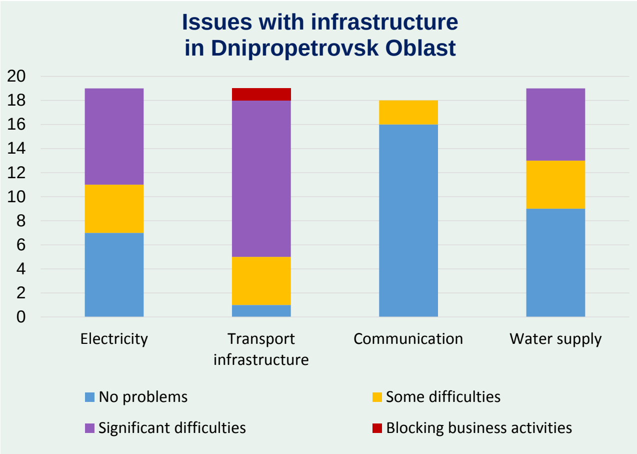
Businesses in the oblast suffer from a drop in demand for their goods and/or services, whether their clientele was based in Ukraine or abroad. Most struggled to deal with the deep fluctuations of the hryvnia. The security situation was mentioned in two interviews, but a majority of the respondents' reported serious concerns about the overall standing of the economy instead, including growing production costs and a weakened currency, as well as Ukraine's political instability. For metallurgical companies and chemical producers in particular, political instability and limited access to credit are major concerns.

Both large and medium sized enterprises across sectors cited low domestic demand for their goods and services as a serious business concern. Medium sized businesses, however, were more concerned with taxation rates and taxation officials' actions than large enterprises. Large enterprises were more concerned about the political situation and production costs.

Infrastructure

Over half of the medium sized enterprises surveyed reported regular issues with the electricity supply, citing either their demand not being fulfilled or the poor quality of the electricity.

A large enterprise also reported transportation issues resulting from their old trade routes going through areas in the Donbas conflict zone. The other large business surveyed, which operates in the agricultural sector, cited only the generally poor condition of roads as being an issue, albeit not a serious one.



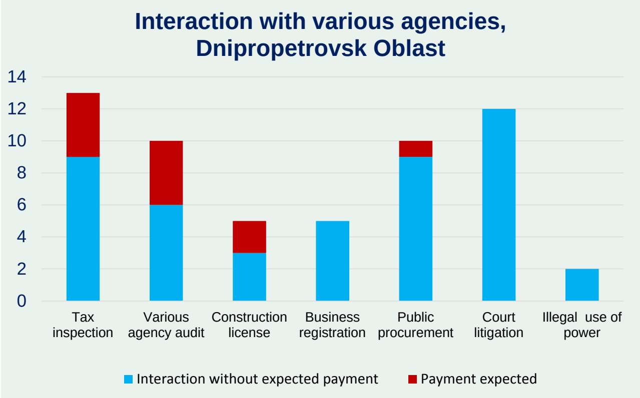
Medium sized businesses also reported having to find new trade routes because of the conflict. One respondent stated that road cargo transport now depends on "unofficial" channels to get to areas not under Ukrainian government control.

Internal regulatory environment

Neither of the large businesses pointed out specific issues with internal regulations. Medium sized businesses, however, frequently listed two primary areas of concern. The most common issue was VAT returns which the state was very slow in issuing. Having to make VAT payments in advance was cited as creating a shortage of capital.

They also identified the high tax burden on medium sized enterprises as a major problem. However, there were few complaints concerning the state tax authorities acting in an improper manner on the local level.

Taxation officials



Each of the two large businesses interviewed were similarly concerned by the varied documentation needed for tax officials and the absence of publicly available information about changes to the taxation system. Medium sized businesses stated they faced the same issues.

One medium sized hi-tech manufacturer noted that there were a number of inconsistencies between the information and operations carried out electronically and those on file with tax officials, suggesting a disconnect between services theoretically offered to taxpayers and those actually provided.

Three other medium sized businesses from various sectors reported that tax officials expected bribes in order to overlook alleged violations of the tax code.

Medium sized enterprises in the oblast reported an especially difficult relationship with customs. Due to the complex system of licensing procedures, businesses often try to conceal what they are transporting (e.g. stating they are transporting old equipment needing repair rather than new equipment) to avoid needing a license.

Licenses, permits and certificates

Both of the large businesses declined to respond to questions about changes in licenses, permits or certificates, or how they respond when they arise.

Medium size businesses, by and large, did not report having serious issues with acquiring permits in their respective sectors. The exception to this rule was in construction where all of the companies reported regularly battling with the Dnipropetrovsk City Council for permission to start new construction projects.

One construction company reported abruptly having their application for a license turned down after 20 years of operation. They were directed to a specific bureau in order to secure a new license, where they understood they needed to pay a bribe to have their construction license renewed.

Access to financing/capital

Access to financing and capital was a concern that cut across sectors and business size categories. In addition to the weakened state of the hryvnia, one of the large enterprises stated that their inability to access additional financing made them put investment projects on hold, as they could not afford the necessary raw materials. A lack of financing also limited their ability to enter new markets to make up of their loss of access to the Russian market.

Over half of medium sized enterprises surveyed stated that access to additional financing was necessary to maintain their current level of productivity, but ultimately inaccessible. They pointed to the prohibitively high interest rates. One respondent commented that the general instability of the banking system restricted their ability to do business. One of their accounts was frozen when the bank was inspected by the National Bank of Ukraine to determine whether it was solvent.

Changes in business profitability

The large machine manufacturer reported their industry is struggling to stay competitive after losing access to their major source of raw materials in Russia. As a company whose products were customized to be sold as inputs for manufacturers in eastern Ukraine, Crimea and the Russian Federation, they have had to target other markets. They believed, however, that if the economic situation improved and they had access to more financing, they could access new markets in the region and in Asia.

The large agricultural company interviewed saw a slight decrease in their overall profits, though they stated they had maintained most of their client base, which is primarily in Ukraine.

On a sector-by-sector basis, medium sized businesses noticed a marked drop in their overall profitability. Nearly half of respondents said that a sharp decline in domestic demand, their primary market, was the main cause of their financial difficulties. Medium sized businesses associated a weak hryvnia with reduced demand for their goods and services. As businesses tries to find more affordable inputs, several companies said customers were also seeking to spend less or stop making purchases altogether.

Labor force

There was no serious difficultly reported by either large business surveyed in securing new qualified employees. While the machine manufacturing business stated they had not sought to add new positions, they had been able to maintain roughly the same number over the past year.

Medium sized businesses reported having no issues with retaining employees, though 43% had concerns that low paid technical positions would be difficult to fill in the future. Five SMEs stated they had difficulty or significant difficulty securing qualified personnel for their companies, which operate in the machine manufacturing industry, energy sector, and construction.

Given the decreased demand for most of their goods and services, and the weak hryvnia, several companies noted they had to lower wages in real terms for many of their employees in order to keep them on and reduce layoffs.

Trade Climate

International trade

The large agricultural business surveyed was encouraged by potential to expand their operation and export to the EU, though they had no specific plans because current operations consumed all of their capital.

The large manufacturer, however, noted a new series of challenges hampering them from entering new markets or re-entering old markets in the EEU. The conflict had driven their exports to the Russian Federation down to 1% of overall exports.

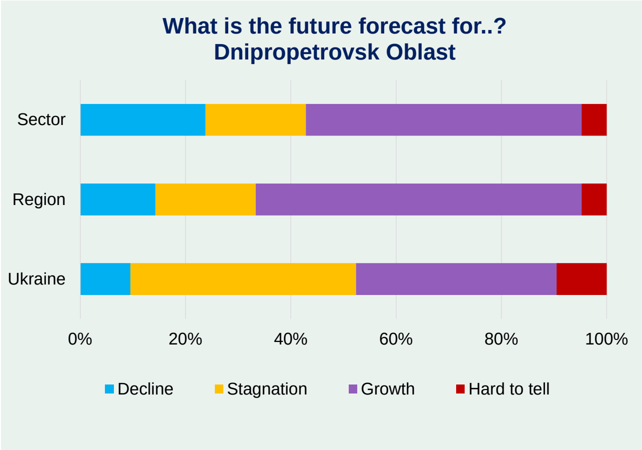
According to the manufacturer, the EU market is difficult for them to enter because there is little established import/export trade in their sector with the EU. They said they did not have the funds to establish that trade. They also believed limited contact between the EU partners and Ukrainian business, and the preference of potential EU customers for companies they already knew prevented new trade from emerging.

One medium sized business, working in the metallurgy sector, no longer held any contracts with Russia. They noted that negative impressions of the conflict caused clients in both Turkey and the Netherlands to turn to other businesses to meet their needs. Medium sized enterprises engaged in wholesale, particularly with Russia, had seen demand for their goods disappear almost entirely.

However, the two enterprises that reported a majority of their imports coming from the EU and had a share of their exports headed to areas other than Russia (i.e. China) saw no change in the volume of their trade despite the local economic downturn.

Trade with non-government-controlled territory

Due to the annexation of Crimea and the subsequent security developments in eastern Ukraine, the large manufacturing company reported losing 15% of their overall domestic business, and 30% of their business in the Luhansk and Donetsk oblasts. While they were able to find some new domestic market substitutes for their goods, they were not able to compensate for the losses they had endured after having ties with some traditional domestic markets severed.



These losses were the result of enterprises being unable to fulfill contracts and conduct business (particularly in areas controlled by the so-called Donetsk Luhansk People's Republics), as well as murky border guard and customs practices at official crossing points into and out of the non-Ukrainian controlled territories.

With few customers in Crimea or the non-Ukrainian controlled territories in the Donetsk and Luhansk oblasts, the large agricultural business reported little change domestically. They anticipated that aside from rising fuel costs there were no real obstacles to conducting business domestically.

A medium sized enterprise in the metallurgy sector said they stopped doing business with Russia and companies in the territories not controlled by the Ukrainian government. While there were some initial losses, their traditional business partners (some of the largest steel producers in Ukraine) have continued to work with them.

The conflict had little effect on the three medium sized businesses engaged in construction because their services are almost exclusively used locally. The same was reported by other medium sized service providers, including an insurance and IT company. One manufacturer, whose business involved selling common components for housing exteriors, said that while domestic trade had noticeably declined they maintained some trade with Crimea, though they were trying to find clients in regions under Ukrainian control.

Each of the four wholesale companies reported significant decline in demand for their goods, with all of their previous domestic trade with Crimea ending. As one wholesale business explained, whereas before their regional clients in different oblasts would purchase goods from them and then resell them to other clients in Crimea, the flow of goods from their own warehouses to Crimea has stopped.

Future potential

In general, businesses were more pessimistic about the possibility for growth in their respective region and sectors than throughout the rest of Ukraine. The IT sector, for example, cited potential low consumer demand for their goods for years to come as a reason that they do not see their sector, specifically in their region, recovering anytime soon.

While businesses from the food processing, furniture manufacturing, and extractive industries were optimistic about growth in their respective sectors, they were less optimistic about overall economic growth in Ukraine or the Dnipropetrovsk Oblast.

Conclusion

The Dnipropetrovsk Oblast's economic connectivity has been damaged by its proximity, economically and geographically, to the conflict zone in the Donbas. Medium sized businesses struggled to maintain their domestic market, while large enterprises' reliance on a production chain that extended through Ukraine's industrial heartland and into Russia caused significant downturns.

The serious decline in trade with the EEU has not found a substitute in the EU, nor did businesses involved in exports expect a replacement to be found soon. Businesses are open to increased ties with the EU, but do not feel they have the information or resources needed to enter and compete on the European market.

Medium sized enterprises were focused on surviving the ongoing economic recession. Traditional machine manufacturers and extractive industries were struggling to find new domestic and foreign markets for their potentially valuable goods, but finding their products incompatible or uncompetitive with analogous goods from elsewhere. Metallurgical and chemical companies particularly struggled to find affordable substitutes for inputs lost because of the armed conflict in the Donbas.

Retail and wholesale sectors previously intertwined with the Donbas and Crimea, have witnessed similar problems. Decreased demand for consumer goods and services, such as in the IT or finance sector, are unlikely to improve until the currency stabilizes for an extended period of time and restores consumer confidence.

The Dnipropetrovsk Oblast's geographic ties to the conflict zone in the Donbas and traditional economic ties to member states of the EEU, and Russia in particular, have left it vulnerable economically. Even when Ukraine's overall economy begins to recover the oblast's businesses are skeptical that they will be able to make up these losses.

Improved domestic economic connectivity may aid medium sized enterprises to increase demand for their goods, but the oblast's large enterprises are not optimistic they can make up for lost demand domestically.

Zakarpattia Oblast

Located in western Ukraine, the Zakarpattia Oblast borders EU member states Hungary, Romania and Slovakia. Part of Czechoslovakia prior to World War II, the region has deep historic links to neighboring countries and after the collapse of the Soviet Union the region began expanding economic links with them again. Proximity has brought investment from neighboring countries into the region and encouraged many locals to go and work in the EU. That proximity has also created a lucrative smuggling industry, mainly focusing on cigarettes. The oblast's geography has limited its exposure to fighting in eastern Ukraine, but in July 2015 clashes between authorities and Right Sector in Mukacheve connected to smuggling damaged the oblast's idyllic image.

Economically, Zakarpattia Oblast's strong trade links with the EU and limited trade with Russia put it in a comparatively good position compared to other Ukrainian regions. As the general economic situation has worsened, however, the oblast has not been able to escape the effects of diminished domestic consumption. Nonetheless, the oblast's proximity to the EU and experience trading with the EU make it poised to benefit from free trade under the Association Agreement.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 5 sectors were the most prominent:

Zakarpattia Oblast	recreation and tourism forest and timber industry light industry food industry (including wine production) transport services wholesale and retail trade.

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Economic Overview

Zakarpattia Oblast generates 1.4% of Ukraine's GDP (2013)[18], 0.9% of industrial output (2014) and 2.6% of total merchandise exports (2014). Zakarpattia Oblast accounts for 2.2% of Ukraine's total retail turnover. Economic sectors contributing the most to regional gross value added include: agriculture (14.0%), manufacturing (15.5%), wholesale and retail (15.9%), transport (8.4%), education (9.7%) and medical treatment (5.9%). The region's industry includes the following sectors: machine-building (metal-cutting machine-tools, electric motors, valves etc), food industry (wine, cognac, tinned fruit, soft drinks and mineral water), textiles and clothing, wood industry and the chemical and petrochemical industry.

Zakarpattia's industrial output increased by 6.1% yoy in 2014 compared to 2013, but fell by -15.7% in 1H2015 (Table 1). Growth in 2014 came from increased machine-building (11.6% yoy), textile and clothing production (5.6% yoy) and wood products (8.1% yoy). Computer, electronic and optical production picked up by 42.0% yoy, and electrical equipment manufacturing by 6.2% yoy.

Machine-building is the largest sector of the Zakarpattia industry making up 45% of industrial output in 2013, and 40.8% in 2014. Regional machine-building enterprises rely on manufacturing components and auxiliary equipment for EU partners. Links with EU enterprises are also a major part of the textile sector. In 1H2015, production of both machine-building and textile industries fell by -28.3% yoy and -14.5% yoy respectively.

The average unemployment rate of the working age population in the region went up from 8.2% of the working-age population in 2013 to 9.6% in 2014, and to 9.8% in 1H2015.

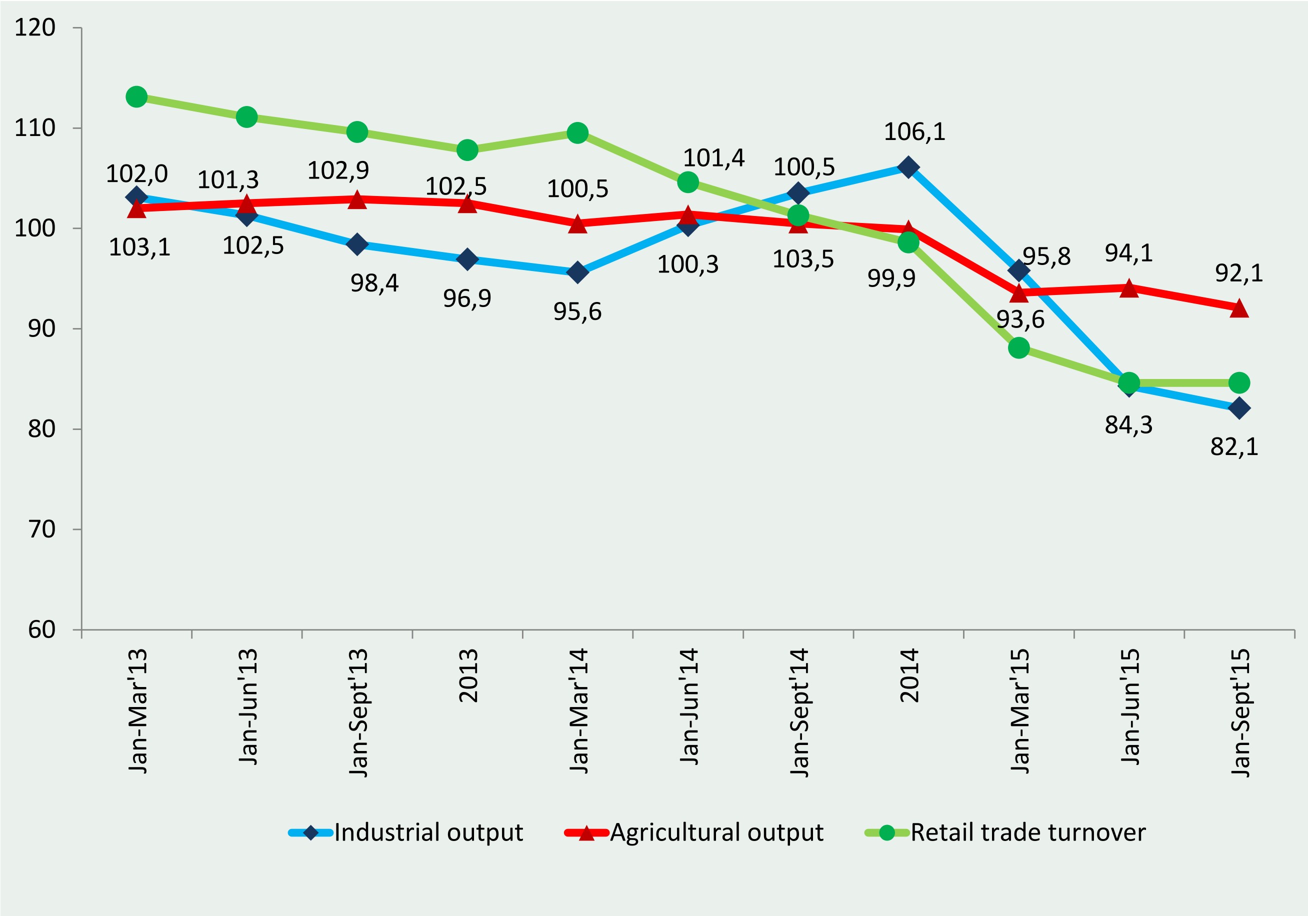
Trade overview

Exports of goods from the oblast rose by 6.4% yoy in 2014, while imports of goods fell by

[18] The latest available data.

Figure 1

Indices of industrial production, agricultural production and retail trade in Zakarpattia Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

-15.9% yoy (Figure 2). Merchandise exports, however, fell in 1H2015 (-19.0% yoy). Regional exports depend on EU markets, which made up about 85% of total regional exports in 2014. Most are conducted under tolling schemes whereby goods are made using imported materials and Ukraine's inexpensive labor, and then exported to the EU (a common practice for machinery and electrical equipment, as well as textiles).

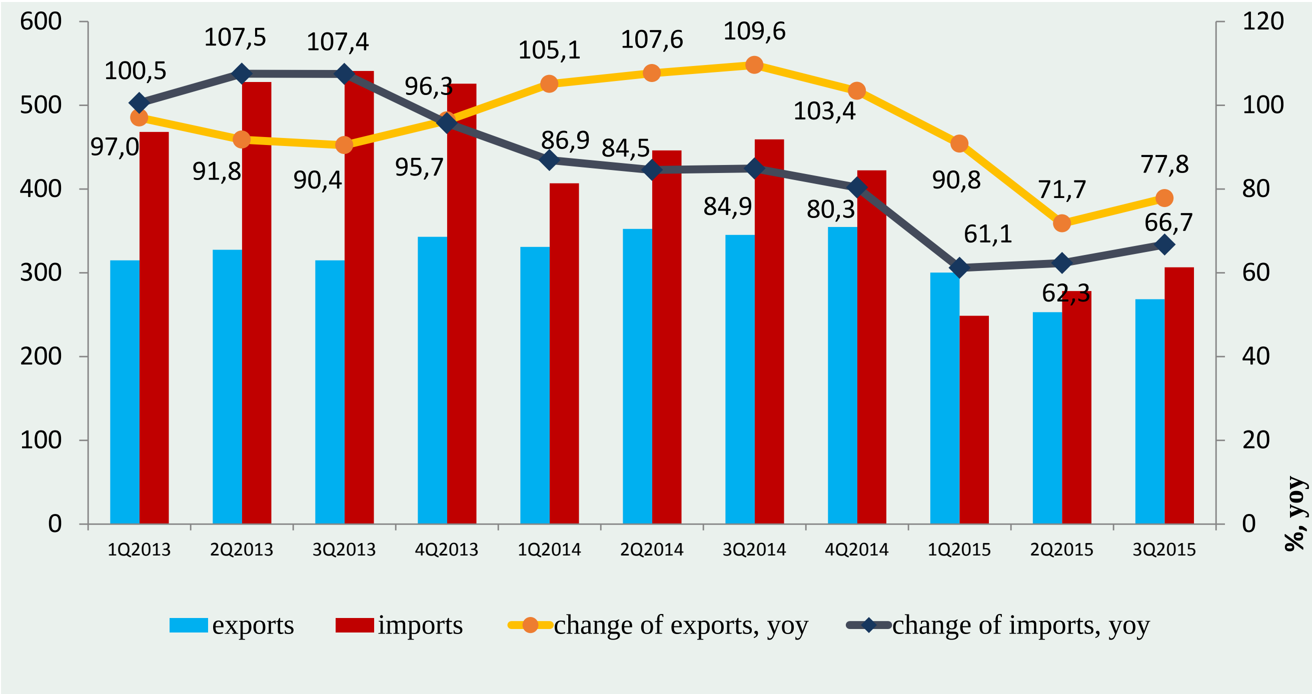
In 2014, exports to the EU increased by 14% yoy (Table 2). The EEU markets are the second most important destination for regional export supplies, however, they contracted by -25.6% yoy in 2014 due to trade restrictions and the conflict with Russia. The share of the EEU markets fell from 18.6% in 2013 to 13% in 2014.

Machinery and electrical equipment are the largest exports (63.9% in 2014), increasing by 6.6% in 2014. Textiles, wood, furniture, and chemical exports also grew. However, in 1H2015 performance of all major exports fell. Material resource processing and transport services are the largest service exports. Both dropped in 2014 and in 1H2015, leading to an overall decrease in regional service exports by -31.4% yoy and -13.3% yoy respectively.

Zakarpattia's economy was a top oblast performer in 2014 and 1Q2015 because of its limited trade with Russian/EEU markets as well as with the conflict zone in Ukraine, and its extensive trade with EU markets.

Figure 2

Dynamics of exports and imports of goods in Zakarpattia Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Survey

Of 41 businesses matching the selection criteria, 26 agreed to be interviewed. As in other regions, respondents were suspicious of the interviews. Interviews were conducted during armed conflict in Mukacheve between Right Sector and authorities, making businesses less eager to share information.

Number of responses by sector, Zakarpattia Oblast	
Food processing	7
Textile and clothing	6
Wood and furniture production	6
Wholesale and retail	4
Transportation and logistics	2
Other	1

Of the 26 respondents, 8 were large business, and 18 were medium sized businesses. The food processing, textile, furniture producers, wholesale and retail, and transportation sectors were all included.

Business climate

Political instability, growing production costs, low demand on external and internal markets are the biggest challenges for businesses in Zakarpattia. Medium size businesses are also concerned with the high tax rates effecting their profitability. Electricity cuts are also a concern for medium sized businesses. Large businesses are engaged in international trade, and are concerned about customs and trade barriers.

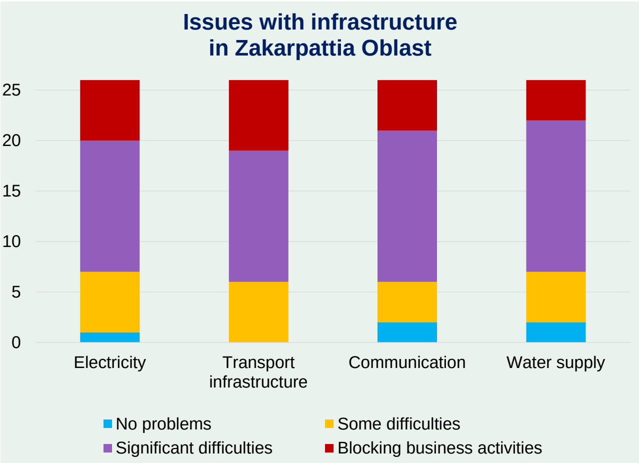
Infrastructure

Businesses reported problems with the supply of electricity. Frequent breakdowns and low voltage in the networks caused production interruptions and equipment to breakdown. Increased electricity prices meanwhile add to growing production costs. Six businesses reported electricity issues that stopped their activities, and 13 said they present a significant difficulty.

Businesses reported intensively using road infrastructure for delivering goods both within Ukraine and to EU countries. They reported that poor road infrastructure increased fuel costs and vehicle repair costs, increasing overall costs from 5 to 20%.

Internal regulatory environment

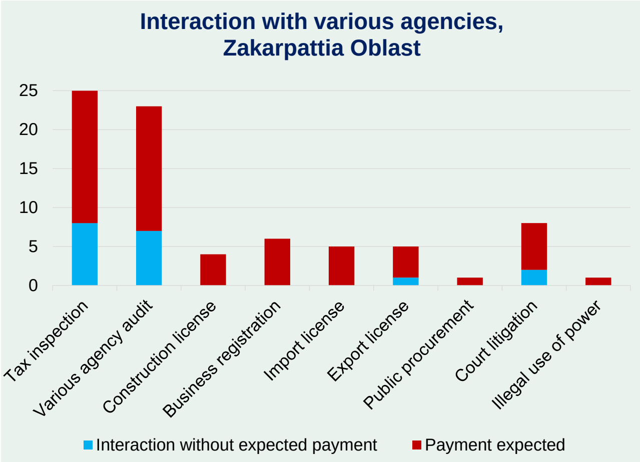
Respondents believed that state economic development policies are uncoordinated and create challenges for business. Respondents not only believed that Ukrainian officials did not have a plan for the Ukrainian economy, but that short-term solutions and constant tweaking of regulatory framework created instability that made it hard for businesses to make plans for themselves.



Constant regulatory changes require businesses to spend heavily to keep up with them. Businesses reported suffering from high taxes, increased fees for licensing and frequent audits by regulatory bodies. Respondents wanted the regulatory framework to support exporters through a simplified tax system, providing export loans, adopting international standards and promoting innovation and competitiveness. One respondent believed the state should prioritize key sectors and invest in their development and provide preferential treatment to increase their exports.

Relationship with tax officials

Respondents said they deal the most with tax authorities. They reported corruption in tax collection that took advantage of complicated procedures, lack of information, and constant changes. Businesses specifically mentioned faiures to return VAT, and the complicated systems of taxes and fines.



Despite the moratorium on tax audits, the majority of respondents were audited and in absolute majority of cases were expected to pay bribes. Similarly, of the 23 businesses that went through audits, 16 reported having to pay bribes.

The majority of respondents reported no significant changes in officials' work. Only five respondents said they use only legal recourse when there are difficulties with officials, noting it usually takes longer and causes losses. Others most often use connections to speed the process or pay bribes. Medium-sized businesses are more vulnerable to corruption. "It hasn't changed much. Corruption leads to 5% losses every month," one respondent said.

Companies reported delivery delays due to customs. One company estimated customs delays cost them as much as 15% of their income. One reason for losses in agrarian sector reported by a respondent was the need to issue an export certificate during grain transportation every time vehicles are changed.

Licenses, permits and certificates

Constant changes in licensing procedures delay the delivery of goods. One company reported that due to the delay in certification they lost UAH 80,000. Medium size businesses reported longer waiting times for certificates and permits in comparison with large businesses. For example, to receive construction permits a medium business must wait 45 days (as opposed to 30-35 days in case of large business). Difficulties in obtaining permits and licenses means that bribery is common and expected. Problems with licenses can causes companies loss of up to 25% of their profits.

Medium businesses are struggling to pay taxes and fees for certification. One local wine producer reports that they will not be able to pay for the necessary license that now costs over UAH 200,000.

Access to financing/capital

Four businesses were refused loans by banks. Four had bad credit history and one could not provide enough collateral for the loan. One business unable to acquire a loan could not buy additional supplies and had to stop an investment project to launch a new product and enter a new market. About half of respondents reported that lack of access to credit prevents their businesses from growing.

Changes in business profitability

Businesses suffered as a result of decreased demand on the internal market. Increased costs of fuel, utility services and hryvna depreciation hurt profitability. A textile company reported Ukraine's supply of raw materials like wool, cotton and linen had drastically decreased (by 70-90% in some cases), making the industry dependent on expensive imports. Mid-size businesses reported difficulties paying suppliers and contractors as well as creditors. One business reported having to lay off two thirds of their staff to survive.

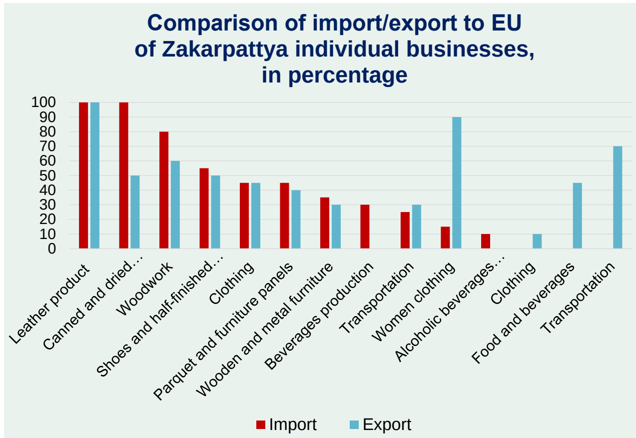
Labor force

Businesses faced challenges with staff leaving to work abroad and being drafted into the armed forces. Some businesses reported people resigning from their positions or wanting to be hired off the books to avoid being drafted through employers' registries.

Trade climate

International trade

Half of the 26 respondents are engaged in export. Ten export directly and three through brokers. On average over 52% of exports goes to the EU. Twelve respondents export to the EU. Two companies export 90% and 100% of their products respectively to Italy and other EU countries (mainly, leather goods and women clothing). Other products that are being exported to EU include clothing, shoes, woodwork and food products. Only 4 businesses exported to Russia, averaging 14% of exports.



The EU is also the main source of imports. The chart below analyzes the individual trade of companies in the sample. One company that exports 100% of its goods to the EU also imports 100% of its supplies from the EU, serving as a production base in Ukraine. Few businesses in the clothing production sector had imports to EU countries equal to exports. The EEU and Turkey are other major sources of imports. Those importers mainly produce shoes and clothing, timber, food and beverages.

One internal barrier to international trade mentioned by respondents is implementation of the Customs Code. According to the Code, businesses regularly engaged in international trade should receive "Economic Operator" status. This status allows for simplified customs procedures, priority customs inspection, opportunities of free storage, and exemption from goods transit guarantees. The law came into force in 2012, abolished the mechanism for acquiring this status.

In order to transport goods from the border to the delivery point businesses have to provide a guarantee at customs. Previously companies could receive general guarantees for the whole year.

Now changes in legislation mean companies have to acquire guarantees on a case-by-case basis, creating a massive obstacle for exporters.

In order to cover decrease in local Ukrainian demand, one respondent increased their exports to the EU by 25%. Transport and logistics companies have been hit hard by low domestic demand for goods and fewer goods imported from abroad. Four companies reported decline or termination of all trade with Russia. One transportation company reported that Russian sanctions stopped them from being able to ship to Russia ending their exports. Previously 90% of their sales went to Russia before the sanctions were introduced. Another transportation company reported decline in international trade because foreign partners were concerned about delivering to Ukraine.

One large clothing producer reported they now heavily import, as there is a shortage of Ukrainian raw materials like wool, linen and cotton. They are forced to import to sustain production, creating difficulties dealing with customs.

Trade with non-government-controlled territory

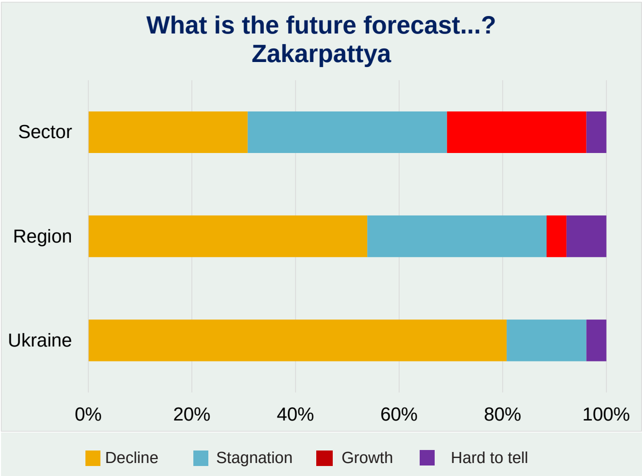
Of 26 companies interviewed only five reported that they traded in 2013 with territories now not under Ukrainian government control. Those companies are clothing producers, a food and beverage producer and transportation and logistics companies.

Large businesses reported losing partners and clients in the territories not under Ukrainian government control, but most were easily replaced.

Future potential

Zakarpattia businesses had worse expectations for the economy of the country than for their region or sector. Eighty percent of respondents believe that Ukraine's economy will continue to decline. The war in eastern Ukraine and loss of the Russian market are the biggest reasons for their pessimism. The lack of a strategic approach to economic policy on the national level is another significant reason.

Some sectors and industries are more positive about their future. They hope to attract investors and open new markets including the EU, US and Middle East. Of those surveyed, five are reporting that they expect to shorten their production and in the worst cases close their businesses. Others see opportunities for stabilization and growth in the future.

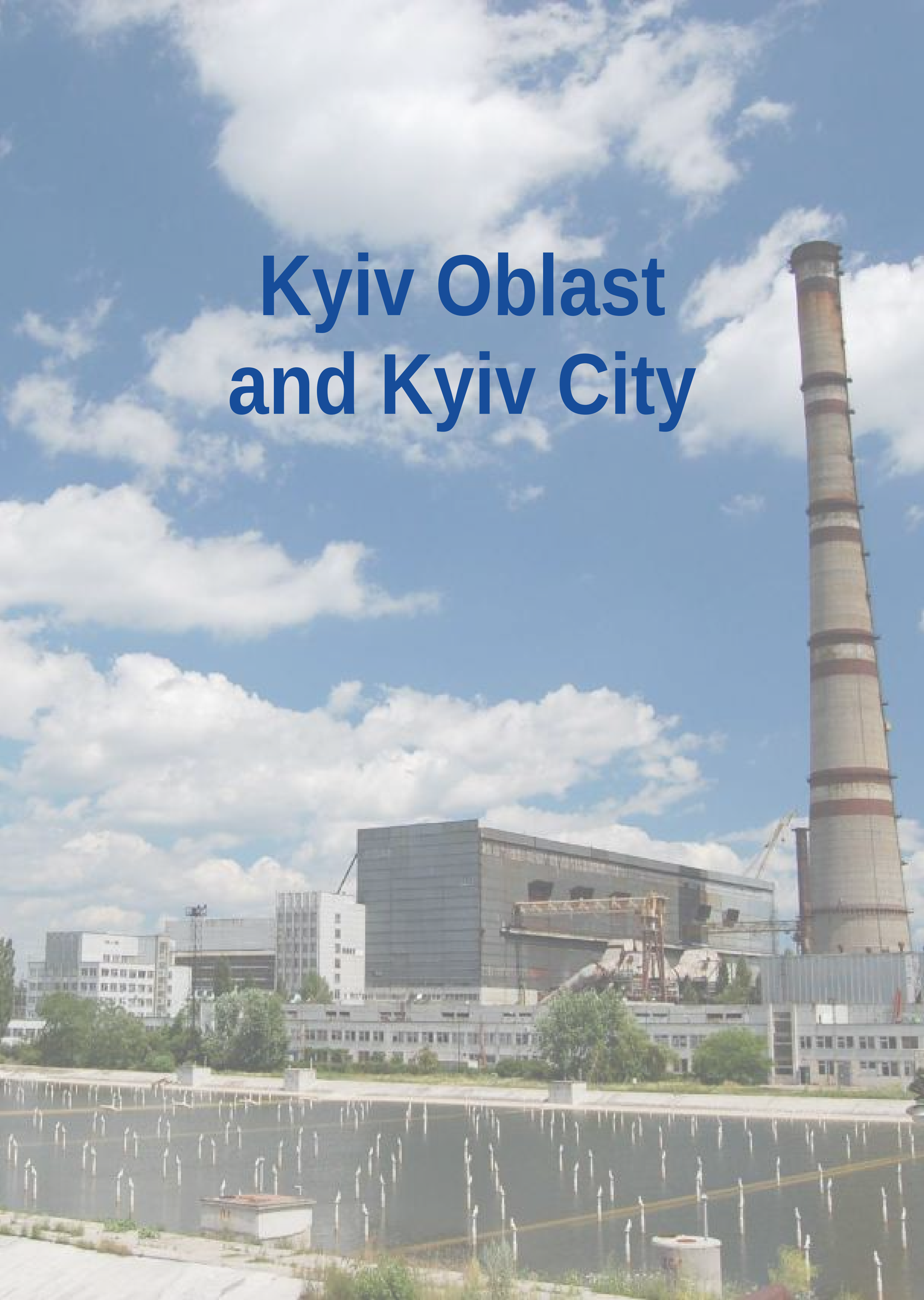


Conclusion

Due to its geographic location, Zakarpattia had good trade connectivity with the EU and has been less affected by the current conflict than other oblasts. While highly engaged in international trade, Zakarpattia trades mainly on its location. Businesses either export raw materials such as timber to the EU, or serve as a production base for goods assembled from imported materials and exported to the EU. These practices will likely expand under the Association Agreement, but there is little value added to the economy by these business models.

Local businesses aspire to do more, but are limited by the shrinking of the Ukrainian market and being shut out from the credit needed to enter new markets. As elsewhere in Ukraine businesses look to the state for a plan to overcome these obstacles, but consider the state to more often hinder than aid their efforts despite the mutual benefits of greater foreign trade.

Kyiv Oblast and Kyiv City



Located in north-central Ukraine, Kyiv City is the capital of Ukraine and is surrounded by Kyiv Oblast. The two are extensively interlinked economically and function as a commercial hub for the country. Many of Ukraine's major companies have their headquarters in Kyiv and that dynamic combined with its comparatively diversified economy and exports have limited exposure to the current economic recession.

To better evaluate the region's economy industries in key sectors were identified in Kyiv Oblast and Kyiv City to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 8 sectors in Kyiv Oblast were the most prominent:

Kyiv Oblast	machine building
	food industry
	wholesale and retail trade
	paper industry
	Agriculture
	transport services (airport, rail, etc.)
	construction industry
	electricity power generation

7 sectors were the most prominent in the capital:

Kyiv (City)	IT
	financial and banking sector
	wholesale and retail trade
	real estate transactions
	professional, scientific and technical activities
	Transport
	construction industry

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Kyiv Oblast Economy

Kyiv Oblast accounts for 4.5% of Ukraine's GDP (2013)[19], 4.0% of Ukraine's industrial output (2014), 3.4% of total merchandise exports (2014) and contributes 4.7% to Ukraine's total retail trade. The following sectors were major contributors to Kyiv Oblast's gross total value in 2013: agriculture (13.5% in 2013), manufacturing (13.4%), wholesale and retail (20.9%) and transport (11.2%). Kyiv Oblast's industry specializes in machine-building (electronic and electromechanical products, etc.) and metal-working, food (sugar, sunflower oil, milk, butter, alcohol, starch, canneries, meat and poultry), electricity production, chemicals and petrochemicals, woodworking, cellulose-paper and construction materials (see Table 1).

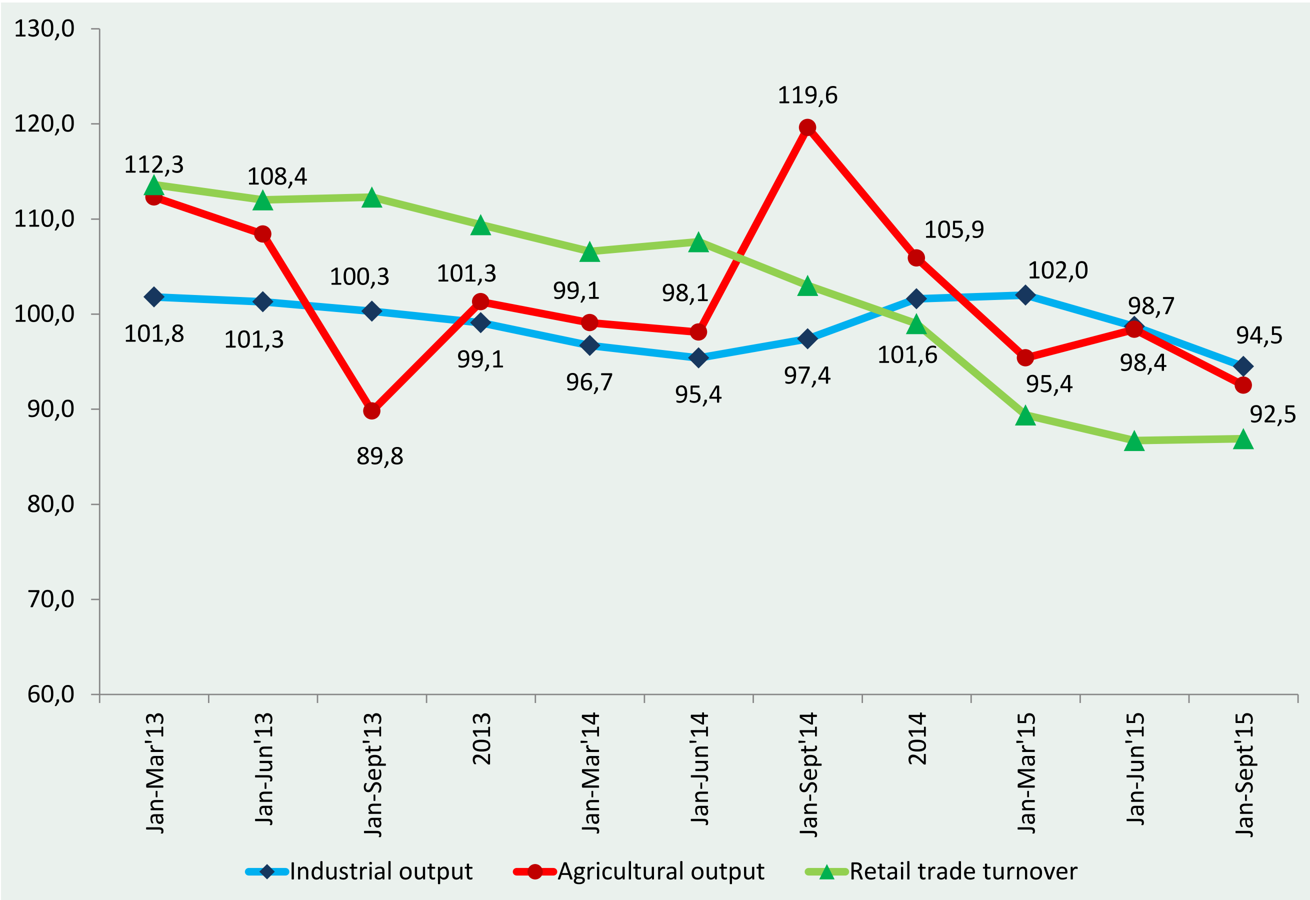
Kyiv Oblast's industry performed comparatively well in 2014 and 1H2015. Regional industrial output grew up by 1.6% yoy in 2014 (versus -10.1% yoy in Ukraine), while the drop in 1H2015 was much smaller than elsewhere (-1.3% yoy). The food industry, the biggest regional industry, grew 33.4% in 2014 and 37.9% in 1H2015 (Table 1). Despite its overall positive growth in 2014, food production fell by -7.9% yoy in 1H2015, suffering downward pressure from weakening domestic consumption and trade restrictions on the Russian market.

Metal-working and metallurgical production grew by 36.2% yoy in 2014 and 35.1% yoy in 1H2015. Machine building observed weak growth over 2013-1H2015 (-6% yoy in 2013 and 3.3% yoy in 2014, and 3.6% in 9M2015). Electricity production fell due to a shortage of gas and coal supplies caused by the military conflict in Donbass (-8.8% yoy in 2014 and -23.3% yoy in 1H2015).

The average unemployment rate for the working age population in the region went up from 6.4% of the economically active population of the relevant age in 2013 to 8.1% in 2014 and down to 6.9% in 1H2015.

[19] The latest available data.

Indices of industrial production, agricultural production and retail trade in Kyiv Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

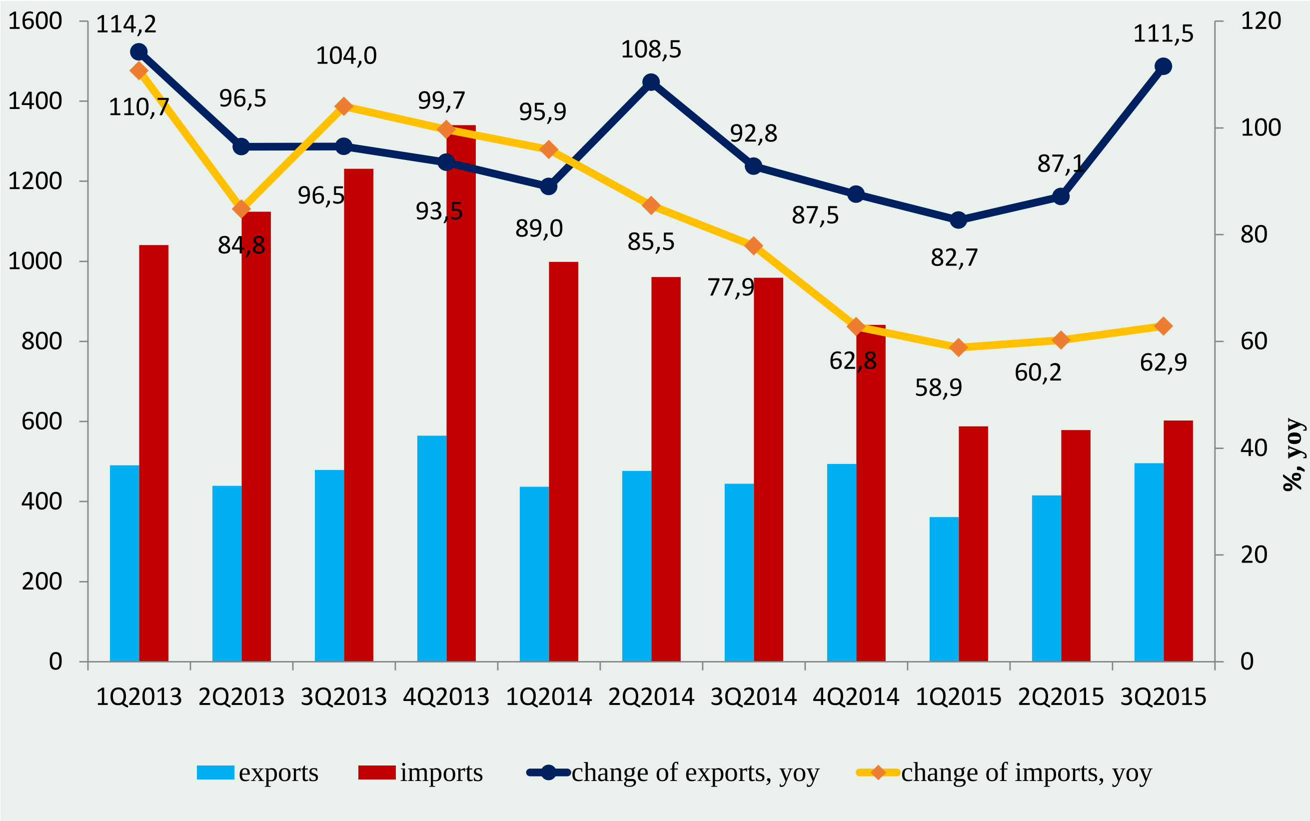
Trade overview

Kyiv Oblast's merchandise exports contracted by 6.1% yoy in 2014 while imports fell 20.6% yoy. The fall of exports started in 3Q2014 and accelerated in 4Q2014 and 1Q2015 (by -17% yoy each) (Figure 2). Kyiv region significantly decreased its dependence on the EEU markets over the last five years: while in 2010 about half of regional exports went to the EEU markets, in 2013 it was 37% and in 2014 23% (Table 2). Regional export supplies to EEU markets experienced a dramatic drop in 2014 (by -42.6% yoy). Decline of supplies to the EEU markets contributed the most to the overall drop in Kyiv Oblast merchandise exports. Exports to the EU meanwhile grew 19.3% yoy and its share were up to 27.6% in 2014. Asian countries, however, were the main destination for regional exports (mainly agricultural products) in 2014, accounting for 31% of exports (up by 27.9% yoy in 2014).

Kyiv Oblast exports mainly consist of sunflower oil, prepared foods, products of animal origin and vegetables, wood products, paper, paperboard and printed books, machinery and electrical equipment, and plastic and rubber. In 2014, most agricultural exports grew (except prepared foods for the EEU markets), while wood products and paper, plastics and rubbers, machinery (for the EEU markets) fell significantly. Regional service exports mainly consist of transport services (about 65% in 1H2015) whose sharp decline in 2014 depressed service exports by -20% yoy and by a further -51.9% yoy in 1H2015.

Figure 2

Dynamics of exports and imports of goods in Kyiv Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Kyiv City

Kyiv City is the biggest contributor to Ukraine's GDP (20.5% in 2013). It became the biggest Ukrainian exporter in 2014, accounting for 21.3% of total merchandise exports (previously Donetsk Oblast was the export leader). 7.4% of Ukraine's industrial output is produced in Kyiv City (2014), and 13.9% of Ukraine's retail trade originates there. Kyiv's gross value added is created by the following sectors: wholesale and retail (26.3%), the manufacturing industry (4.5%), information and telecommunication services (10.9%), finance and insurance (13%), professional, scientific and technical activities (10%), real estate transactions (7.1%) and transport (6.4%).

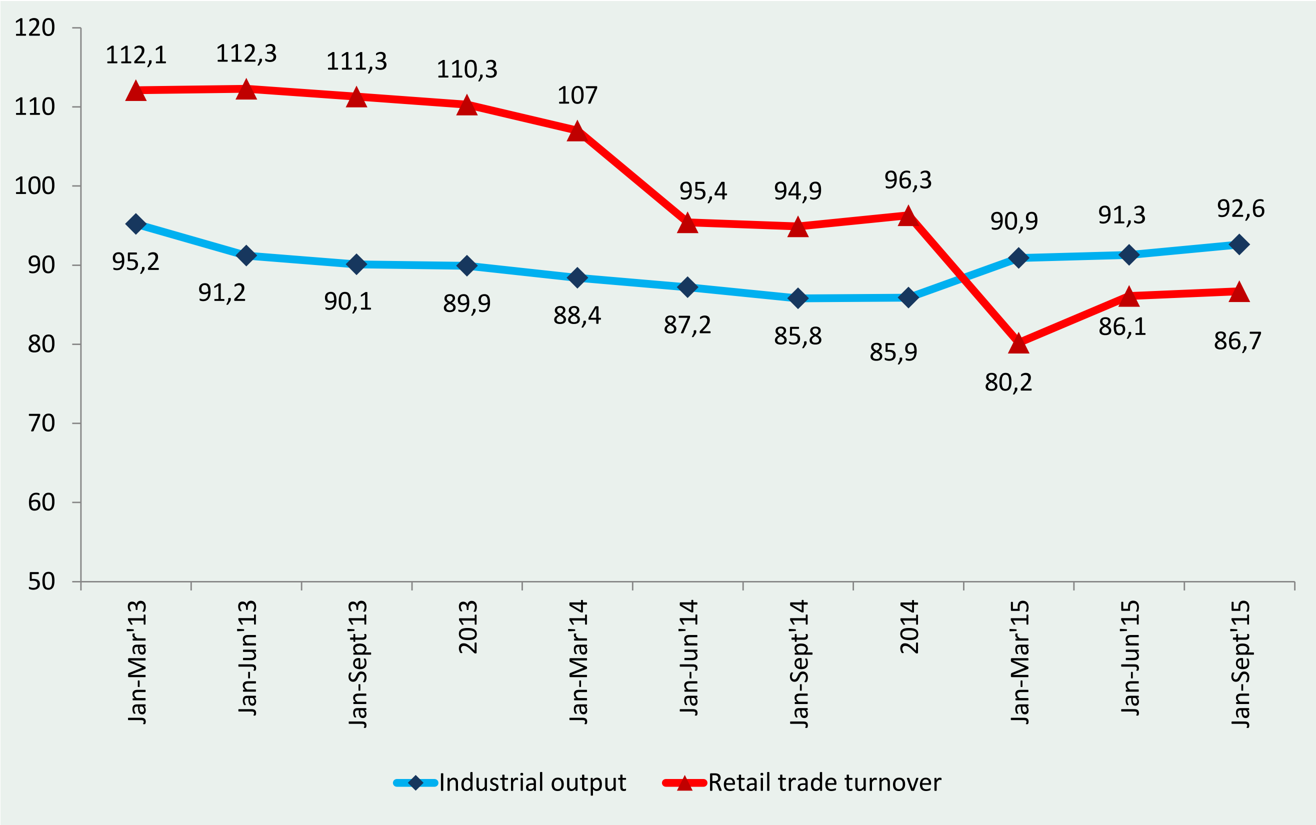
Kyiv City has the largest IT sector in the country. Kyiv's manufacturing industry meanwhile consists of the food industry, the manufacture of non-metallic mineral products, the pharmaceutical industry and machine-building.

Kyiv City's industrial production fell in 2013, 2014 and 1H2015 (about -10% yoy each period). The decline of food production (accounting for 40-45% of total industrial output in the city) hurt growth. Food industry was forced to deal with trade restrictions on the Russian/EEU market (confectionary, milk and meat products, beverages, etc.), and weakening domestic consumption (due to the decline in real income). Production of non-metallic mineral products declined because of the downturn in the construction industry.

The machine-building sector contracted in 2013 and 2014 as a result of lower domestic and external demand. Due to shortage of gas and coal supplies, production of electricity also declined. The pharmaceutical industry improved its competitiveness on domestic and foreign markets due to hryvnia depreciation and increased its output from 2013 to 2014, but turned negative in 1H2015.

Figure 1

Indices of industrial production and retail trade in Kyiv City during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

Kyiv City has the lowest unemployment rate in Ukraine. The average unemployment rate of the working age population in Kyiv City went up from 5.7% of the economically active population of the relevant age in 2013 to 7.2% in 2014, and down to 6.9% in 1H2015.

Trade overview

Kyiv City's merchandise exports observed sharp drops in 4Q2014 and 1H2015 (down by about 25% yoy) (Figure 2). Overall, in 2014 exports of goods declined by 7% yoy, while imports of goods fell by nearly a quarter.

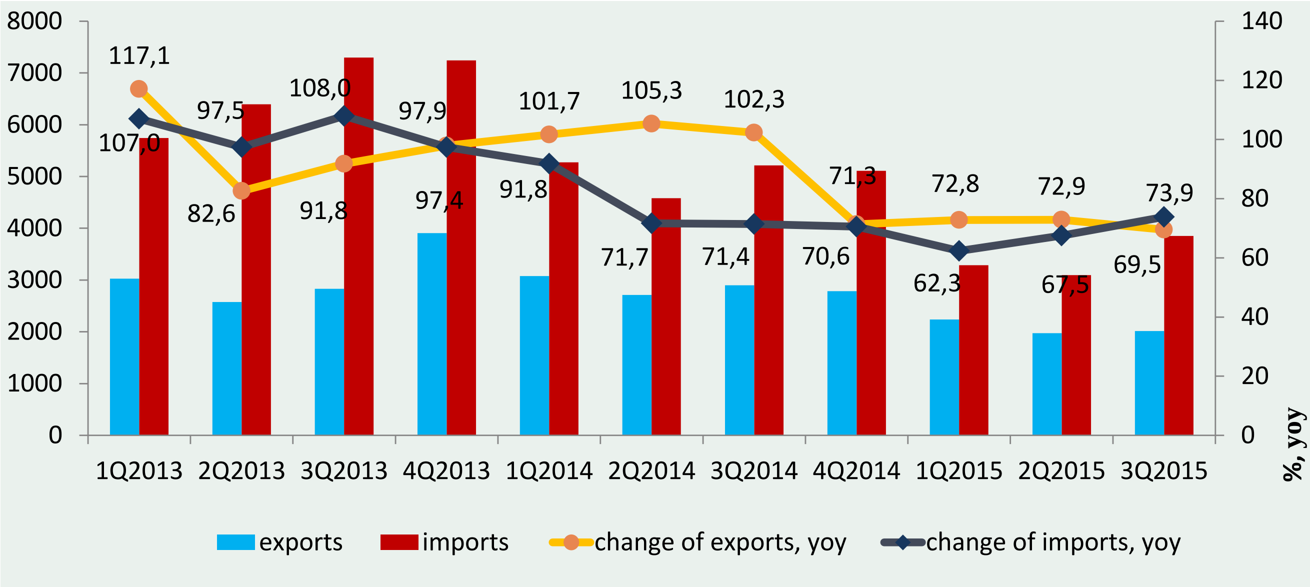
The EU and Asian markets are major destinations for Kyiv City exports, accounting for over 30% each in 2014. Aided by the improved access to the EU market, Kyiv's exports to the EU increased by 10% yoy in 2014. Exports to the EEU markets fell by -18.9% yoy (their share is half of the EU's or that of Asian countries).

Kyiv City exports are dominated by agricultural and food products, mainly grains and sunflower oils and seeds (more than half of total Kyiv's exports in 2014) because major agricultural holdings register their headquarters in Kyiv City. Other important exports include machinery and electrical equipment, chemicals, mineral fuels, base metals and products, aircraft, ground transportation vehicles, craft agents, polymers, plastics and articles thereof.

Growth of exports of services also turned negative (-11.2% yoy in 2014 and -28.2% yoy in 1H2015). IT, telecom and information services, transport and business services prevail in Kyiv's exports of services structure. Exports of IT, telecom and information services had the largest volumes in 2014 (31.1%) and were the only service sector that kept positive growth in 2014 (7.0% yoy), but slightly decreased in 1H2015 (-3.9% yoy).

Figure 2

Dynamics of exports and imports of goods in Kyiv City during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Survey (Kyiv Oblast and Kyiv City)

142 enterprises matched the sample criteria, with 65 of them in Kyiv City and 77 in Kyiv Oblast. 16 interviews were conducted in Kyiv city, 8 in Kyiv oblast and 2 with stakeholders from the Oblast and City Administrations.

Number of respondents by sector, Kyiv City and Kyiv Oblast	
Wholesale and Retail	3
Transportation and logistics	3
IT and telecomunication	3
Finance and insurance	3
Machinery production	3
Real Estate	2
Food processing	2
Agriculture	1
Construction	1
Profesional and techincal consulting	1
Textile and clothing	1
Pharmaceuticals	1

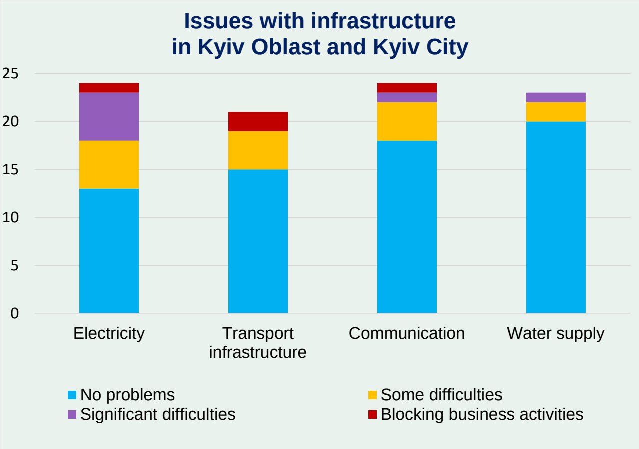
Kyiv business is often included in research, thus larger enterprises with the large PR departments were more willing to be engaged in the survey. Those who took part in the survey were eager to provide detailed information.

Business climate

Businesses are suffering as a result of hryvna depreciation and political instability. Both of these factors limit consumers' purchasing power and investment. Currency fluctuation and exchange and government imposed limits on foreign currency have hurt traders and driven some out of business.

Infrastructure

The majority of businesses deliver their goods within Ukraine as well as to Europe and Customs Union countries using road infrastructure. Worsening road infrastructure significantly influences business operations by increasing costs and time for delivery. One company reported that there were higher risks of the crime on the road when transport is moving slowly due to road conditions. Businesses estimate that the cost of transportation has increased by 3 or 4 times in

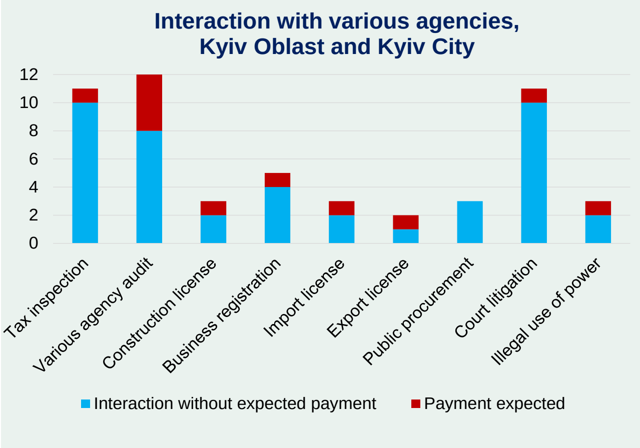


the last 12 months due to poor roads and that is has increased fuel and maintenance costs. Large business are less affected as they have their own large logistics units that are better able to deal with these issues.

Shortage of electricity is also an issue. Machinery producers reported that unplanned cuts damage expensive equipment. The food processing, real estate and banking sectors are also affected by electricity cuts.

Internal regulatory environment

Businesses mentioned specific regulations hindering their operations. For example, one business stated the lack of regulation of e-commerce made it more difficult for them to operate in that arena. Another media company stated that the ban on Russian produced content meant they weren't able to use content they had already bought and were bearing losses as a result. The business engaged in both export and import reported losses due to currency exchange limitations. When they export their products, they have to exchange



75% of the income into UAH and to import they have to buy foreign currency again.

Kyiv-based enterprises are very critical of how regulations are enforced by regulatory agencies. Respondents that reported performing all operations as required by law complained about the length of various legal procedures. "We would be able to solve the issue in a minute if we would pay an extra USD 1,000, but instead we choose to do things officially and it takes a long time," said one respondent. Other respondents acknowledge being forced to pay bribes to judges and to the ecological agency upon inspection. In order to protect their rights in the face of regulatory bodies, companies require large legal departments to deal with the courts.

The majority of respondents said that there were no significant changes in the work of regulatory agencies. One respondent mentioned new inspections, including of outdoor advertisements and KyivGaz gas system checks. Only five respondents reported some minor positive changes, described as "more accurate" or "less impudent" behavior, but said bribes were still required for smooth and quick turnaround.

Taxation officials

As in other oblasts, tax agencies have the most influence on business operations. While working with the tax administration businesses often deal with complicated procedures, long wait times and lack of information about requirements and changes.

Three respondents reported incidents when the tax administration unlawfully seized funds from them. One company said they had to fight in the court for two years for UAH 2 million that was only recently returned them, which due to the exchange rate is now worth much less. Another respondent reported that when the new electronic VAT system was introduced UAH 3 million disappeared from their account. A third company says that even after a court decision in their favor the tax administration continues to pursue the same "tax debt" and conduct audits and inspections concerning this debt.

Licenses, permits and certificates

One company reported delays with export and import licenses, but said they did not create many problems. This business also reported long waits for licenses for business activities from 90 to 700 days. To receive a construction permit respondents reported it took between 21 and 30 days. It took 7 days to receive either an import or an export license. Four respondents reported that in cases of public procurement officials expect bribes of 10-50% of the value of the contract.

Access to financing/capital

No respondent reported being denied a loan, however, a shortage in financing has hit the banking, real estate and retail sectors. Banks are not able to provide better loans rates because of the shortage of capital in Ukraine and an inability to access foreign markets.

Changes in business profitability

Businesses reported decreased profitability because of decreased purchasing power as a result of the unstable hryvnia, which makes it difficult to sell goods locally when goods or supplies need to be purchased abroad.

A milk producer reported that since their goods are legally classified as "socially important" and their pricing subject to state regulations they can only raise price by 1% a month, making production unprofitable.

Labor force

Businesses reported that the payroll tax has increased from 17 to 22%, increasing their expenses. Companies said inflation and currency depreciation created pressure to increase wages, but said finding the necessary funds was difficult. "We raise our salaries by 15-20% annually, but this year it will be very difficult," one media organization in Kyiv said.

A large logistics company employing over 15,000 people across Ukraine said it is becoming difficult to find personnel who will work officially. Younger men don't want to be employed officially because men are drafted using employers' records. Businesses stated that draft practices via the workplace were unfair because companies that legally employ personnel and pay all taxes are more affected than companies that employ their personnel off the books.

Three organizations said the crisis improved the personnel situation as now more people are looking for jobs. All three companies represent industries that does not require the highly trained staff such as logistics and retail. However, IT companies experience problems finding qualified personnel as many leave to work abroad.

Trade climate

Half of the businesses interviewed export either directly or indirectly, and half of business directly import supplies or goods. The exporters' sales are distributed equally among Russia, the EU, and Moldova/Georgia/Azerbaijan with the majority of sales happening on the local market (on average 60%). Three exporters reported decreased Russia sales ranging from -1–25%. One of these companies reported replacing Russian exports with export to the EU.

The majority of imports came from the EU. The importers represent businesses from machinery production, retail and wholesale, IT and telecommunication.

Before the conflict, Kyiv-based business was engaged in the trade with territories not currently under Ukraine's control. With the conflict, businesses lost on average 8% of sales in Crimea and 10% of sales in Donbas. A few businesses from Kyiv had suppliers in Crimea and the non-government-controlled Donbas, but they said the percentage was insignificant and these losses did not influence business performance.

International trade

Businesses reported that a law requiring them to convert 75% of foreign currency to hryvnia hurt business by requiring them to covert again to make new imports.

Most challenges concerned Ukrainian regulations, but there were also issues with EU requirements. For example, there are different requirements in the EU and Ukraine for cosmetic products and no assistance in navigating those differences. A food processing business also reported that EU quotas on chicken eggs limited their ability to export.

Businesses planned to enter new markets, including in Brazil, Kazakhstan, the EU, the US and Australia. Companies are taking part in international trade fairs and explore these perspective markets and their regulations.

Two respondents had negative expectations for the effect ofEU DCFTA implementation on their business. A representative of an interior design company believed that the Association Agreement will make people poorer and less people able to afford their services. Positive views of the DCFTA focused on the potential for more clients and increased variety of suppliers.

Thirteen businesses reported a decrease in export to Russia, but the effects of this decrease did not significantly affect business operations.

Trade with Ukrainian non-government-controlled territories

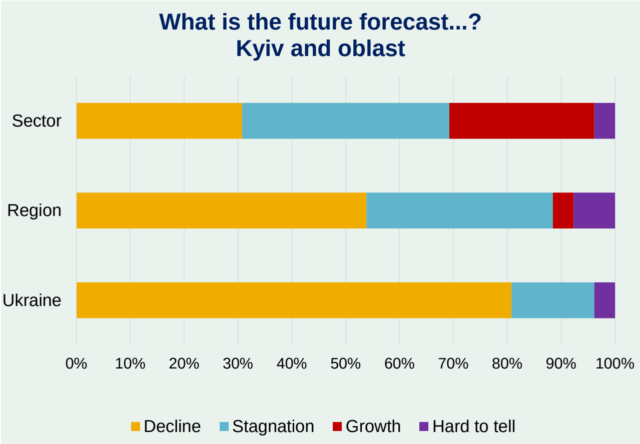
Due to the conflict, businesses lost clients and partners in Crimea and non-government-controlled territories in the Donbas. Many had closed their offices there and lost their assets. In some cases, business partners located in these areas ceased to exist. Banks have reported that they have stopped operating in the uncontrolled territories and carried losses, as they lost their property and assets there. One respondent reported closing 130 offices in uncontrolled territories in the Donbas, about 15% of their network.

One businesses in agriculture sector said they continue to work with partners in the uncontrolled territories but this is very problematic. One of the telecommunications provider reported that they still work with Crimean suppliers and partners, but have stopped cooperation with the uncontrolled territories in the Donbas.

Future potential

More than 40% of respondents negatively evaluate Ukraine's general economic situation. The consider state of hostilities in the east to be the major determining factor for the economy. They expect recovery in the mid term after reforms have been implemented.

Expectations for Kyiv City and Kyiv Oblast are more positive then for the country overall.



Respondents believed that with both functioning as centers for investment and with a large well-trained workforce, business would fair better than in the country as a whole.

The sectoral assessment varies based on field. The IT sector is the most positive about its future with all three respondents in this sector expressing positive expectations for future growth. The other sectors that are mainly positive in their assessment of the future include machinery production, agriculture and logistics companies.

The most pessimistic prognosis come from respondents from the banking and insurance as well as consulting sectors.

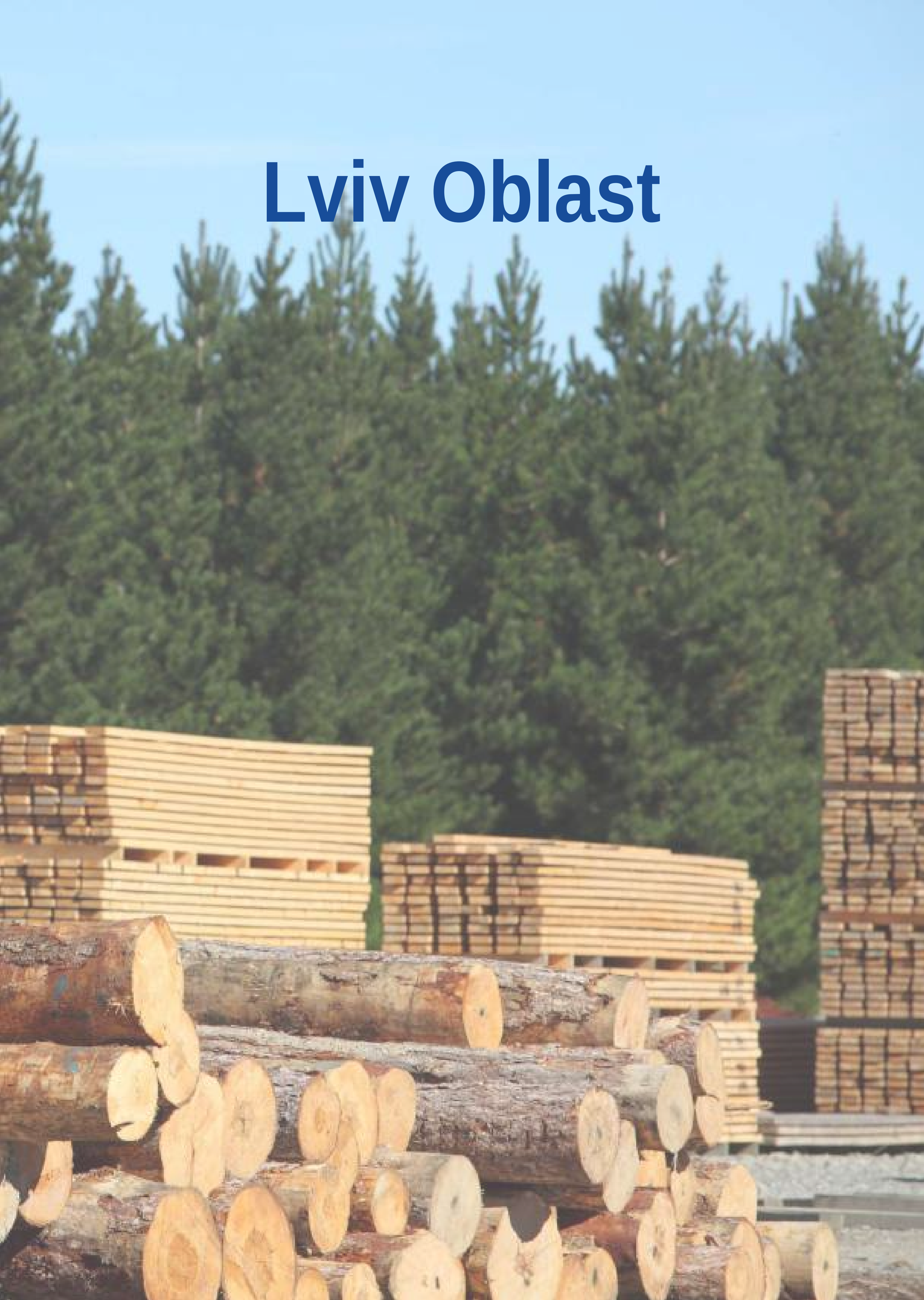
Conclusion

Both Kyiv City and Kyiv Oblast suffered from the general economic decline, but have a unique position as centers for business in the county. Both have high connectivity with all other oblasts. Loss of exports to Russia hurt the economies of both, but strong trade ties with the EU and Asia helped to minimize damage.

Kyiv based business see opportunities for the future of international trade in the sector of agriculture, IT, machinery production and raw materials. While many see the EU market as the top priority, there is skepticism that Ukrainian companies will benefit from the DCFTA implementation. Some companies instead are looking to expand into China, Russia, US, India, Africa, Kazakhstan and Turkmenistan.

Kyiv-based business emphasized the need of rapid improvements of the legislative framework. Specifically, reducing corruption, reform of public services, deregulation of business and decrease and simplification of taxes.

Lviv Oblast



Located in western Ukraine and bordering Poland, Lviv Oblast is one of Ukraine's key gateways to the European Union. Its location has given its strong export links to the EU and the potential to profit from the Association Agreement. Since fighting began in eastern Ukraine its comparable stability has made it a popular destination for Internally Displaced Persons (IDPs) and a center for new enterprises in Ukraine as investment also shifts west in search of stability. Its position in relationship to the EU makes Lviv Oblast a potential staging ground for a Ukrainian economic recovery, if a plan for economic development in the framework of the Association Agreement can be put into place.

The region has a comparatively diverse and dynamic economy despite struggling with the same infrastructure challenges that plague all of Ukraine. To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 10 sectors were the most prominent:

Lviv Oblast	recreation and tourism
	food industry
	forest and timber industry
	coal mining industry
	transport services (rail, etc.),
	wholesale and retail trade
	financial and banking sector
	chemical and oil refining industry
	real estate transactions

A review of the overall trends for the Lviv Oblast follows to provide an empirical basis for survey respondents' replies. A comprehensive review of responses from large and medium size enterprises in the Lviv Oblast follows. Special attention has been given to providing not only an overview, but a report that takes into account important outliers and sector specific issues.

Economic Overview

According to the latest available data, the Lviv Oblast is responsible for 4.2% of Ukraine's overall GDP (2013) and 3.0% the nation's overall industrial output (2014). Lviv Oblast's greatest contribution to the economy are in manufacturing (10.8% in 2013), agricultural (8.6%), wholesale and retail (16.7%), transport (9.4%), education (8.5%) and information and telecommunication services (5.3%).

The Lviv Oblast's information and telecommunication service sector is second only to Kyiv's in Ukraine. The food processing industry, machine-building, cellulose-paper production, the printing industry, textile manufacturing and mining industry are also significant. In the manufacturing sector, the largest industry is food processing, accounting for nearly 30% of the region's industrial output. Because of the strength of these different sectors Lviv Oblast has one of Ukraine's most diversified regional economies.

Prior to the Maidan protests at the end of 2013, Lviv Oblast's industrial output was generally stable. In 2013 it showed modest growth (+1.2%), but downturn in 2014 (-2.8%) extended into the first half of 2015 (-1.8%). In contrast, The food processing and mining industries have stayed steady since 2013. A strong harvest in 2014 bolstered the food processing industry. Demand for coal from the region's mines rocketed after fighting in eastern Ukraine causing country-wide coal production to drop by 70%. The textile industry also saw growth through 2014 as demand for their goods remained strong in the EU aided by comparatively low production costs.

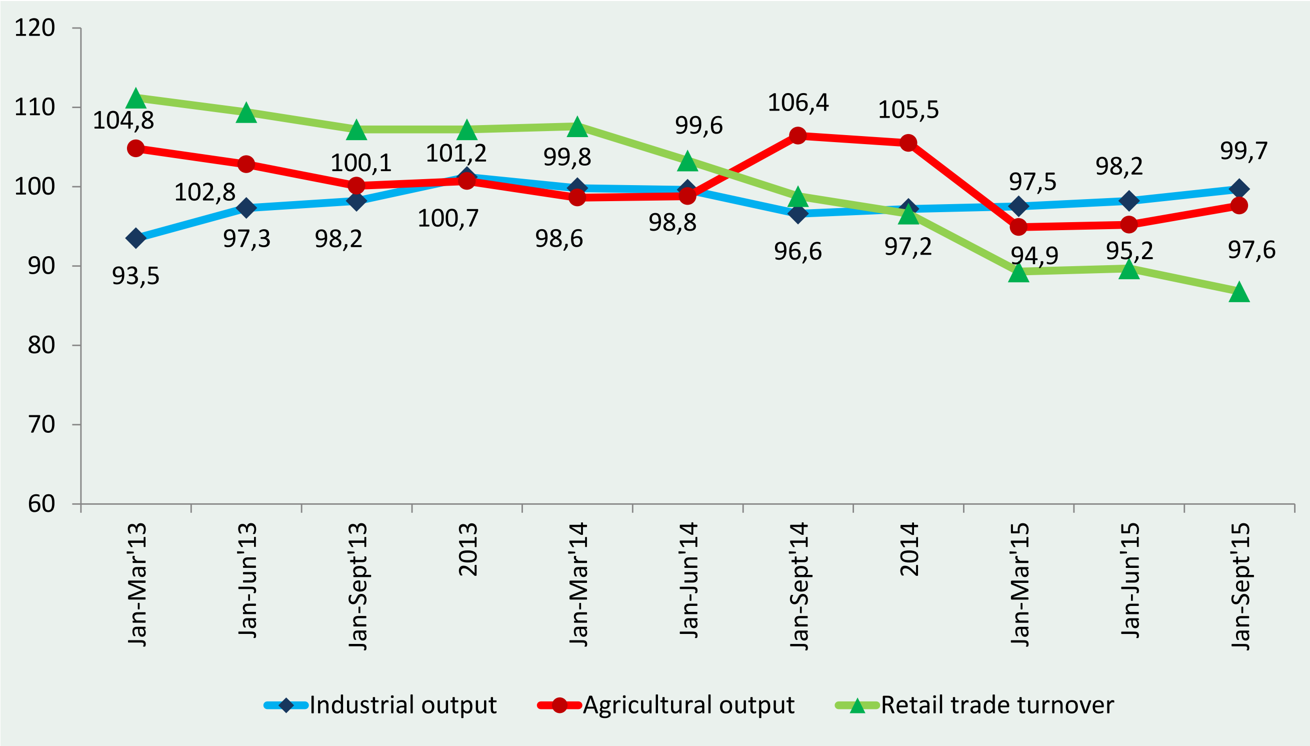
Despite areas of growth, unemployment is a major issue. The average unemployment rate for the working age population climbed from 7.5% in 2013 to 9.0% in the first half of 2015.

Trade Overview

Overall, exports witnessed a steady decline in the second half of 2014, worsening in the first half of 2015, with the first quarter seeing a -28.7% decline and the second a -19.7% drop (see Fig-

Figure 1

Indices of industrial production, agricultural production and retail trade in Lviv oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

ure 2). Imports saw an even more marked decline, with a -28.8% decline in the first quarter spiral into a -42.9% drop in the second.

The share of the region's exports headed to the EU has gradually increased with 72.2% of the Lviv Oblast's exports in 2014 going to the EU thanks to improved access and relaxed trade barriers. A majority of exports from the region are either reprocessed raw materials or semi-finished goods, like those from the textile or machine-building industries, accounting for 43.9% of the regions total exports in 2014.

The EEU market observed a sharp -23.1% decline in 2014, falling to only 16% of the region's exports.

Regional service exports are dominated by information and telecommunication services accounting for 28.9% in 2014, while transport and transit accounted for 18.8%. IT, which prominently relies on outsourced work, was the only industry to exhibit continuous growth from 2013 through the second half of 2015.

Survey

A total of 27 interviews were carried out with businesses in the Lviv Oblast. Nine were conducted with representatives of large enterprises and eighteen with SMEs. Two interviews were conducted with local authorities, including an official of the Lviv City Council Administration and an official from the Lviv Chamber of Commerce.

The interviews were conducted in multiple sectors in the Lviv Oblast, focusing on the region's primary sectors, including the food processing industry, construction, real estate and the chemical and oil reprocessing industry.

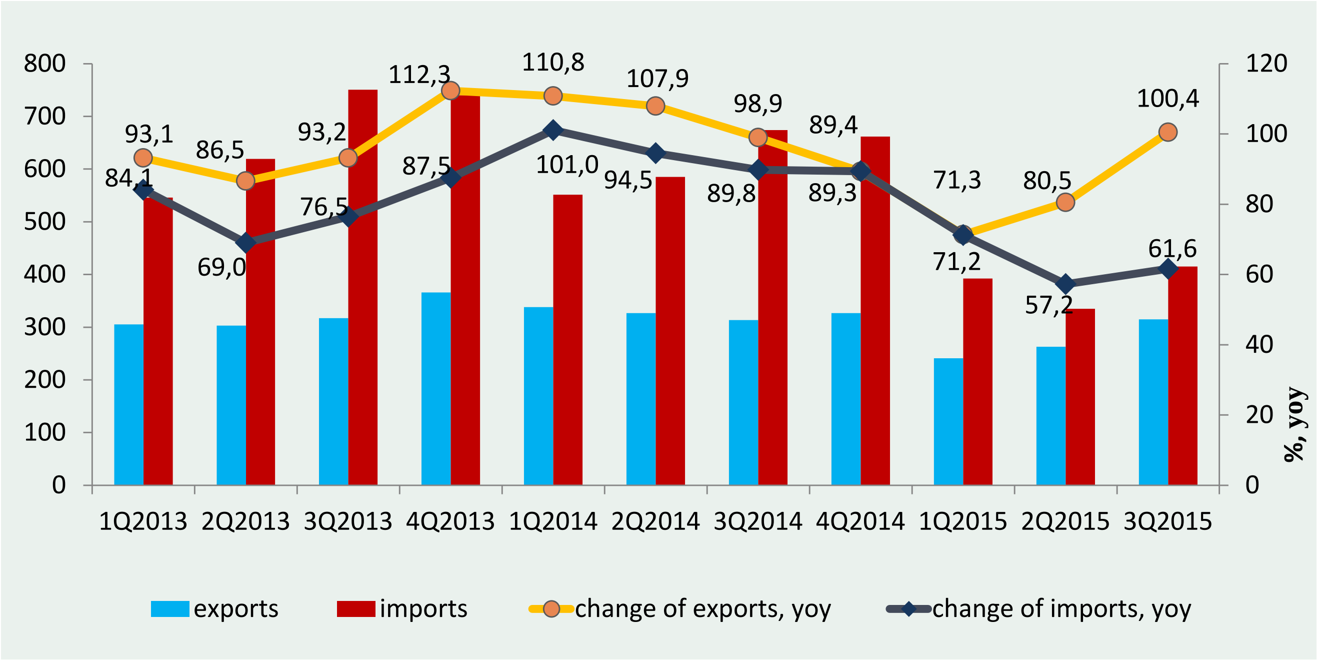
Business climate

Businesses in the Lviv Oblast ranked poor transportation infrastructure and political instability as top threats to their growth.

Additionally, large enterprises struggled to make up for lost domestic demand as the economy fell

Figure 2

Dynamics of exports and imports of goods in Lviv Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Number of respondents by sector, Lviv Oblast	
Furniture and wood products	4
Food processing	3
Chemical and oil	3
Extractive	2
Construction	2
Wholesale and retail	2
Real estate	2
Transportation	1
Hotels and restaurants	1
IT	1
Finance and Insurance	1
Health services	1
Textile and clothing	1
Plastic and rubber production	1
Machinery production	1

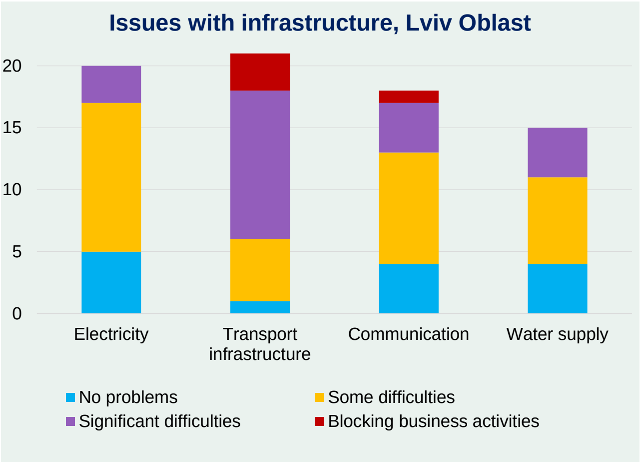
into a deep recession in 2014, while medium size enterprises felt squeezed between high tax rates and growing production costs.

Across the economy rising production costs have hurt regional businesses as they struggle to anticipate local demand and prices of materials.

Barriers on trade with Crimea and the Donbas have also cut off previously lucrative domestic trade. Large businesses specifically cited military conflict as taking a serious toll on their operations.

Infrastructure

Large businesses reported difficulties securing access to the needed volume of electricity. None cited the cuts or limitations as prohibitive to their work, but the issue is one of growing concern. Limitations were mainly due to shortages created by electricity distributors' input problems.



Large enterprises were concerned about the state of transport infrastructure. Three large food processing companies stated poor infrastructure served as an internal barrier to the smooth conduct of business. One business in the hospitality industry reported that the poor state of transportation infrastructure prevents their business from operating at full capacity.

Nearly half of all medium size respondents cited issues with having their electricity needs met, with two reporting that access to electricity was a serious obstacle to conducting business, though not prohibitive.

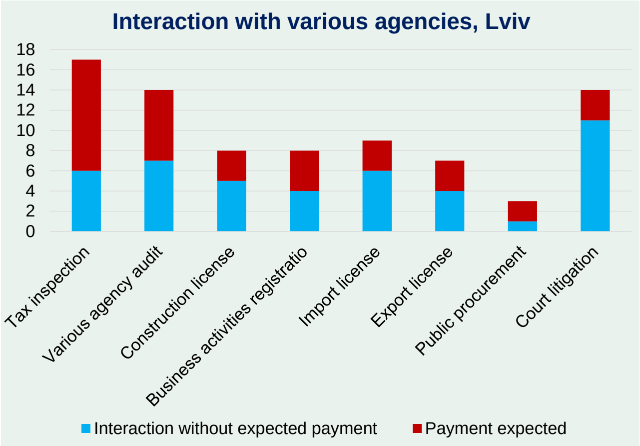
Nine of the medium size enterprise said that transportation infrastructure was in very poor condition and was an obstacle to their operations. The effects were felt by an array of diverse industries, including an extractive industry business as well as those working in healthcare, transportation and logistics services, plastic and oil reprocessing and wholesale and retail industries.

A construction company even reported that transport infrastructure was so poor that it prevented them from conducting business because of the dangers presented by moving heavy machinery and construction goods on the poorly maintained roadways.

Internal regulatory environment

Over half of the large businesses interviewed reported considerable difficulty properly reporting information to the tax authorities due to the multitude of unclear new rules and regulations. A construction company commented that the lengthy and complicated procedure involved in legally securing building permits often set the company's projects several months behind schedule before they even began.

Both large and medium size enterprises took note of the limited attempts to reduce bureaucracy. None of the large enterprises surveyed reported seeing a noticeably positive change in the internal regulatory environment, citing the current regulations in place in their respective sectors as remaining largely unchanged.



For their part, a majority of medium size enterprises described experiencing only moderate difficulty in securing the proper permits and licenses for their businesses. No other specific issues were singled out among them, but nor were there improvements over the past 12 months.

Access to financing/capital

Four large companies reported applying for loans over the past 12 months, though only two were able to secure financing. Both reported that projects had to be halted while they waited for their applications to be approved. One respondent, a textile manufacturer, reported having their application for a loan denied by a bank, which led to the company being unable to purchase needed equipment and additional materials, hampering their ability sell goods.

Of the three medium sized companies that applied for loans, all three failed to open lines of credit. One company, from an extractive industry, attempted to secure a loan through the Chinese Development Bank, but after asking for a state guarantee on the loan (required under Ukrainian law), the government required it to pay for the responsible state expertise service to review their work which made costs prohibitive. Consequently, several jobs were lost at the company after the project was cancelled. Another extractive industry business applied for a loan at a local bank, but after being told that it would be subject to a 30% interest rate, they moved on and successfully secured a loan from a foreign financial institution at a more reasonable interest rate.

The number of large enterprises interested in seeking financing and additional capital in the near future was relatively high in the Lviv Oblast, signifying a cautious optimism that the economic situation would improve. Demand for additional financing was not a primary concern for most medium sized businesses, but the standing obstacles, particularly risk adverse banks or the excessively bureaucratized procedures a company needs to go through to receive a foreign loan, are especially powerful deterrents for medium sized businesses seeking to invest in their operations.

Changes in business profitability

Of the six large companies who reported losses, two attributed their loses to losing the Russian market as a consequence of rising associated expenses, whether it be in inputs or transit costs, and their inability to remain competitive with other companies outside of Ukraine due to a weakened hryvnia.

For their part, medium sized enterprises also pointed to growing production costs, in combination with decreasing demand (particularly for those companies doing business with Russia) as initially driving down profitability. Now that they have begun refocusing their business on the domestic market they have seen gradual improvement.

In addition, medium sized companies cited a decline in domestic demand and delays in VAT refunds as issues that limited companies' resources for further growth and development. While lower domestic demand was a concern for them, issues with restrictive policies or new policies not being fully implemented were viewed as being of equal or greater concern by nearly half of the medium sized enterprises surveyed.

Labor force

Three large businesses reported losing employees to military conscription, whereas three other companies, from the pharmaceutical, IT and telecommunications, and construction industries reported significant difficulty finding qualified employees to fill open positions. The IT and telecommunications company reported that a large proportion of qualified candidates regularly emigrate to the EU, where there are more competitive wages and better opportunities.

Despite rising costs and a drop in profitability, nearly half of the large businesses increased the size of their staffs, with cuts being made at less than a third of all companies interviewed. While the economic climate had affected some large companies negatively, most expected a gradual recovery that would allow them to maintain their current level of employees or expand.

Nearly 60% of medium sized enterprises reported having little or no difficulty finding qualified employees. However, companies from the real estate, rubber and plastic manufacturing, furniture manufacturing and transportation and logistics service sectors, said they had significant difficulty in finding qualified new employees due to the skills required.

Trade Climate

International trade

None of the large enterprises interviewed said they suffered from any formal or informal trade barriers with Russia, largely because most of them had not previously done business in Russia. However, two that previously exported to Russia said they voluntarily ended those commercial arrangements over the past 12 months due to the armed conflict in eastern Ukraine and the annexation of Crimea.

Medium sized businesses reported greater difficulties. One company previously relied on an American laboratory located in Russia to conduct analysis for them. Following the occupation of Crimea and the outbreak of the conflict in the Donbas, they continued to use the laboratory's services, but getting their samples through the Ukrainian-Russian border became much more difficult and time consuming.

Three other medium sized businesses that previously exported or imported goods to or from Russia, cited several issues preventing them from doing business. One company noted that their former business partners were not honoring contracts leading them to sever ties. Another noted that a moratorium on importing certain goods set by the Ukrainian government meant that the beneficial two-way trade previously enjoyed by both parties in the past had all but disintegrated.

Half of large enterprise respondents held a positive view of the Association Agreement, noting that it would open new markets and push them to improve their own products' standards. While the medium sized enteprises surveyed were not actively trading with the EU, nine companies were very enthusiastic about the Association Agreement and the potential for deeper economic ties and growth.

One large company from the wholesale and retail sector took a decidedly negative view, stating that the rising level of competition from neighboring countries like Hungary and Poland had already led to the closure of many local businesses, something they expected to continue as the Ukrainian market opened up to the EU. This stance was echoed by two medium sized businesses, one from the wholesale and retail sector and a furniture manufacturer, who believed that increased competition would be bad for business and would lead to local businesses closing.

Of the large and medium sized companies that held a positive view of closer ties with the EU, none had any specifics on how precisely they or their respective sectors would positively impact their business or the economy in either the short-term or long-term.

Trade with non-government-controlled territory

Of the three large businesses that previously sold their goods to Crimea and the non-government-controlled territories of the Donbas, only one maintains minor ties with clients in the region. Currently they are seeking new opportunities in Moldova and the EU, albeit without any concrete strategy at present. Two other large enterprises reported that as a result of the conflict they have successfully secured more clients from central Ukraine and also from companies that have moved out of the non-government-controlled territories.

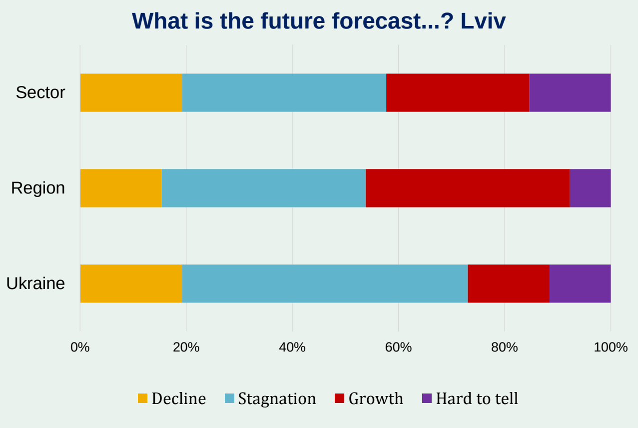
For large businesses, a shift in focus to the domestic trade market is the most promising for nearly every sector in the Lviv Oblast as they remain largely competitive with other regions.

Only four medium sized businesses traded with the non-government-controlled territories, though among them, it accounted for no more than 8% of their overall domestic trade. Whereas two medium sized businesses made up their losses, the other two replaced their former clients in the non-government-controlled territories with clients who had left the regions and moved their offices to Lviv.

Many large enterprises expect the domestic trade environment to improve for them, particularly where the domestic market continues to have shortages. Medium sized enterprises were more cautious, feeling the overall economy had to improve before they would see any sustained growth.

Future potential

When looking at the future of Ukraine as a whole, a third businesses interviewed were very critical of the current government, its policies and the absence of deep and comprehensive reform. Even where positive reforms have been made into law (e.g. e-governance), implementation has been uneven or non-existent. There was little confidence among these companies that the government would take measures that business would view as a decisive step away from corrupt



practices. With regard to the country's economy, a majority of respondents felt that it would either stagnate or witness further decline.

Lviv Oblast businesses were more optimistic about the region's economy, which nearly a third of respondents felt would see some growth in the near future. Citing a better relationship between the state and business, particularly in Lviv City, business believed that foreign investment would become more readily available, citing how the region's image has improved over the past couple of years in the eyes of investors, particularly from the West (i.e. the European Union, the United States and Canada). Those respondents who held a more pessimistic outlook pointed to corruption at multiple levels, both regional and national, as a limiting factor when it came to attracting new investment and helping the economy return to growth.

A majority of businesses from the Lviv Oblast were not optimistic about their respective sectors' future, predicting continued stagnation or decline. They listed two standing issues: a weak national currency and the diminished purchasing power of consumers. At the same time, half of the businesses interviewed expressed a great deal of optimism about deeper trade ties with EU member states and the West as a means to improve the standing of their own businesses.

Conclusion

The Lviv Oblast has witnessed its overall economic connectivity grow domestically as a result of the armed conflict in eastern Ukraine, though large and medium size enterprises alike pay little thought to improving their connectivity with neighboring countries, despite their border with the EU.

Of the sectors surveyed, manufacturing (textiles and machine-building) has some of the best potential to increase their exports as they have already developed ties with clients in the EU. Their goods either meet or could easily be modified to meet the basic standards set by the EU, though the lack of strategic planning in this direction by this sector seems to indicate that these potential markets are considered out of reach, even if they are not.

The health of the food processing industry in the region, which relies primarily on the domestic market (except for consumable plant-based oils like sunflower oil) is witnessing new opportunities as the conflict opens new domestic markets.

The IT sector, which is much more flexible in terms of how it operates and how it can sell its services, exhibits some of the most dynamic potential economic connectivity not only within Ukraine, but globally. Despite the emigration of qualified specialists in this field, successive generations and an increasingly competitive domestic IT sector suggests that its relative importance will only grow, though only if taxation and regulations allow the sector to become continuously more competitive.

As one of the most diverse regions economically, the Lviv Oblast has exhibited a great deal of resilience since 2013, particularly since the conflict in eastern Ukraine and the annexation of Crimea have had little bearing on the surveyed businesses of the oblast. While its unique geographic position and the experience traditionally strong sectors may not be replicable across the country, the respective sectors drive towards improving its reach domestically would benefit from policies that promote domestic trade and efforts to improve the very real physical infrastructure challenges faced throughout the region.

Odesa Oblast

Located in south western Ukraine, Odesa Oblast with the port of Odesa is one of Ukraine's gateways for imports and exports. As instability has grown in other parts of the country, and especially after the loss of Crimea's ports, the oblast's economic importance has only grown. The Odessa Oblast has also seen its own instability, culminating with the deaths of over 30 pro-Russian activists on May 2, 2014 when the Odessa City trade union house was set on fire during clashes between pro-Russian and pro-Ukrainian protestors. Though frustration looms over incomplete investigations into those killings, the appointment of former Georgian President Mikheil Saakashvili as Odessa Oblast governor has created a new wave of economic optimism in the oblast unseen elsewhere in Ukraine. Though the Odesa Oblast is faced with similar economic problems as elsewhere in the country, Saakashvili's clearly articulated and publicized program of reforms has made businesses believe the Odessa Oblast will be able to more quickly return to growth than the country as a whole.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 5 sectors were the most prominent:

Odessa Oblast	transport services food industry agriculture chemical and oil refining industry recreation and tourism

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Economic Overview

The Odesa Oblast is one of Ukraine's major transit points for cargo, accounting for 4.6% of Ukraine's GDP (2013), 2.5% of its overall industrial output (2014) and 3.3% of its total merchandise exports (2014). In 2014, the oblast's retail trade made up 6.9% of the nation's total. The oblast's transportation sector, particularly maritime transportation via the oblast's eight ports is the region's highest value added sector, accounting for 18.7% (2013) of the oblast's GDP. The transportation sector is followed closely in GDP contribution by wholesale and retail (15.4%), as well as agriculture (9.7%), manufacturing (9.4%) and real estate (8.4%).

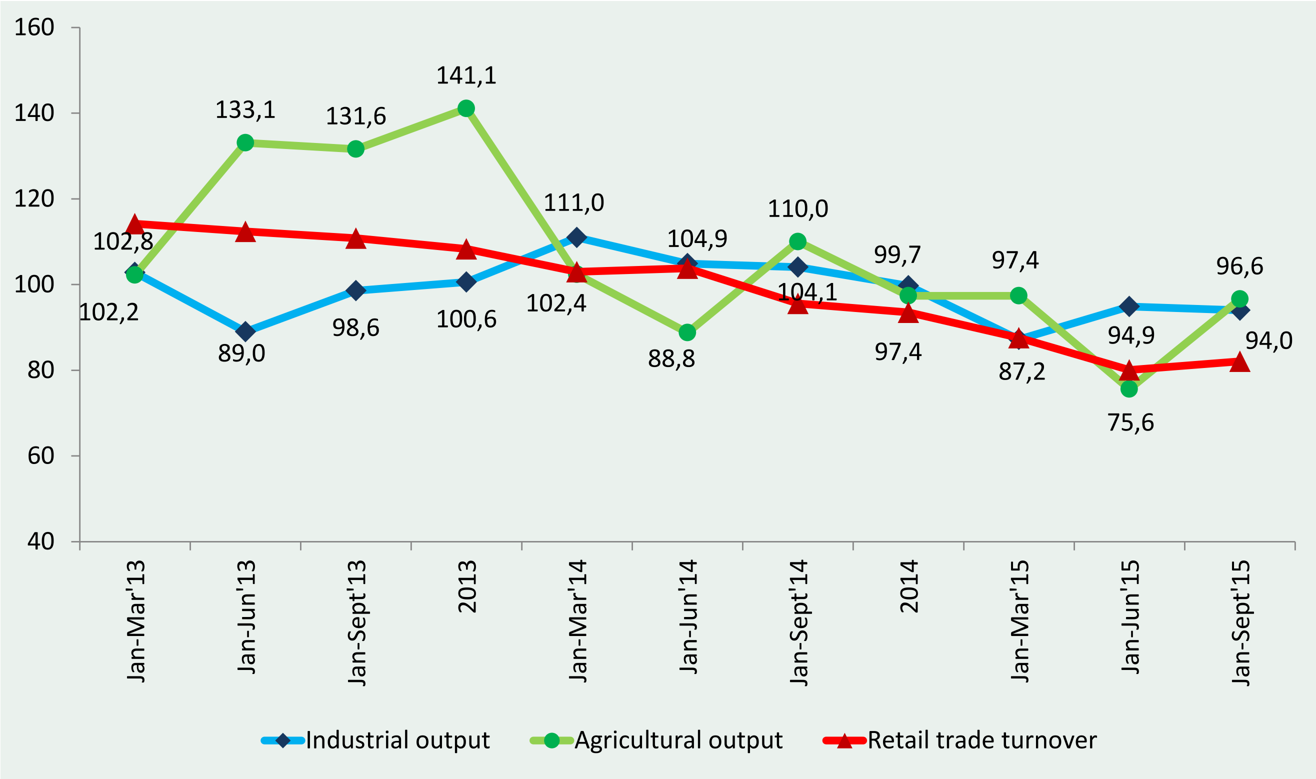
Industry in the Odesa Oblast consists of three primary sectors: the food industry, the chemical and oil reprocessing industry, and machinery. The food industry accounts for about 30% of the oblast's total industrial output, primarily producing sugar, oil and fats, processed vegetables, wine and food concentrates. The oblast's chemical and oil reprocessing industries, contributed 17.9% and 4.7% respectively to Ukraine's 2014 industrial output. They principally produce mineral fertilizers, chemical detergents, varnish-and-paint, plastic wares and industrial rubber goods. The machinery industry, focusing on metal-cutting machine-tools and shipbuilding, made up of 9.4% of the oblast's industrial output in 2014.

Industrial and agricultural output in the Odesa Oblast only declined by 0.6 and 0.3% respectively in 2014, but deteriorated in the first half of 2015, falling -5.1% in industrial and -24.4% in agriculture output. The oblast's food industry grew by 13.7% in 2014, a trend that continued in the first half of 2015. The chemical industry fell -15.2%, machine-building by -6.5%, and metalworking by -22.1% in 2014. Cargo transportation, reflecting a fall in domestic demand and exports, fell -5.7% in 2014, but showed recovery in the first half of 2015, climbing +17.57%.

The average unemployment rate for able bodied working age individuals in the oblast climbed from 5.7% in 2013 to 7% in 2014 and the first half of 2015.

Figure 1

Indices of industrial production, agricultural production and retail trade in Odesa oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

Trade Overview

Exports in the Odesa Oblast grew 9.3% overall in 2014 despite a considerable -23.6% drop off in the final quarter of 2014. The Odesa Oblast successfully substituted export losses on the EEU market with exports to the EU market. As exports to EEU countries fell -44.7% in 2014, exports to the EU increased by +36.6%. As a result, exports destined for the EEU fell from 14.8% in 2013 to 7.5% in 2014, dipping to 6.2% by mid-2015.

Meanwhile, the share of the oblast's total EU exports grew from 20.5% in 2013 to 25.7% in 2014, though fell to around 20% in the first half of 2015. Asian markets continue to play a significant role for the oblast's exports, accounting for 40.5% of the oblast's exports in 2014.

The agricultural and the food industry continued to be a bright spot for the Odesa Oblast economy. Agricultural and food exports' strong performance in 2014 is attributed to record 42.3% growth in 2014, making up 55.6% of the oblast's total exports. Chemical, machinery and metalwork exports dropped off approximately -20% each over the same period, partly as a result of lower demand on the Russian market. The overwhelming share (about 90%) of the oblast's service exports are in the transportation sector, specifically maritime transportation. Transportation services steadily declined by -12.3% in 2014 and by -14.9% in the first half of 2015, leading to the oblast's overall service exports to fall -14.4% in 2014 and a further -17.4% by mid-2015.

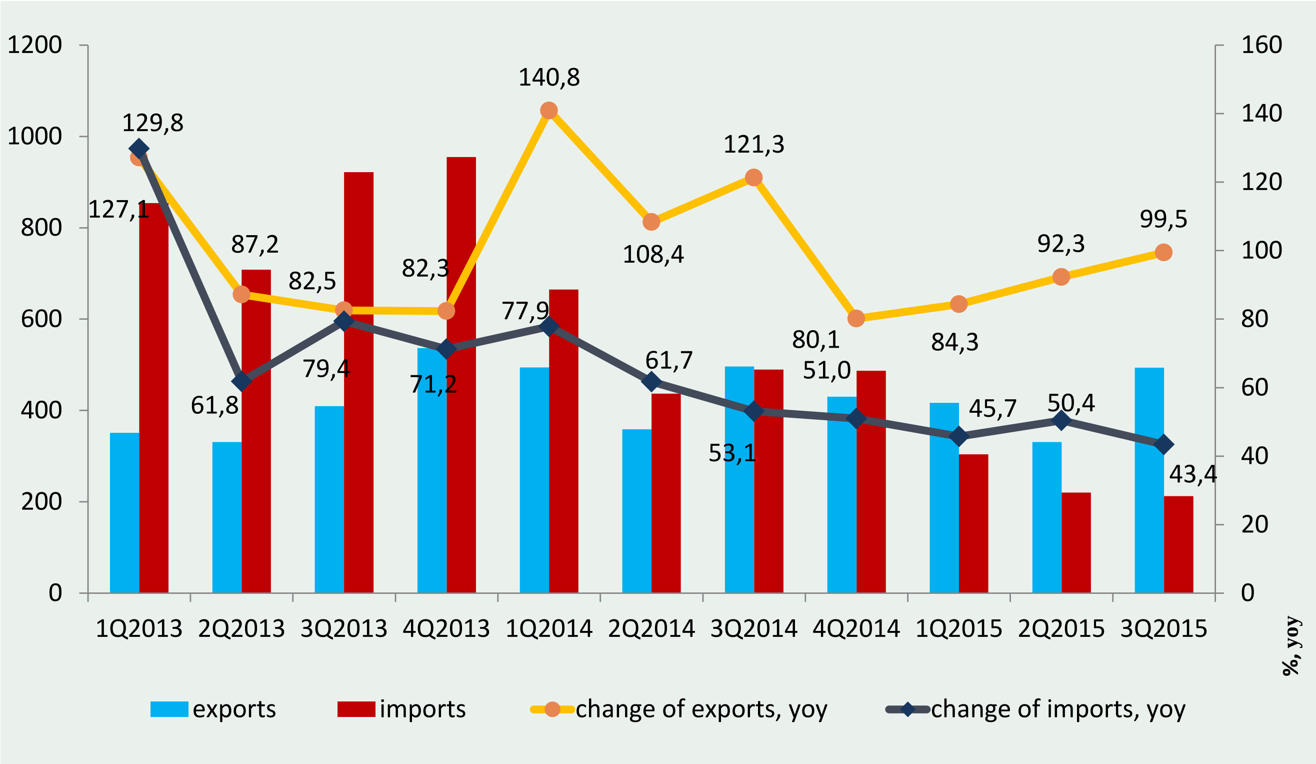
Survey

While a preliminary screening identified 47 businesses matching the sample criteria, only 15 interviews were possible to arrange, breaking down to 4 with large enterprises and 8 with SMEs. The appointment of a new regional governor for the

Odesa Oblast, the former President of Georgia Mikheil Saakashvili, in May 2015, received

Figure 2

Dynamics of exports and imports of goods in Odesa Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Number of responses by sector, Odesa Oblast	
Transportation and Logistics	5
IT and Telecommunications	3
Wholesale and Retail Industry	3
Agriculture or Forestry sector	1
Hotels and recreation	1
Food processing	1
Other	1

mixed reactions from the local business community. The change in regional leadership made businesses more reluctant to participate in interviews, in part due to the anti-corruption program of Saakashvili and the political upheaval that followed in the regional state agencies, particularly the Odessa Oblast General Prosecutors Office and the State Customs Service.

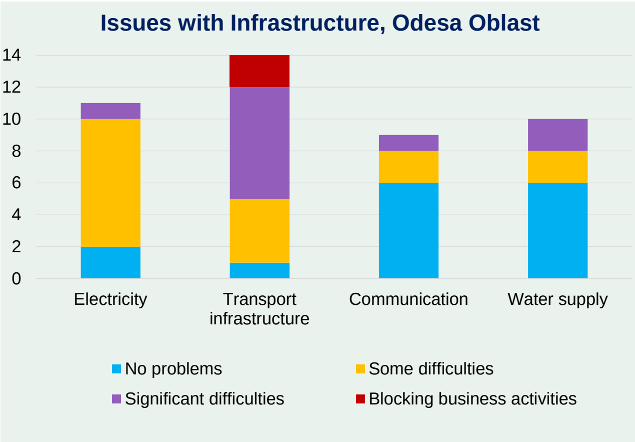
Interviews were conducted in key sectors for Odessa Oblast, including transportation and logistics services, the IT and telecommunications sector, the wholesale and retail industry, food processing industry and the agriculture and forestry sector. The majority of interviews were conducted with businesses that had fewer than 100 employees.

Business climate

Political instability and the threat of renewed armed conflict in the country ranked highly among both large and medium sized enterprises concerns, with over half of survey respondents citing those risks. While not ranking anywhere in the top 10 concerns of large enterprises, medium sized enterprises cited the poor state of the region's transportation infrastructure and infrastructure in general as a key issue for business. Over half of the respondents also reported low domestic demand as another significant issue.

75% of large and medium sized enterprises cited the new restrictions on trade with the Donbas and Crimea as a significant issue for their operations over the past 12 months.

Infrastructure (transportation, electricity, water etc.)



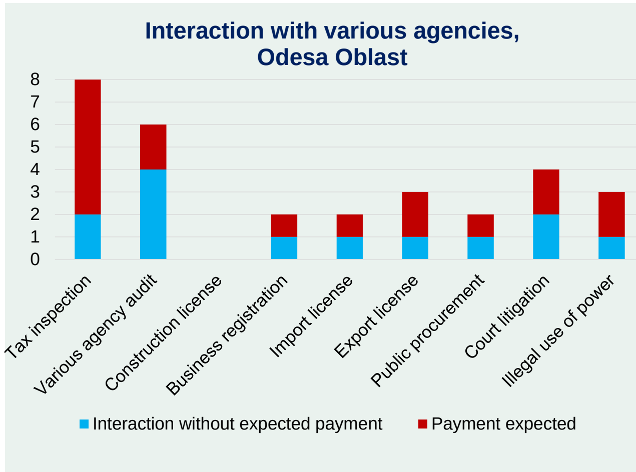
With the exception of four companies, all respondents reported moderate to serious concern about the poor state of the region's transportation infrastructure. Medium sized companies cited poor transportation infrastructure as significant obstacles to doing business. Two said the situation was so dire that at times it prevents them from doing business at all. For example, delivery vehicles will simply refuse to make deliveries to certain areas, particularly rural areas, where road disrepair risks seriously damaging vehicles.

While no medium sized enterprises reported any issues with electricity, three large enterprises reported electricity shortages over the past 12 months. One business stated the shortages were caused by an outdated grid unable to meet demand and badly needing upgrades.

Internal regulatory environment

Three businesses reported that high tax rates negatively affect their business. The two large business respondents specifically criticized to the high payroll taxes that amounts to nearly 45% that they are required to pay for any full-time employee. 25% of all respondents cited poor administration of the VAT system as one of the most serious issues their businesses faced. Businesses that are due VAT returns either wait for extended periods to receive them or do not receive them at all, creating additional financial stress on their companies during a recession.

Many of the issues with the regulatory environment are sector specific. For example, one business working in car retail sales reported that a new luxury tax imposed on automobiles based on the relative size of their engines will drive prices up, pushing record low automobile sales down even further. They also noted that while the tax is designed to target luxury automobiles, the authors of the legislation did not understand that luxury vehicles often have smaller engines than non-luxury vehicles.



A medium sized business working in the agricultural sector criticized the re-introduction of what they said is a 5% customs fee on seeds and herbicides/pesticides imports. They said farmers were already struggling and these extra costs put their operations under considerable and unnecessary stress.

Access to financing/capital

Only one large and one medium sized enterprise attempted to secure a loan over the past 12 months. The lending bank ultimately denied the large business a loan, resulting in the business halting an ongoing project they already invested in. The medium sized business received a loan at what they considered a very high interest rate and noted that had they did not already had a long-term relationship with the bank and made a substantial down payment upfront, it is unlikely that they would have gotten the loan at all.

Labor force

Work force needs vary greatly depending on sector and size of the business. Only one large business reported searching for new employees, but four medium sized enterprises struggled to find qualified employees in the IT and communications and transportation sectors. In general, a majority of respondents said they maintained roughly the same staff size over the past two years and did not anticipate any changes in the near future.

Trade climate

International trade

Only three of the companies interviewed had exported to the Russian market. The large enterprise reported the Russian market was 70% of their overall business, but over the past 12 months they lost their entire Russian market share. They blamed the loss on lower demand, rising re-export costs for foreign made automobiles and formal and informal Russian trade restrictions. The two medium sized enterprises previously re-exported goods from Crimea to Russia, but stated that demand evaporated following the annexation of Crimea and the beginning of the armed conflict in the Donbas. None of the respondents planned on trying to reestablish trade ties with Russia, but did not rule out seeking opportunities in other EEU countries.

Neither large or medium sized enterprises reported actively pursuing trade with the EU. Two large companies from the food processing industry and IT and telecommunications sectors, whose currently focus exclusively on the Ukrainian market, said that the Association Agreement with the EU is unlikely to affect them.

A majority of large and medium sized businesses in the Odesa Oblast viewed the Association Agreement and the Deep and Comprehensive Free Trade Agreement favorably. They welcomed the opening up of the EU market to Ukrainian business, but they had no plans of trying to enter the market.

Trade with non-government-controlled territory

Two large companies reported continuing to do business with Crimea, while none of the medium sized business respondents said they were engaged in trade with the peninsula. One medium sized firm reported stopping doing business with Crimea businesses because businesses could not ensure their shipments would make it to mainland Ukraine. They blamed the absence of clear procedures on both sides of the administrative boundary line with Crimea as a serious obstacle to trade. One of the large enterprises engaged in trade with Crimean businesses reported no significant losses in terms of their overall sales, but were concerned the unclear relationship between Ukraine and Russian-controlled Crimea could suddenly result in business ties being cut off.

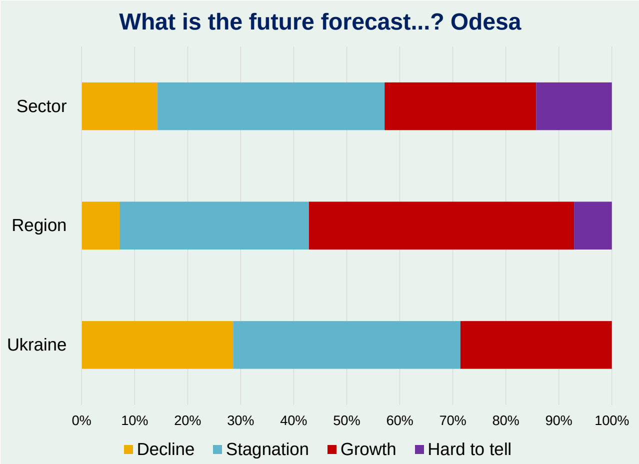
All eight companies that previously traded in non-Ukrainian government controlled areas of the Donbas stated they no longer did so. The five of medium sized businesses engaged in trade with the region faced a 10-15% drop in overall domestic trade as a result of the armed conflict in the region. The remaining medium sized company, operating a transportation and logistics business, reported losing 30% of their overall service exports as a result. None of the respondents expressed any desire to return to the region.

Future potential

Overall economic predictions for the country were more pessimistic than those held by respondents for both their own regions and sectors. While a majority of businesses felt that the national economy would stagnate or even face a downturn, only one respondent felt the Odesa Oblast would see continued economic decline.

While around a third of respondents believed that the regional economy and their sectors would continue to stagnate over the next 1-2 years, half of the respondents saw growth returning to the region.

Unlike other regions, respondents pointed to a specific catalyst for possible change in many



of their responses: former Georgian President turned Odessa Oblast Governor Mikheil Saakashvili. While this represents only a third of those surveyed, all of those who had an optimistic view of the region, and nearly all who held a similar view for Ukraine and their own sector, named Saakashvili as a central driving force towards economic prosperity.

Conclusion

The Odesa Oblast's economic connectivity on the whole remains strong, though the recent trade restrictions on the Russian market hit businesses that relied on it to export and re-export goods. Losses experienced as a result of the virtual closure of the Russian market and restricted access to some EEU markets will not be easy to make up, but the oblast demonstrated in 2014 that it is capable of finding substitute markets in both the EU and Asia. As economic ties continue to develop with the EU through the Deep and Comprehensive Free Trade Agreement, which entered full force at the beginning of 2016, the ports of Odesa can play an important role as a regional hub for trade for EU member states.

The region's food processing and agricultural industries are among the oblast's strongest candidates for improving its international economic connectivity and to profit from increased trade with the EU.

At present, the oblast's internal economic connectivity is severely hampered by neglected roadways and the disruptions they cause for any company trying to do business within the oblast. As local businesses point out, if the roadways were revitalized, commerce within the oblast itself would see significant gains. Odesa's well-developed ports and railway infrastructure, however, is a strong foundation which local companies can utilize to find new markets both abroad and within Ukraine.

Unlike in other regions and despite the proximity of the region both to Crimea and Transnistria, a potential source of the conflict, business is more positive on the future of the region. As Odesa continues to be an important link in connectivity of whole Ukraine through its sea port, there are high hopes for the changes in the region associated with the Governor who is seen as a promoter of the development of the region.

Sumy Oblast

The Sumy Oblast is located north east of Kyiv and borders Russia. Its economy represents a mixture of higher monetary value goods from the chemical and oil refining industry and machine building industry, and lower monetary value goods from the agriculture and the food industry. Like the Donetsk and Luhansk Oblasts the proximity to Russia created strong trade ties and the breakdown of Ukrainian-Russian trade during the crisis has hurt the oblast's economy. Unlike Donetsk and Luhansk Oblasts, however, Sumy Oblast has not seen fighting on its territory. These factors have made economic decline in Sumy Oblast less dramatic than in Donetsk and Luhansk Oblasts, but means it faces similar changes in finding new markets.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, six sectors were the most prominent:

Odessa Oblast	transport services
	food industry
	agriculture
	chemical and oil refining industry
	recreation and tourism

An overview of the specific characteristics and dynamics of the regional economy follows to provide context for the qualitative information in the survey section.

Economic Overview

The Sumy Oblast contributed only 1.8% to Ukraine's GDP (2013), accounting for just 2.1% of its industrial output (2014) and 1.4% of its total merchandise exports (2014). The leading contributing sectors to the oblast's gross value added are agriculture (18.5%), the manufacturing industry (14.9%), extractive industries (8%) and wholesale and retail (14.6%).

The oblast's agro-industrial complex is well developed and consists of several extractive industries (oil and natural gas), machine-building (chemical and oil-extraction equipment, gas-compressor plants, among others), metal-working, as well as the chemical and food industries. Its economy is largely export oriented and highly dependent on the Russian and EEU markets, with more than half of the region's exports previously going to them.

The Sumy Oblast's industrial production suffered a sharp decline in 2014, dropping -12.1%, which followed 7% growth in 2013, though was showing signs of recovery in the first half of 2015, growing 1.6%. Machine-building was among the hardest hit sectors in region whose overall output shrunk -21.3% in 2014 and -6.2% through mid 2015. As a result, its share in regional industrial output dropped from 20.6% in 2013 to 13.5% in the first half of 2015.

Disrupted or severed trade links and commercial dealings with Russia contributed the most to industry's downturn. The negative growth of other prominent sectors, such as the extractive industry and the food industry, which saw a -8.4% decline and -5.3% decline respectively, also contributed to the overall economic slowdown in the region.

At the same time, the chemical and metal-working sectors observed positive change in 2014, with the chemicals industry growing 34.9% and the metal-working 7.1%. This was particularly significant for the chemical sector, which had witnessed a -31.9% decline in 2013.

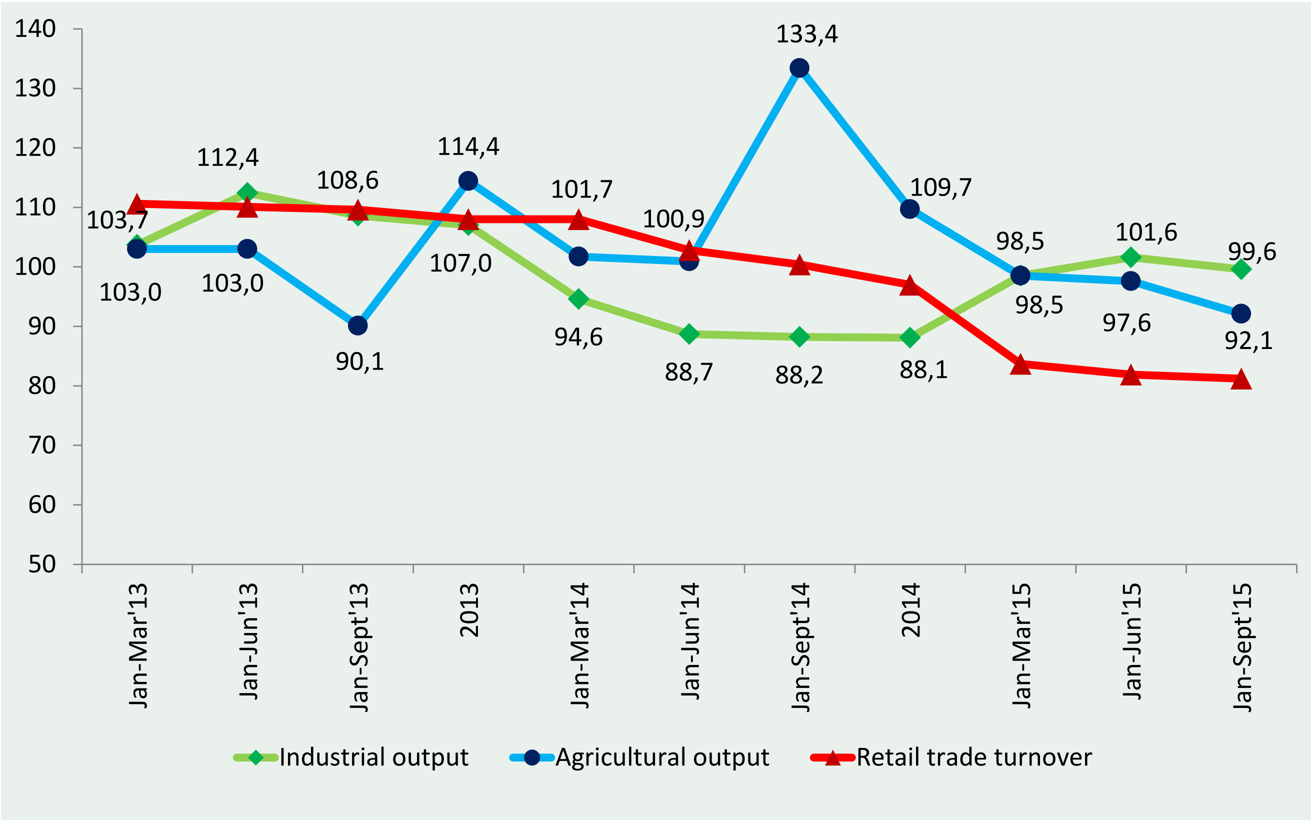
The average unemployment rate for able-bodied working age individuals in the oblast grew from 8.5% in 2013 to 10.2% in 2014, and rising once more in the first half of 2015 to 11.1%.

Trade Overview

The Sumy Oblast exhibited significant negative growth from 2013 to mid-2015, especially in its merchandise exports, which shrank by more than -20% in 2014 and the first half of 2015. In terms of its major export destinations, the most

Figure 1

Indices of industrial production, agricultural production and retail trade in Sumy Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

significant shocks were in the Asian and EEU markets, which in 2014 dropped -25.4% and -29.4%, respectively.

The importance of the EU market rose considerably from 2013 to 2015, climbing to 19% of the oblast's total share of exports in 2014 and to 23% in the first half of 2015. The oblast's overall exports to the EU increased by 8.9% in 2014.

Russian and other EEU member country's markets accounted for 57.3% of the oblast's total goods exports in 2014 and 53.35% in 2014. Despite exports to the EEU falling to 44% in the first half of 2015, it remains the main destination market for the oblast.

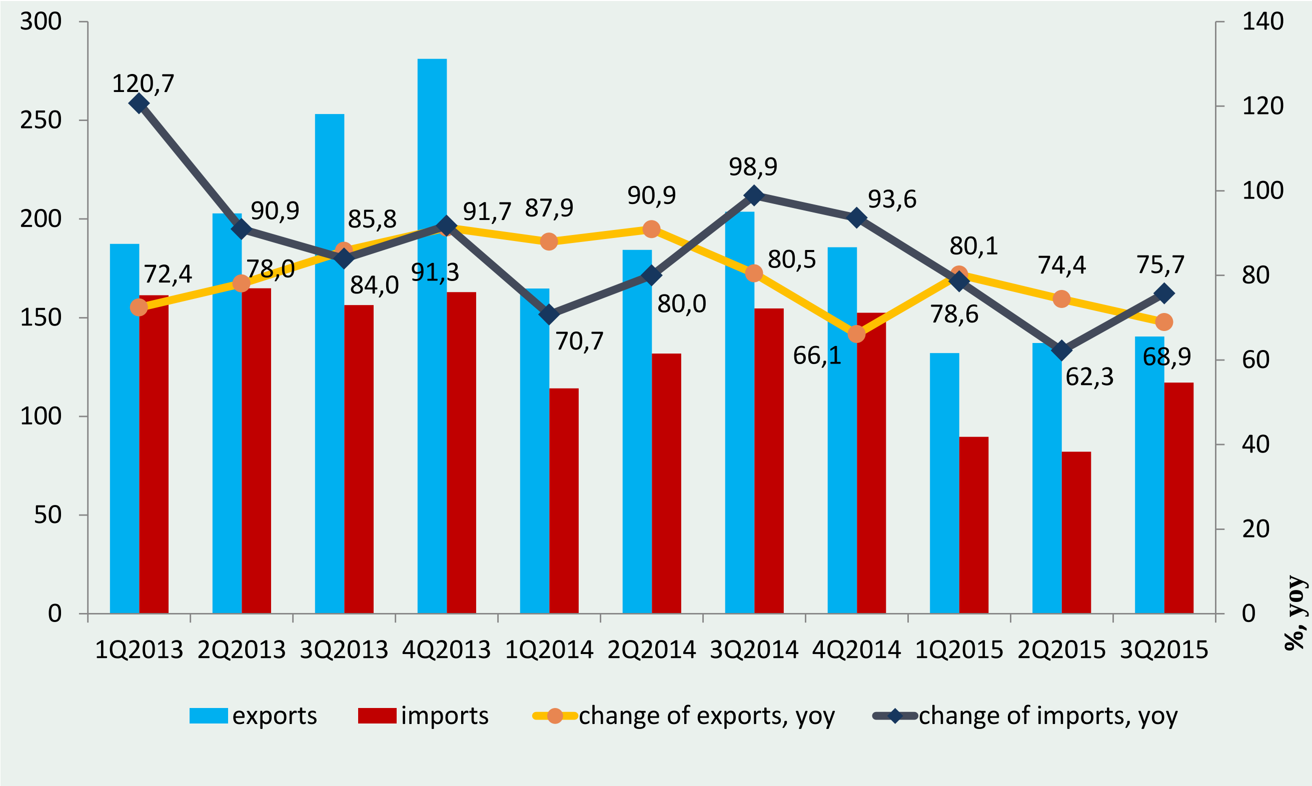
Regional exports rely heavily on sales of machinery and electrical equipment (45% of the region's exports in 2013), agricultural and food products (grains, sunflower seeds, prepared foods) and chemicals (fertilizers and tanning extracts). Chemicals, and machinery and electrical equipment were the worst performers in terms of exports from 2013 to mid-2015. Machinery/electrical equipment exports, deeply intertwined with Russian/EEU markets, dropped -46% in 2014 and -37% the first half of 2015 as a consequence of trade restrictions put in place on the Russian market.

Exports of vegetable products (grains), largely directed towards EU and Asian markets, picked up considerably, climbing 84.4% in 2014 and 37.1% by mid-2015. Important regional service exports in construction, material resource processing, and business services all demonstrated poor performance in 2014 and the first half of 2015. Overall, service exports fell -21.3% in 2014 and -18.2% by mid-2015.

Machine-building the oblast's most prominent industrial sector and is the most sensitive to trade restrictions on the Russian market.

Figure 2

Dynamics of exports and imports of goods in Sumy Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

Survey

15 interviews with representatives from business and one with a representative of the Sumy Oblast Administration were conducted. The interviews were divided relatively evenly between medium sized enterprises and large enterprises. Some respondents were reluctant to discuss their thoughts and/or concerns about the local authorities.

Number of responses by sector, Sumy Oblast	
Food Processing	4
Extractive Industry	2
Agriculture and Forestry	2
Chemical and Oil Refining Industry	3
Metallurgy	1
Machine Manufacturing	2
Textile Manufacturing	1

The interviews were conducted in oblast's key sectors, which include agriculture, food processing, chemical and oil refining, machine manufacturing, metallurgy, extractive industry, and textile manufacturing. The interviews covered 7 large enterprises and 8 smaller enterprises.

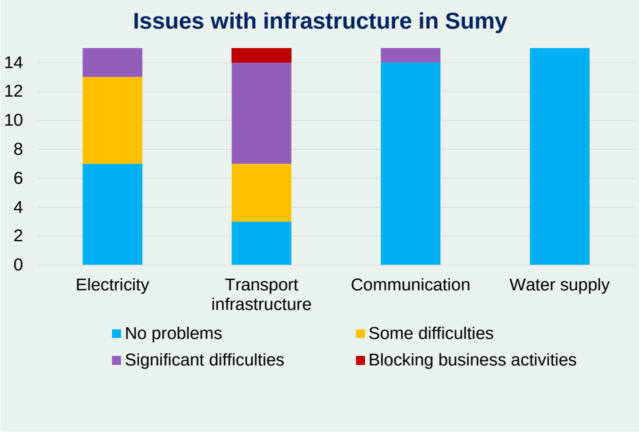
Business climate

Business in the Sumy Oblast is mostly concerned with political instability and growing production costs and low demand. Large enterprises were more concerned with external markets, whereas medium sized enterprises were worried more about the domestic market. Medium sized enterprises were also apprehensive about their ability to access financing in an economically turbulent period. Sectors that are more dependent on trade with Russia such as food processing and machinery manufacturing are more sensitive to the political instability and conflict.

For the past 12 months, growing production costs – associated with the weakening of the hryvnia – were listed as primary concerns by all medium sized enterprises interviewed and nearly every large enterprise. Securing qualified personnel was seen as an impediment by large businesses as employees were being drafted into Ukraine's armed forces.

Infrastructure

Five large enterprises cited significant difficulties with local transportation infrastructure, specifically the condition of roads in the region. Six of the seven enterprises surveyed primarily used the roadways as their main means of cargo and other transportation, with one citing air transportation and two citing the railway as their main means of exporting their goods.



Five of the large enterprises stated that rising transportation costs was one of the most significant issue they faced. Of these five, two cited delays caused by issues with roads as a regularly recurring obstacle to conducting business.

The same issues with the region's roadways were cited by all of the medium sized businesses interviewed. It was their main means of transportation, though two of them also made use of the railways for their domestic transportation needs. Of all transport issues which respondents reported, rising transportation costs were the most prominent among half of the respondents, with two of these businesses operating in the agricultural sector.

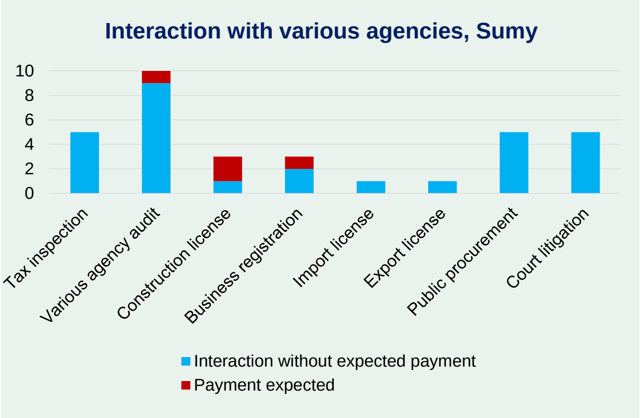
With the exception of one medium sized company working in the chemical and oil reprocessing industry, the remaining companies had no issues with their access to electricity. There were no significant issues with the water supply and only one machinery company reported significant problems with the communication infrastructure.

Internal regulatory environment

One large business cited issues with the limits imposed by the National Bank of Ukraine in the first half of 2015 on the amount of foreign currency they could purchase. While the issues were not long-standing, the delays made their foreign partners (in Russia and Turkmenistan) worry they would not be able to pay. Two other businesses reported that constantly changing legislation caused difficulties because they were never sure if they were in full compliance with the law and new taxation regulations.

Taxation officials

The majority of large and medium sized enterprises interviewed identified local tax inspection authorities as the official body they interacted with the most. Four large businesses, all from different sectors, stated it was difficult to determine what was required by tax authorities. They reported they found it unclear what documentation was required of them, and when they filed something incorrectly or did not file the right paperwork, they were approached by the local authorities to either pay a fine or pay a bribe to have the issue set aside.



Medium sized enterprises also reported that local tax authorities failed to explain what documentation was needed before a business was due to report to the authorities. They stated that the authorities did not promptly reply to requests for information, sometimes for weeks at a time.

Due to a moratorium on tax audits put in place by the Cabinet of Ministers of Ukraine in 2014, and extended through 2015, medium sized enterprises reported that they had not undergone any tax inspections.

Licenses permits and certificates

There were few if any specific issues reported by large businesses with acquiring official licenses, permits or certificates. In general, large enterprises commented that they did have trouble on occasion securing official documentation as a consequence of the sheer number of authorities they had to visit and the time it took to process applications. The process, as one respondent in the food processing sector explained, can be drawn out for weeks and months for no discernible reason.

Three medium sized enterprises who had interacted with customs officials cited serious difficulty acquiring the proper permits or licenses. The difficulties stemmed from the large number of documents they needed to submit, a long list of procedures, which they needed to go through, and the pressure to pay bribes at almost every level in order to secure the documents they required.

Access to financing/capital

None of the large or medium sized businesses interviewed were seeking additional financing at the time of the interview. Medium sized enterprises in particular said they were interested in securing credit, but the interest rates were prohibitively high.

Changes in business profitability

All of large enterprises interviewed noted a marked decline in their business profitability from the beginning of 2013, with a steeper decline taking hold in mid-to-late 2014. In the food processing industry, these loses were attributed to lost markets in both Crimea and the areas of the Donbas region not controlled by the Ukrainian government. All of the large enterprises noted that they had fewer clients as a result of the overall poor economic climate in Ukraine, but kept business with clients operating in areas under Ukrainian governmental control. One respondent from the machine manufacturing industry said they lost a large portion of their clients in Russia as a result of the ongoing conflict and were struggling to find new clients in Ukraine to make up for those losses.

Four medium sized enterprise respondents, two of which operated in food processing, said there was no noticeable decline in their profitability over the course of the past year. A bread manufacturer reported a nearly 30% drop in profitability, while another medium-sized enterprise in the chemical and oil reprocessing sector claimed a 40-50% drop in their profits from the year prior. In general, medium enterprises did not claim noticeable losses, citing a strong domestic customer base for their goods.

Labor force

Six of seven large enterprises reported that finding qualified personnel had become an increasingly serious issue for their business, particularly for positions that require technical training, like engineers. One respondent stated that of the new employees they hired over the past year (summer 2014), many had either left their work or been drafted to serve in the Ukrainian armed forces, while others were underqualified and were fired.

Of the medium sized enterprises interviewed, four reported that they had not had any particular difficulty in keeping qualified employees for their business, though one of the general concerns for a majority of the businesses was their inability to pay reasonable wages. Two businesses from the chemical and oil reprocessing industry released over 20% of their employees over the past year, citing declining sales and lost markets as one of the primary motivating factors to scale back their operations.

Trade Climate

International trade

None of the large enterprises mentioned any formal barriers to trading on the Russian, EU or other markets. A dairy product manufacturer said the Russian market is very volatile because of sudden temporary Russian bans for the alleged poor quality of Ukrainian dairy goods. They said sometimes no reason is given for why their goods are not allowed through Russian customs.

While a majority of their trade was conducted within Ukraine, sizable losses have been sustained by businesses that exported to Russia. Among large enterprises, there is little interest or understanding of the European Union market at present, though two companies said they exported to EU member states. Three large enterprises stated that having to follow EU export rules was an obstacle to exporting their goods, though they did not describe any specific rule or issues.

Two large businesses stated they are planning a marketing campaign in new markets, including the United States, though at present they were still in the initial stages of developing their strategy. Another enterprise said that due to the poor financial standing of their company they could not afford to even locally advertise their goods. They understood, however, that they need to develop a strategy to gain access to new markets in order to survive.

Medium sized enterprises were optimistic about the future of trade within Ukraine as well as with the EU, though many enterprises said that they were not currently prepared to meet the EU's standards.

Of the two medium sized companies engaged in selling their goods abroad, both of which worked in the chemical and oil reprocessing industry, neither mentioned specific barriers keeping them from conducting business with foreign markets. Respondents said their sector was severely hit by the conflict in Ukraine, losing almost all exports to Russia, which for one company was 95% of its overall sales. The same company reported that as a result it had pivoted to the domestic Ukrainian market.

When the remaining respondents were asked if they were going to pursue new markets outside of Ukraine, they stated would consider it in the future, but at present had no plans to do so.

Trade with non-government-controlled territory

None of the large enterprises interviewed reported doing business with companies that were in any of the territories not controlled by the Ukrainian government. One business, a machine manufacturer, had previously used metal that came from the non-government-controlled areas, though reported they switched over to purchasing metal from the European Union before the conflict began due to quality concerns.

Another enterprise, working in the chemical and oil reprocessing industry, had previously bought some raw materials via companies in the Donbas, but after the conflict began, they found raw material providers in Russia. However, prices in Russia for raw materials climbed to such an extent, that it was cheaper to buy them on the European market.

Two large businesses noted that many of their former clients had moved their operations into government-controlled territory since the beginning of the conflict and they continue to do business with them.

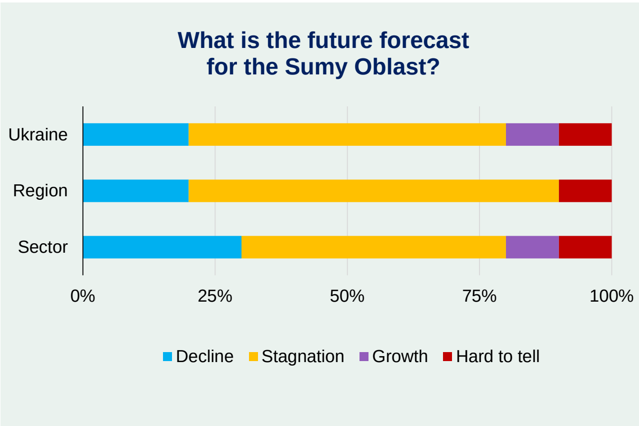
Overall, outside of the non-government-controlled territories, large enterprises reported that they were continuing to do as much, if not more, business with clients in regions under the control of the Ukrainian government.

As a majority of the small and medium-sized enterprises' customer base was primarily local, few had any dealings with the non-government-controlled territories. Of the three businesses that had done business in those areas, two reported that they continued to work with them as they had previously, though noted that both their expenses and the formal and informal costs (i.e.

bribes at either customs or border guard checkpoints) had risen considerably over the past year.

Future potential

Of the eight medium size enterprises interviewed, seven held decidedly pessimistic views about the future of the economy. Citing the armed conflict in eastern Ukraine, several respondents said that as long as it continues, they expect both their business and people in general to focus on surviving. Only one business listed corruption as a serious issue that was hampering them, while a majority of respondents said it depended on factors external to them and their environment.



In general, businesses in the Sumy Oblast felt Ukraine would see further economic decline in the coming 1-2 years and that their region would be worse off than the country as a whole. On a sector-by-sector basis, business was divided on whether or not there would be growth in their respective sectors or whether they would continue to decline. Those who believed they would see growth were from the food processing, construction, wholesale and retail industries.

Still, larger enterprises were much more optimistic, with four of them stating that with time new markets would open and the economy would improve. However, so long as the conflict in the east continued and the political and economic situation remained unstable, they felt that the economy would not see any growth.

Conclusion

The Sumy Oblast's economic connectivity within Ukraine, particularly for medium sized enterprises, has remained very strong. Large enterprises whose primary export markets were tied to Russia or the EEU have suffered a noticeable breakdown in terms of their economic connectivity, with few seeing an opportunity to pivot to the EU or Asia.

Machine manufacturing is likely to face mid-term to long-term difficulty in finding proper market substitutes for their highly specialized goods, though other prominent sectors that had faced decline like the food industry, were slowly recovering as the hryvnia stabilizes and they find new markets domestically.

According to medium sized enterprises, decreased internal demand in many sectors is a result of the weakened hryvnia and generally poor economic situation in the country. Given their relatively strong hold on the local economy and their absence of ties to the non-government-controlled territories and the EEU market, they are able to maintain their operations provided there are no more significant economic shocks.

Among large enterprises, the oblast's chemical producers, particularly its fertilizer producers, have potential to continue their push into the domestic market, providing them a much more stable, but less lucrative market. Other large export-dependent enterprises in prominent sectors like machine-building and the food industry require access to new markets and assistance in connecting with them if they are to recover in the short to mid-term.

Kharkiv Oblast

Located in eastern Ukraine, the Kharkiv Oblast borders the Donetsk and Luhansk oblasts, as well as Russia. The first capital of Soviet Ukraine, it was a major center of Soviet industry and extensively integrated with supply networks in Russia and the Donbas. Those networks survived the collapse of the Soviet Union, but have broken down following sanctions on trade and the outbreak of fighting in parts of the Donbass. The Kharkiv Oblast primarily relied on the Russian and domestic markets, and was hit hard by sanctions limiting access to the Russian market and the collapse of demand on the Ukrainian market. The oblast has a developed economy, but is struggling to find new markets for its goods.

To better evaluate the region's economy industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 6 sectors were the most prominent:

Kharkiv Oblast	machine building industry
	food industry
	production of construction materials
	electric power generation
	wholesale and retail trade
	Transportion

An overview of the specific characteristics and dynamics of the regional economy has been assembled to provide context for the qualitative information found in the survey section.

Economic Overview

The Kharkiv Oblast is Ukraine's fifth-largest industrial region, generating 5.6% of its GDP (2013) and 6.1% of its industrial output (2014), but only 3.4% (2014) of Ukraine's exports. In 2014, the oblast accounted for 7.9% of Ukraine's total retail turnover. Sectors that contribute most to the regional GDP are wholesale and retail (14.0%), manufacturing (13.8%), agriculture (10.5%), educational services (9.3%), real estate (8.3%), and transportation (8%).

The oblast's industry specializes in manufacturing machinery and equipment for electrical devices and multi-purpose vehicles like aircraft and tractors. The fuel and energy industry, food processors, metallurgy, and chemicals and pharmaceutical producers are also significant contributors to the economy.

The oblast's moderate -5% annual decline in industrial output over 2013 and 2014 steepened to -17.6% in the first half of 2015. The hardest hit of the oblast's industries were electricity distributors, (-31.9%), machine-building (-28.6%), non-metallic mineral goods producers (-23.4% yoy), and metal goods manufacturers (-19.2%). The rift in economic relations with Russia due to the annexation of Crimea and the armed conflict in the Donbas have affected the machine-building sector and electricity providers the most, as many of the factories produce military-related goods for the Russian military production line.

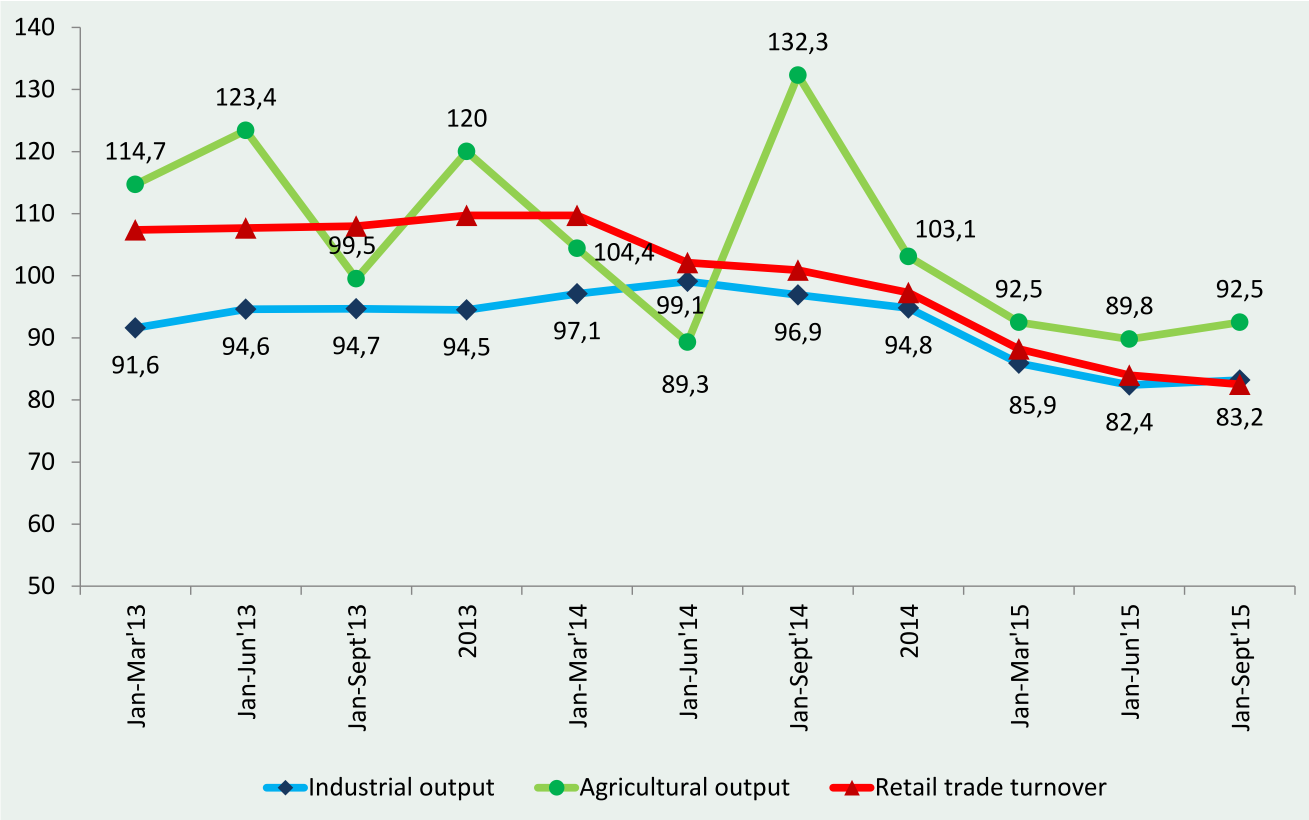
Now many of these machine-building companies are struggling to find buyers for the electric motors, generators, transformers, control devices, and transport equipment that they traditionally sold to Russian buyers. Manufacturers have partially reoriented production towards the Ukrainian Ministry of Defense since the outbreak of the armed conflict in the Donbas.

As of the first half of 2015, the oblast's food industry represented the largest share of the region's overall industrial output, contributing 26.3% in total. While the food processing industry grew by 5.9 in 2014, it fell by almost an equal measure (-5.7%) in the first half of 2015. Dairy producers suffered the brunt of the industry's decline after being virtually shut out of the Russian market.

The average unemployment rate for working age individuals in the oblast grew from 6.8% of the able-bodied working age population in 2013 to 8.1% in 2014, and falling to 7.3% in the first half of 2015.

Figure 1

Indices of industrial production, agricultural production and retail trade in Kharkiv Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

Trade Overview

The Kharkiv Oblast's overall share of Ukraine's trade over the end of 2014 and the first half of 2015 fell by a dramatic -40%. This steep decline is attributed to formal and informal restrictions on the Russian and EEU markets. The oblast's economy is traditionally oriented and concentrated on the markets of the EEU, previously accounting for between 60-65% of its total exports. In the first half of 2015 it fell to 45% of the oblast's overall exports.

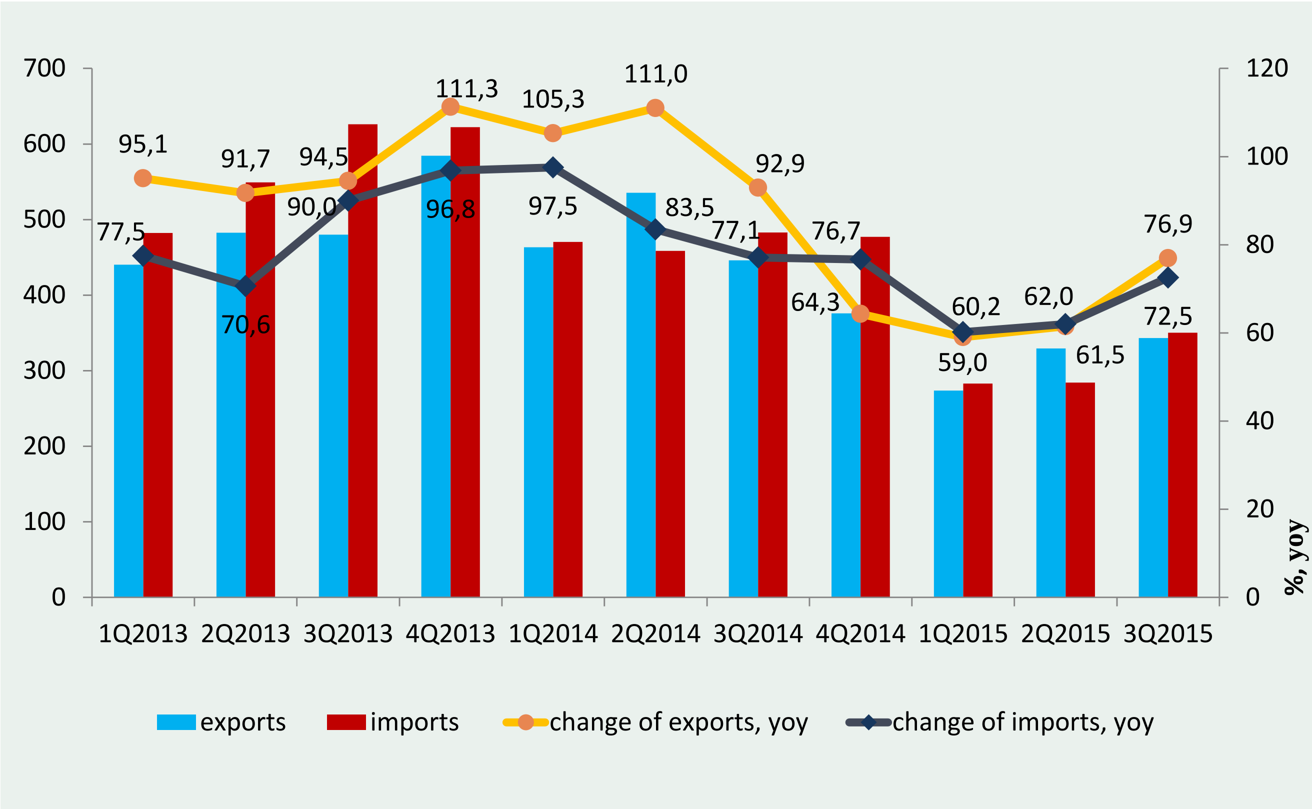
The conflict in the Donbas and the annexation of Crimea, as well as the subsequent market restrictions placed by both Ukraine and Russia on access to the Russian market, led to the oblast's total goods exports to Russia falling from 46% in 2013 to 33.5% by mid-2015.

The Kharkiv Oblast's exports to the EU also fell from 2014 to the first half of 2015 but at a slower pace. However, the overall share of the oblast's exports to the economic bloc has grown since as it replaces the EEU with the European market.

The slump in exports at the end of 2014 through mid-year 2015 is a consequence of a -52.3% decline in machinery and electrical equipment exports, and a -68.9% decline in transportation equipment manufacturing, which account for nearly a third of the oblast's total exports. With both of these sectors in decline the agricultural and food processing sectors took over as the oblast's primary exporters in the first half of 2015, responsible for approximately 40% of exports.

Service exports experienced a -17.8% slowdown in 2014 and a further -16.4% decline in the first half of 2015, largely due to a fall in business and transportation export services. However, IT and telecommunications service exports grew by 23.5% in the first half of 2015, making it the oblast's largest service exporter with roughly a 60% for service exports.

Dynamics of exports and imports of goods in Kharkiv Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

The concentration of Kharkiv's economy on Russian/EEU markets (33.5% and 45% respectively in 1H2015) makes it highly vulnerable to trade restrictions on those markets. It is unlikely that many of the machinery and transportation parts manufacturers will truly recover so long trade restrictions remain in place. However, these losses have been partially compensated for by improvements in agricultural and food industry exports.

Number of responses by sector, Kharkiv Oblast	
Processing industry	12
Energy, whater and gas provision	4
Wholesale&retail trade	3
Agriculture	2
IT and telecomunication	1
Professional and technical activities	1

Survey

42 businesses were identified in the Kharkiv Oblast that matched the selection criteria, of which 27 businesses agreed to be interviewed, though only 23 respondents provided full relevant answers. Additionally, interviews were conducted with the Oblast Administration and Trade Chamber of Commerce representatives.

Distrust regarding the survey's purpose led to difficulties. One survey was eliminated from the sample data due to a respondent's unwillingness to cooperate with the interviewer and complete responses. As part of a quality control check, the central research team made random calls to a few respondents to verify that he or she took part in the interviews. Some respondents refused to confirm their participation and in one case even denied that a respondent was a member of their staff. It was later revealed that the respondent thought that they were being contacted by army recruiters seeking to draft them into the military.

Business climate

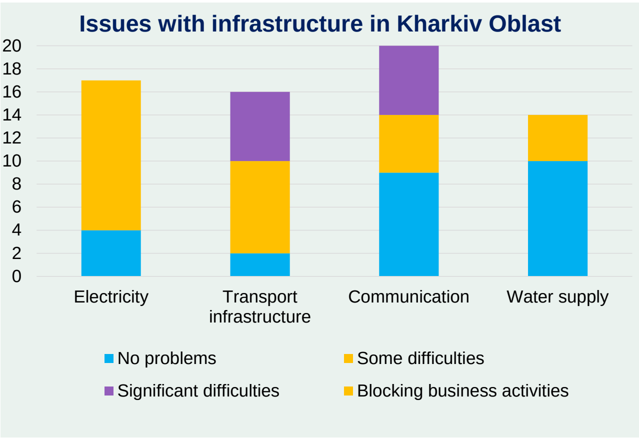
Nearly half of all businesses cited political instability as a major obstacle to their operations. Slightly fewer large and medium sized businesses cited growing production costs. The remaining concerns depended on the size of the enterprise. Larger businesses are more economically interconnected with other regions in Ukraine and thus more concerned about risks connected to the spread of armed conflict. For their part, medium sized enterprises are more concerned about high tax rates and difficulties with tax officials.

Over the 12 months preceding the survey medium sized enterprises also reported gaining access to new markets as increasingly important. Large enterprises faced increasing difficulty finding qualified employees.

Infrastructure

Roadways in the Kharkiv Oblast, already in disrepair, are used intensively by military vehicles traveling to the eastern border with Russia and south to the Donbas. According to a majority of large and medium sized enterprises interviewed, the roadways in the region have significantly deteriorated as a result. That deterioration increases costs for businesses by increasing vehicle repairs, lowering fuel efficiency, increasing delivery prices and delays.

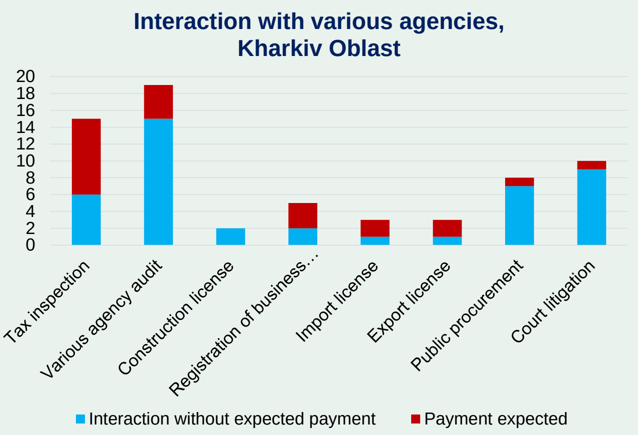
Electricity cuts, particularly in November and December 2014 due to a shortage of coal from areas of the Donbas not controlled by the Ukrainian authorities, affected the operations of large and medium sized businesses.



25% of the large enterprises also reported significant disruptions to their internet and mobile communication mediums over the past 12 months.

Internal regulatory environment

Large and medium sized businesses reported different concerns with the regulatory environment.



Large businesses are concerned by currency controls introduced by the National Bank. They agree business needs a stable currency, but the current system only allows businesses to keep 25% of capital in foreign currency making it difficult for them to pay for new imports.

Large and medium enterprises both cited the constantly changing taxation regulations as an issue impeding their operations. Medium-sized enterprises in particular found it difficult to cope with changing requirements and report investing time and energy trying to stay up to date. Respondents from both large and medium sized enterprises emphasized the need to set a clear set of rules and procedures for a more stable system of taxation. In addition, medium sized businesses noted requiring governmental support to navigate the EU's customs regulations.

Relations with tax officials

Businesses praised the recently introduced moratorium on tax audits, but said that the tax authorities simply became more invasive and uncooperative in other matters. Of respondents subject to tax inspections over the past 12 months, half of large businesses and four medium sized enterprises reported they were expected to pay bribes after the inspection was completed. Businesses reported officials expected these payments in lieu of a fine levied on the companies for alleged violations of tax filing procedures. However, large and medium size businesses both stated that most violations tax authorities cited were due to complicated and changing procedures. Furthermore, they reported that tax officials seemed to do little to assist businesses in finding the information required for correct filing.

Licenses, Permits and certificates

Few businesses reported any specific issues with securing official documentation. According to a large construction company, building permits were issued in 10 days. Medium sized enterprises reported a 7-days waiting period for export licenses and 5 days for import licenses. However, one medium sized business said that the process to open their business took an entire year due to the complicated procedures and sheer volume of state agencies they needed approval from.

Access to financing/capital

Only one large and one medium-sized enterprise attempted to secure additional financing via a loan, though local banks turned down both their applications citing the risk of non-payment. Consequently, the medium sized business laid off some of its personnel, while the large business refrained from purchasing badly needed equipment and supplies.

Changes in business profitability

Large and medium sized enterprises cited the unstable political situation and nearby conflict zone as significantly contributing to a drop in their companies' profitability. The hryvnia's depreciation and lower consumer demand further drove down sales across sectors.

Large enterprises reported paying relatively higher wages to a few of their qualified employees in order to keep them on, though for many of them this meant releasing or placing less-qualified employees on unpaid leave due to financial losses.

The oblast's enterprises also cited the lack of access to additional financing as hurting their profitability, particularly in the machinery and construction sectors that depend on long-term capital investments and financing.

As a result of the armed conflict in the Donbas, enterprises also reported higher spending on security to protect their assets.

Labor force

Army mobilization is also a burden on business as any drafted individual's salary and position should be maintained by the employer while he serves. Companies must also hire temporary replacements. With those limitations, it is hard to find replacements willing to work for the available salary.

Large and medium sized business alike reported difficulty finding qualified personnel willing to work for the lower salaries and the financial constraints they face as a result. Large enterprises, in addition to cutting down on the number of people they employ, also introduced shorter working days to cut back on expenses.

Trade Climate

International trade

Out of companies surveyed, enterprises from the machinery, food production, agricultural, and publishing sectors actively engage in international trade. Russia accounts for roughly 20% of all exports of enterprises surveyed.

As a result of the armed conflict in the Donbas one large business in the publishing industry reported a 50% decrease in their overall exports to Russia. While previously this only accounted for 7% of the companies overall sales, they also reported a 50% drop in sales in Ukraine (previously 90% of their overall sales). Two other large enterprises reported an insignificant drop in their exports to Russia. One medium sized business reported difficulty gaining access to the Russian market as there are no clear rules as to who is eligible for preferential importer status and, consequently, abandoned the market.

Nearly half of the large enterprises reported developing new products for outside markets and increasing the number of staff dealing with exports over a 12 month period, particularly to the EU. While seven respondents stated they expect the Deep and Comprehensive Free Trade Agreement with the EU to influence their business, none cited any benefits despite the one-way preferential treatment already in place. Although some acknowledged they needed to upgrade their operations to meet EU standards, none knew precisely what changes they needed to make.

Trade with non-government-controlled territory

Prior to the conflict businesses in the Kharkiv Oblast had strong trade connection with Crimea and the Donbas. 48% of the oblast's companies, primarily from the machinery, agricultural, food processing and construction material production industries did business with companies located in the Donbas. 30% of the same group of respondents reported having exported goods to Crimea. None reported continuing to trade with either region.

The conflict hurt electricity producers because 75% of the coal used by their plants came from areas now not controlled by the Ukrainian authorities. The new realities in the Donbas forced them to seek substitute sources of coal, often at a higher prices.

Other industries that were connected to the suppliers from the East and Crimea included machinery and construction materials producers, and the food processing industry.

Several large and medium size enterprises continue to depend on inputs from near the conflict zone. Businesses said that if their supply chains are broken as a result of the conflict, substitutes will be hard if not impossible to find at an affordable price.

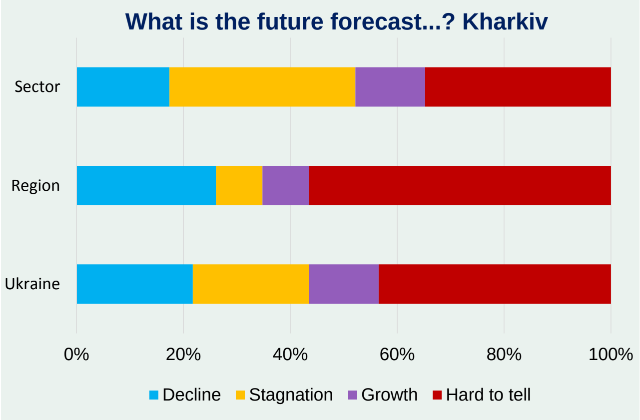
Four large enterprises reported that trade restrictions led to lost sales between 10-20% in the non-government-controlled territories in the Donbas and 5-35% in Crimea. Four medium sized enterprises reported they had stopped doing business in Donbas areas not controlled by the Ukrainian authorities. Only two medium sized companies did business in Crimea.

To compensate for their losses in the Donbas and Crimea, medium sized enterprises reoriented themselves towards other markets within Ukraine. While they continue to seek new domestic markets, large enterprises reported less success in finding them, particularly in the machinery sector.

Future potential

Due to the oblast's proximity to the conflict zone, business is highly uncertain about the future. Over half of businesses say it is hard to tell how the oblast will be develop further, believing that much depends on the situation in the Donbas. About 20% of respondents believe that both Ukraine and the o blast's economy will continue to decline in the near future. Besides the possibility of renewed armed conflict, the oblast's businesses are concerned with the slow pace of reform and low investment. Those who are more positive about Ukraine's future are nonetheless concerned about the potential for renewed armed conflict, though if it can be avoided, they feel that the country's economy could return to growth as soon as 2017.

Respondent's expectations for their own oblast's economy are generally lower than those they



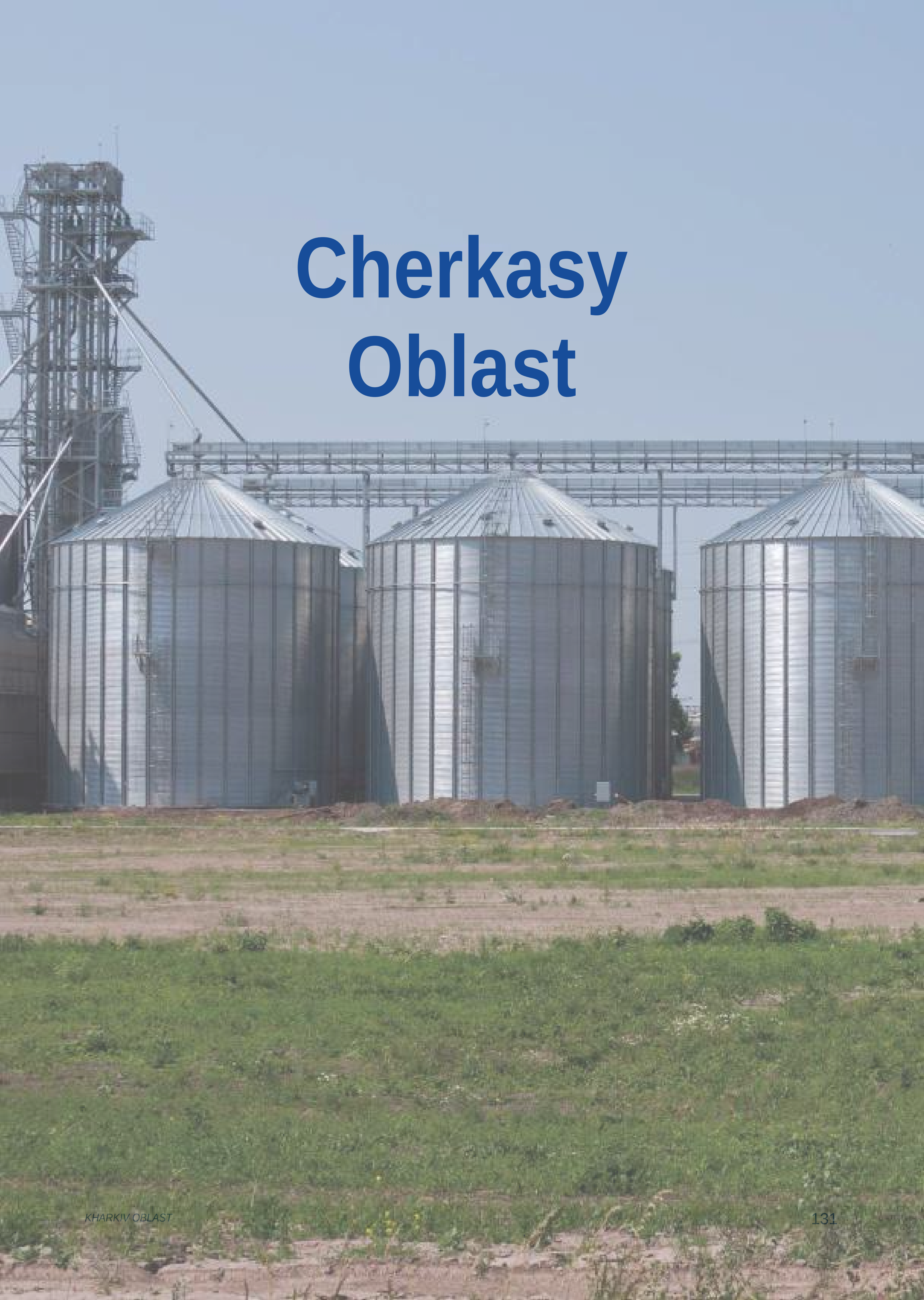
hold for Ukraine as a whole. Their pessimistic outlook for the oblast is at least partially associated with the fact that several major production factories are laying off employees and appear to be closing shop.

The agriculture, machinery, food processing and professional consulting sectors are more optimistic about their near term potential for growth. The machinery sector is confident they can recover due to the high quality of the highly specialized equipment they produce The agricultural sector expects growth to return following agricultural reforms. A majority of businesses are cautiously optimistic about their own future, though five of them expect to linger on in a state of stagnation for the near future, while two others expect to focus on survival.

Conclusion

The conflict has hurt business in Kharkiv Oblast due to proximity and interconnectedness with the Donbas. Kharkiv Oblast businesses have struggled to replace inputs they previously received from the Donbas.

Kharkiv business had experienced decline in trade with Russia, but the Ukraine internal economic recession and decline in purchasing power is presenting a bigger threat to business. Many businesses are hopeful concerning the EU free trade agreement, but none have reported taking advantage of the current one-way remove of trade barriers. Kharkiv businesses recognize they need help to have their goods enter the EU market, but are disappointed by the lack of government assistance.



Cherkasy Oblast

The Cherkasy Oblast is located in central Ukraine and borders on the Kyiv Oblast to the North West. The oblast has not seen active fighting and does not border on oblasts that have, but its economy has been devastated by de facto closure of the Russian market to its goods. Producers in the oblast are now struggling to find replacement markets. The proximity to the wealthy Kyiv Oblast provides opportunities, but potential is limited by the weak hryvnia that has slashed domestic consumption. As in many other areas of Ukraine, the manufacturing industry was already in gradual decline with high unemployment levels before the crisis hit. Now businesses are focusing on finding new markets to replace lost demand.

To better evaluate the region's economy, industries in key sectors were identified to develop a concise understanding of issues influencing both large and medium enterprises. According to a preliminary assessment based on economic data, 5 sectors were the most prominent:

Cherkassy Oblast	machine building industry
	food industry
	production of construction materials
	electric power generation
	Transportion

An overview of the specific characteristics and dynamics of the regional economy follows to provide context for the qualitative information found in the survey section.

Economic Overview

The Cherkasy Oblast generates 2.2% of Ukraine's GDP (2013) and accounts for 2.9% of its industrial output (2014) and 1.2% of its total merchandise exports (2014). Only 2.6% of Ukraine's total retail turnover occurs in the oblast. Agriculture and the manufacturing industry are the oblast's two major sectors, consisting of 23.8% and 17.4% of the regional gross value respectively (2013).

The oblast's primary industrial outputs are food processing and chemicals, accounting for 53% and 18.5% of its overall output in 2014 respectively. The food industry is dominated by sugar, meat processing, dairy, flour, canning and alcoholic beverage production. The chemical industry focuses on mineral fertilizer and ammonia production.

Since 2012, the oblast's industrial output witnessed three years in a row of economic decline. The oblast's food industry declined by -7.1% in 2013 and -2.9% in 2014. In the first half of 2015, companies producing meat products, cheese, and alcoholic beverages faced lower domestic consumption as real incomes slid, as well as new trade restrictions on the Russian market. As a result, the oblast's industrial output declined -8.6% by midway through 2015.

The export-oriented chemical industry contracted in 2013 and 2014 due to high gas prices and unfavorable conditions on the global market. However, in the first half of 2015, the chemical industry grew 7%, thanks largely to hryvnia depreciating, making it more competitive on both domestic and foreign markets. The chemical industry is controlled by just a few companies. Cherkasy Azot, the leading chemical manufacturer in the oblast, produces over 80% of the region's chemicals. Of the other major industries in the oblast, wood manufacturing and machine-building were hit hardest in 2014 and the first half of 2015 due to weak external and domestic demand and a downturn in the construction industry.

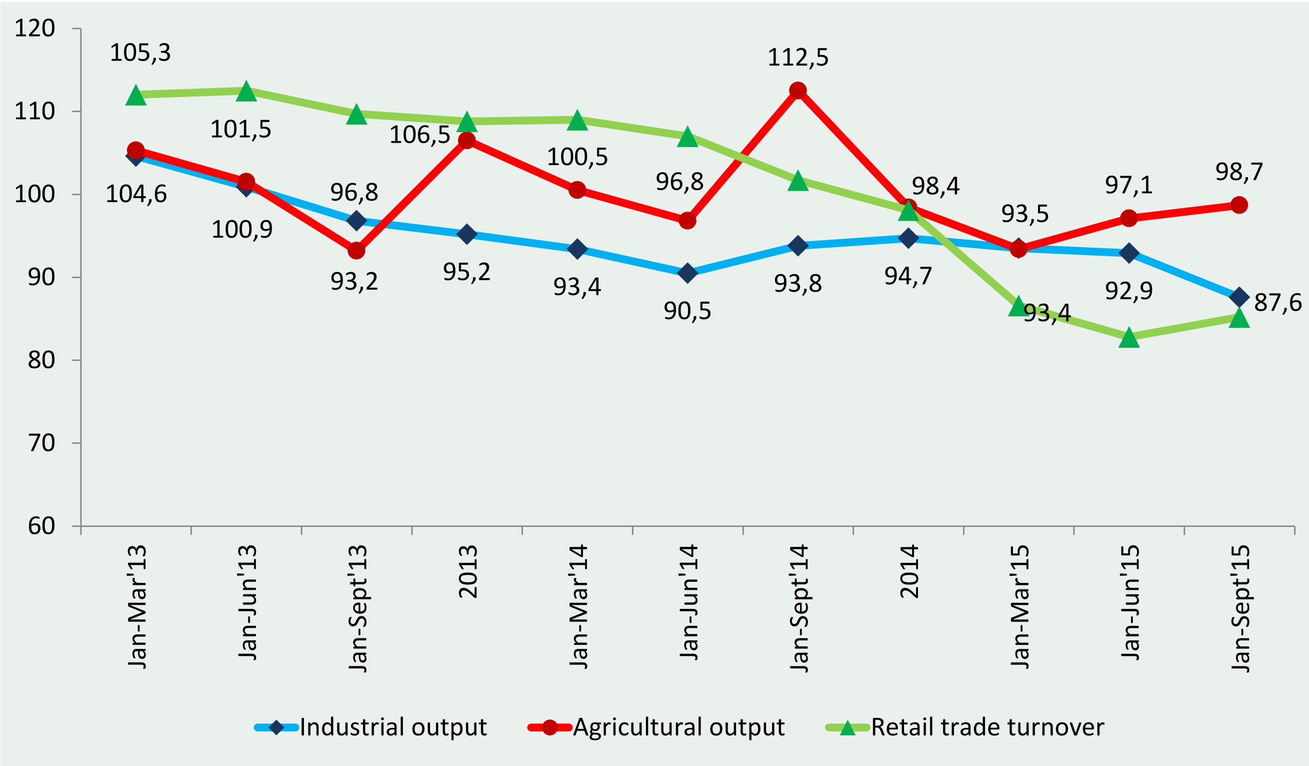
The oblast's average unemployment rate for working age individuals climbed slightly from 9.5% in 2013 to 10.5% in 2014 and the first half of 2015.

Trade Overview

Trade performance further deteriorated in the first half of 2015, with goods exports dropping -31.6% and goods imports by -49.7%. The contraction in exports in 2014 is tied to the shrinking EEU and Asian markets, which fell -33.8%

Figure 1

Indices of industrial production, agricultural production and retail trade in Cherkasy Oblast during 2013-9M2015 (cumulative data), % yoy



Source: State Statistics Service of Ukraine

and -32.8%, respectively. The overall proportion of goods exported to these markets fell to 28.8% and 17.6% of the oblast's total exports in 2014, with the EEU contracting even further to 17.7% in the first half of 2015. At the same time, exports to the EU grew 25.2% in 2014, making the EU the single largest destination for regional exports with a 35.5% share of its goods destined for foreign markets.

Exports to the EU, however, were not enough to offset losses suffered in other markets in 2014, and exports to the EU fell in the first half of 2015. The region's most powerful exporters from the agricultural and food processing sectors, which account for nearly 50% of the oblast's total exports, rebounded in 2014, only to fall again in the first half of 2015 due to low market prices for grain.

Machinery and electrical equipment exports were also hit hard, falling by nearly -40% in 2014 and a further -60% in the first half of 2015 as a consequence of lower demand and trade restrictions on the Russian market. The oblast's service exports, which primarily consist of transportation services, fell as foreign trade shrank. The sole exception among service exports was in the IT and telecommunications sector, exhibiting growth both throughout 2015 and in the first half of 2015.

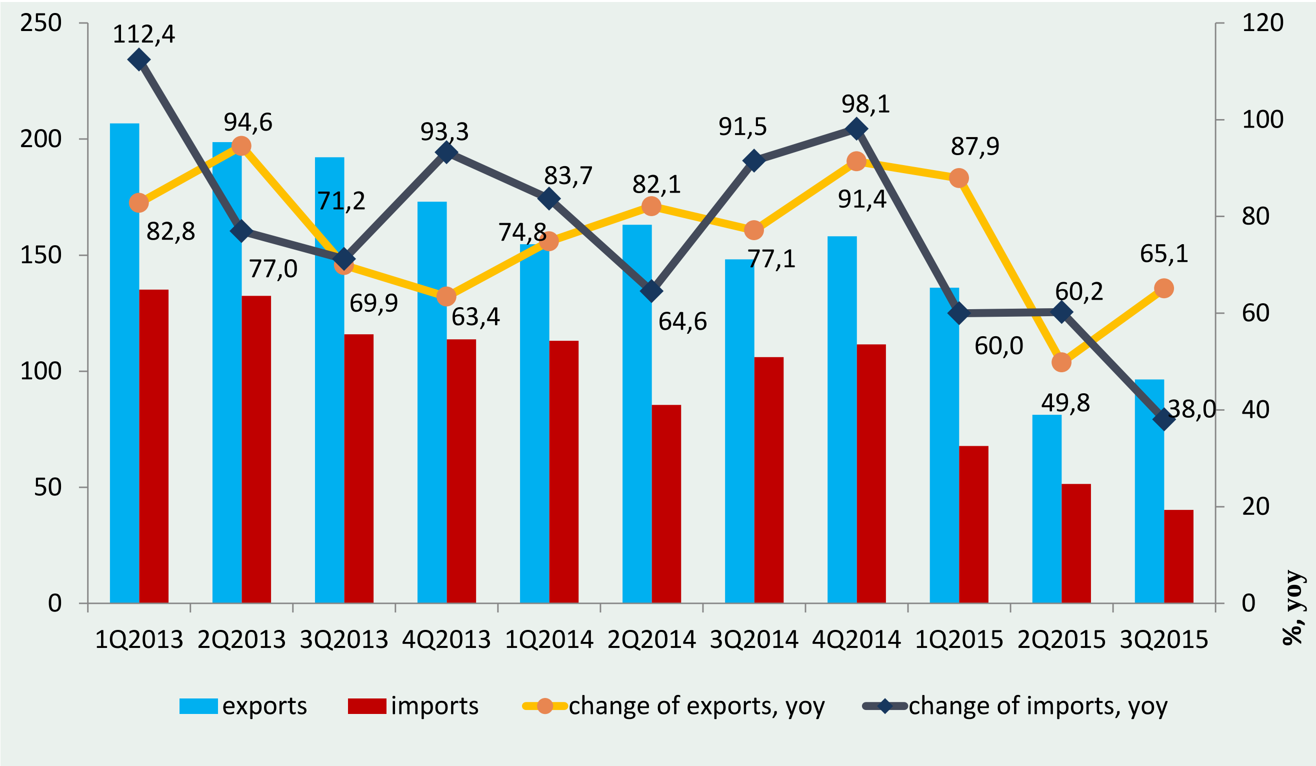
Survey

In the Cherkasy Oblast 22 interviews were conducted with businesses, including 12 medium size enterprises and 10 large enterprises. 4 additional interviews were carried out with the lo-

Number of responses by sector, Cherkasy Oblast	
Agriculture	7
Food Processing Industry	5
Wholesale and Retail	5
Construction	2
Paper Product Manufacturing	1
Furniture and Wood Manufacturing	2

Figure 2

Dynamics of exports and imports of goods in Cherkasy Oblast during 2013-9M2015 (quarterly data), mln USD (left scale) and % yoy (right scale)



Source: State Statistics Service of Ukraine

cal authorities, which included a representative from the

Cherkasy City Council, 2 officials from the Cherkasy Oblast Administration and one official from the Cherkasy Chamber of Commerce.

The interviews were conducted in key sectors for Cherkasy Oblast including agriculture, food processing, retail and wholesale, machinery production, chemical and oil. The interviews covered 10 large enterprises and 12 medium sized enterprises.

Business climate

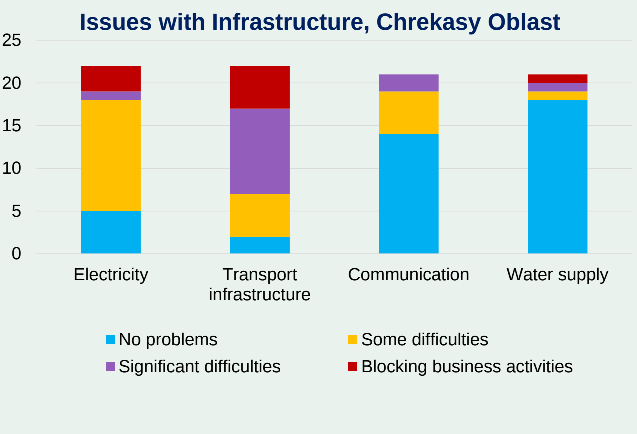
Growing production costs concerned medium sized businesses the most, followed by difficulty finding qualified employees to help run their operations. Issues with access to additional financing and credit ranked highly for over half of medium and large enterprises in the oblast as an obstacle to doing business. The number one issue facing business according to large enterprises in the oblast is the potential for continued political instability, closely followed excessive taxes as well as poor transportation infrastructure.

Besides these issues, over the past 12 months, customs and trade barriers became a major concern for medium sized enterprises.

Infrastructure

Issues with the oblast's infrastructure were company specific and did not run across sectors. Electricity shortages, for example, affected three large and one medium sized enterprise.

16 total large and medium sized businesses mentioned transportation infrastructure problems focusing on the poor state of roadways. Five of them, all from different sectors, said that the issue was so severe that it was an obstacle to their distribution operations and kept them from doing the maximum volume of business.

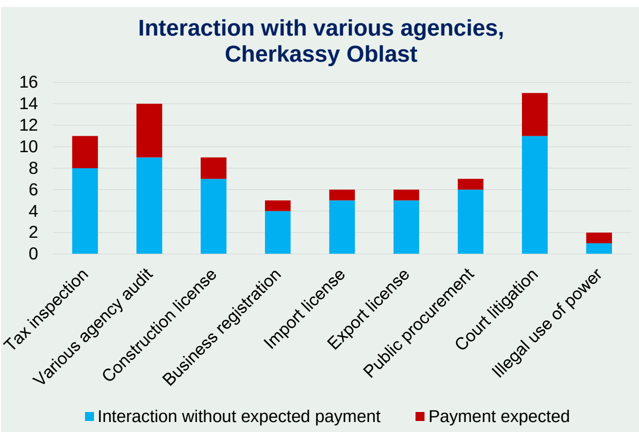


Two large enterprises also cited occasional issues with their water supply, though the issue was not deemed a serious impediment to their operations.

Internal regulatory environment

Both large and medium sized enterprises reported difficulty navigating the taxation system. Half of large enterprises reported difficulty navigating the tax system, despite years of experience. They criticized the cumbersome procedures, confusing new requirements and contradictory information.

Medium sized enterprises' difficulties were specific to each particular business, with only two citing general issues. One business reported that the foreign currency limitations put in place by the National Bank of Ukraine in 2014 and through 2015 made it very difficult for them to do business with foreign clients. Another stated they did not receive their VAT refund in a timely manner and cited the general inconsistent administration of VAT.



In addition to the issues navigating the taxation system, two large enterprises identified expenditures associated with contributions to the state pension fund and payroll taxes as burdens to business. According to one of them, payroll taxes are too high for a business to be able to afford to pay them for all of their employees so some are employed off the books.

Relations with taxation officials

Large and medium sized businesses praised the moratorium on tax audits, with three large enterprises specifically stating that it improved relations between business and the authorities.

One large enterprise reported an abuse by tax authorities, but was able to win in court. Only one medium sized business reported a specific negative interaction with tax officials in which they were asked for a bribe to resolve an issue with paperwork they filed.

Licenses, permits and certificates

Large enterprises reported no systemic issues with licenses, permits or other official paperwork, though one medium sized business from the agriculture sector cited regular delays in receiving permits.

There was a mixed response concerning the work of customs officials, particularly concerning the rate of clearing goods. Of the two large businesses that reported having issues with customs officials, one stated that they are approached for a bribe whenever an 'error' in their paperwork is found. The other said that customs officials regularly kept agriculture produce at checkpoints for extended periods of time for no explicable reason, leaving their foodstuffs to spoil. Three medium sized businesses listed a similar complaint, stating that goods often got stuck at customs for unreasonable long periods of time without explanation. Interestingly, another medium sized enterprise reported a noticeable improvement in customs service after the introduction of electronic applications and permits, as well as being able to request information online.

Access to financing/capital

Access to credit was not a key concern for either large or medium sized enterprises. Two medium sized enterprises reported seeking financing, but have not been able to secure it. One large enterprise in the food processing industry reported having no interest in securing additional financing because the terms of the loans were too unfavorable. They said that if the state ensured lower the interest rates on loans, it would encourage businesses to begin taking out credit and investing it in their enterprises.

Changes in business profitability

Over half of respondents reported a significant drop in profitability. Seven previously did business with either Crimea or the territories in the Donbass not controlled by the Ukrainian government, but for the majority the losses were not significant. Several large companies stated they had to lower prices for their goods to deal with lower demand, reducing profits.

Medium sized businesses, and the agriculture sector in particular, were hit by these issues. The agricultural companies reported that fluctuations in the value of the hryvnia towards the end of 2014 and through the first quarter of 2015 made any kind of financial planning extremely difficult.

Labor force

Of the 22 businesses surveyed, 16 reported either maintaining their current work force levels or hiring more employees. Three large food processing businesses was able to expand their workforce, but reported having significant difficulty finding qualified employees. Nearly 75% of medium sized businesses cited trouble finding qualified personnel as a significant issue, though a majority of them maintained the size of their labor force or even expanded it.

Trade Climate

International trade

None of the large or medium sized enterprises expressed interest in either restoring or initiating export trade with Russia. However, four of the five companies that exported said they exported to members of the Eurasian Economic Union besides Russia.

Three medium sized businesses from the agricultural sector and paper manufacturing industry exported their goods. One of them exported to Turkey, which made up a small but dependable proportion of their exports in recent years.

Large businesses largely viewed the Association Agreement and Deep and Comprehensive Free Trade Agreement positively. Only five medium sized businesses viewed it positively. Large and medium sized enterprises were uncertain how they could benefit from the agreements, even those who viewed it favorably.

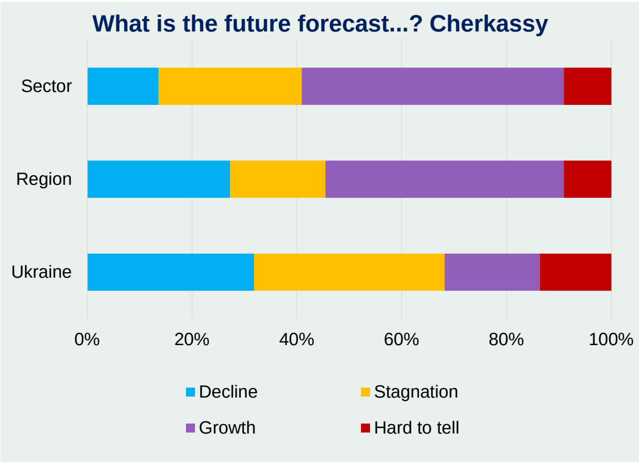
Trade with non-government-controlled territory

An enterprise working in the food processing industry and another in the wholesale and retail sector continue to work with their former business partners in territories not controlled by the Ukrainian state in the Donbas, but they have become increasingly concerned that their partners will not be able to pay them. All companies that previously did business in either Crimea or the non-government-controlled territories reported looking for new markets.

None of the enterprises interviewed were currently engaged in trade with Crimea, with only two indicating that they previously traded with Crimea. Uncertainty about whether a contract would be fulfilled or not, has stopped them from trading with Crimea. They did not plan to conduct business with the non-government-controlled territories.

Future potential

Eight respondents felt that Ukraine as a whole would continue to struggle with economic stagnation over the next 1-2 years, while another seven believed that it would decline further. However, they were much more optimistic about their own region and specific sectors, with ten respondents predicting growth for their region and eleven predicting growth in their sector.



The most common factors businesses listed as influencing whether or not the economy would rebound are progress implementing reforms, particularly those that would unburden businesses (e.g. a new tax policy, support for SMEs in acquiring credit, improved FDI policy). The threat of violent conflict in south-eastern Ukraine resuming and/or growing was of equal concern to respondents, who felt that if the war did not end, the economic situation simply could not improve due to how the conflict influences the national currency, investment and trade climate and the country's general economic stability.

Conclusion

Being largely cut off from the Russia market has badly hurt the Cherkasy Oblast's economy. Its domestic economic connectivity has improved in some sectors, though low consumer demand and a weakened national currency is stunting further progress at present.

The oblast's agriculture and food processing, while struggling, exhibit strong export potential so long as staple goods like grain are competitive on the global market. Major producers of fertilizer in the oblast weathered the initial economic downturn well, even improving their position on the domestic market thanks to a weakened hryvnia. Its new found domestic competitiveness, however, has yet to make up for the losses it has incurred since 2013.

Few large enterprises in the oblast appear to be planning or succeeding in accessing new markets to make up for the markets that they lost as a result of the conflict in the Donbas and the annexation of Crimea. The surveys revealed that none of them have a clear vision of how to seek new markets, including the EU market, and are not confident they could compete. While that may be true for some specialized industries (machine building), the general lack of available information for businesses in other major sectors will likely lead to missed opportunities.

Given its central location and proximity to one of the most prosperous oblasts in Ukraine, Kyiv Oblast, Cherkasy Oblast's medium sized enterprises in its most prominent sectors (agriculture and food processing) are in a strong position to sustain themselves. The oblast's most immediate prospects for improvements in economic connectivity lie in these sectors and chemical fertilizers.

Appendix

APPENDIX I: National Economic Indicators

Gross Regional Product

	Gross regional product				Gross regional product per capita	
	2012		2013		2012	2013
	mln UAH	share (%)	mln UAH	share (%)	mln UAH	mln UAH
Ukraine	1459096	100	1522657	100	32002	33473
Dnipropetrovsk Oblast	147970	10.1	152905	10.0	44650	46333
Donetsk Oblast	170775	11.7	164926	10.8	38907	37830
Zarkarpattia Oblast	21404	1.5	21400	1.4	17088	17044
Kyiv oblast	69663	4.8	68931	4.5	40483	39988
Luhansk Oblast	58767	4.0	55108	3.6	25950	24514
Lviv Oblast	61962	4.2	63329	4.2	24387	24937
Odesa Oblast	64743	4.4	69760	4.6	27070	29118
Sumy Oblast	24933	1.7	26765	1.8	21722	23517
Kharkiv oblast	82223	5.6	85315	5.6	29972	31128
Kherson Oblast	19357	1.3	20767	1.4	17910	19311
Cherkassy Oblast	31265	2.1	33087	2.2	24558	26168
Kyiv city	275685	18.9	312552	20.5	97429	109402
Crimea	44536	3.1	46393	3.0	22675	23595

Indices of physical volume of the gross regional product (set at prices of previous year, percent)

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
112,1	102,7	107,3	107,9	102,3	85,2	104,1	105,2	100,2	100,0
111.0	107.3	108.0	105.3	97.3	83.5	105.8	103.4	97.5	99.3
110.8	97.1	108.3	104.6	97.1	81.6	111.1	111.4	97.1	94.7
106.4	98.5	106.6	108.2	103.9	82.1	107.7	104.7	103.0	100.6
109.8	107.3	108.8	105.9	104.4	89.2	105.1	111.7	101.9	93.4
108.2	100.3	104.3	105.2	98.9	86.7	102.3	109.1	99.1	92.2
105.2	98.1	108.3	105.8	100.7	88.3	102.3	108.7	102.0	98.8
108.1	99.6	103.5	106.3	111.9	86.8	102.4	102.1	96.8	105.7
105.9	104.4	103.4	103.4	103.6	88.7	98.9	107.8	101.7	102.7
112.2	104.8	107.5	107.2	102.1	86.3	101.7	104.5	98.4	98.8
111.2	99.2	104.0	100.4	109.8	93.0	101.8	103.8	100.2	101.1
116.9	107.0	105.6	106.5	114.9	85.5	105.9	106.4	100.9	100.7
116.8	105.8	110.7	119.7	104.4	81.7	101.4	100.7	101.9	106.4
108.5	104.0	106.7	109.0	106.6	90.7	103.4	102.7	98.8	101.0

APPENDIX II: National Trade Dynamics

Foreign trade 2013-1Q2015 – (percentages, year-on-year)

	1Q 2013		2Q 2013		3Q 2013		4Q 2013		2013	
	export	import	export	import	export	import	export	import	export	import
Ukraine	98.5	93.8	84.7	78.2	90.8	98.4	94.5	93.6	92.0	90.9
Dnipropetrovsk Oblast	99.7	80.3	103.9	69.8	88.0	88.3	95.4	91.4	96.7	81.8
Donetsk Oblast	87.9	79.1	77.9	93.0	92.3	109.8	95.8	108.1	87.8	97.3
Zarkarpattia Oblast	98.2	100.6	90.6	104.3	90.1	107.3	96.8	98.9	93.9	102.7
Kyiv oblast	115.4	112,7	93.9	83.9	100.3	103.1	92.5	100.1	99.5	98.8
Luhansk Oblast	61.6	73.5	98.3	93.9	103.3	106.0	88.0	101.8	84.5	93.0
Lviv Oblast	92/9	87.9	86.1	71.7	94.9	76.9	109.1	81.9	96.1	78.7
Odesa Oblast	206,7	129.0	31.6	63.1	84.2	78.4	81.0	72.5	91.3	79.9
Sumy Oblast	72.8	120.1	77.4	89.2	85.8	79.9	91.5	98.7	82.4	95.1
Kharkiv oblast	96.0	78.2	91.3	74.5	95.2	92.3	110.0	87.8	98.3	83.1
Kherson Oblast	125,0	139.0	103.3	70.9	131.8	70.5	97.7	-243.0*	112.4	132.9
Cherkassy Oblast	83.2	113.6	95.1	76.5	68.7	71.0	62.7	93.3	76.5	86.2
Kyiv city	117.7	107.3	82.4	98.2	93.7	106.9	96.3	97.5	96.6	102.1
Crimea	162.2	235.4	93.6	30.7	92.7	134.7	76.1	23.4	101.8	72.8

	1Q 2014		2Q 2014		3Q 2014		4Q 2014		2014		1Q 2015	
	export	import	export	import	export	import	export	import	export	import	exports	imports
Ukraine	93.1	79.5	97.3	81.0	85.9	62.3	70.1	63.2	86.5	71.8	67.1	63.5
Dniprope-trovsk Oblast	87.3	84.2	90.0	79.9	92.0	88.4	88.7	92.0	89.5	86.5	83.8	68.6
Donetsk Oblast	80.8	71.2	90.3	62.9	63.7	46.5	34.6	31.0	67.7	52.3	37.4	46.8
Zarkarpattia Oblast	105.1	86.4	109.0	85.9	110.1	85.5	102.8	79.0	106.4	84.1	90.8	61.1
Kyiv oblast	91.3	97.8	110.5	86.3	95.4	79.9	83.0	60.6	93.9	79.4	82.7	58.9
Luhansk Oblast	85.1	72.0	77.4	78.7	32.3	49.8	12.0	22.1	53.7	55.0	3.3	20.0
Lviv Oblast	112.6	103.6	108.6	90.4	99.5	92.9	86.6	90.9	101.1	93.1	71.3	71.2
Odesa Oblast	141.6	77.0	328.5	62.9	121.8	54.8	76.4	49.1	109.3	60.5	84.3	45.7
Sumy Oblast	89.1	70.4	93.6	80.6	81.4	103.6	62.7	88.9	79.9	85.7	80.1	78.6
Kharkiv oblast	105.2	95.5	108.6	80.6	93.7	75.1	66.4	84.0	91.6	82.8	59.0	60.2
Kherson Oblast	103.9	92.3	126.3	71.9	115.3	66.5	54.5	47.4	97.5	67.8	81.4	66.1
Cherkassy Oblast	75.0	82.5	83.9	63.7	76.8	69.6	90.0	123.6	81.0	83.7	87.9	60.0
Kyiv city	97.8	92.2	103.0	70.9	102.1	72.1	76.4	70.5	93.0	75.6	72.8	62.3
Crimea	27.6	10.4										