

Alternative Economic Models for Ukraine

Lessons from the Past

SIDE-NOTE

In 2014 we have formulated the following strategic alternatives for Ukraine:

- Retaining the social contract within the framework of the “Kleptocratic Oligarchy”.
- Transition to “Capital Markets” model, based on the development of efficient, fair, and competitive markets (with a required improvement in State’s institutional capacity).
- “Export-oriented model” – an attempt to reload the present model by orientation on signals from the export markets as a substitute for the development of efficient internal markets.

We update our analysis in this side-note by answering the following questions:

- Q1.** There are no pure economic models in the real world. How the commitment to different economic models has been changing in Ukraine over time?
- Q2.** If there are changes in the inclinations towards specific models in Ukraine over time, what were the reasons behind such changes?
- Q3.** What are our current long-term expectations?
- Q4.** What could secure a commitment to the “Capital Markets” model in the future?

This side-note could be of interest to policy-makers, think-tanks, and professional investors that could incorporate analyzed institutional factors in their own analysis.

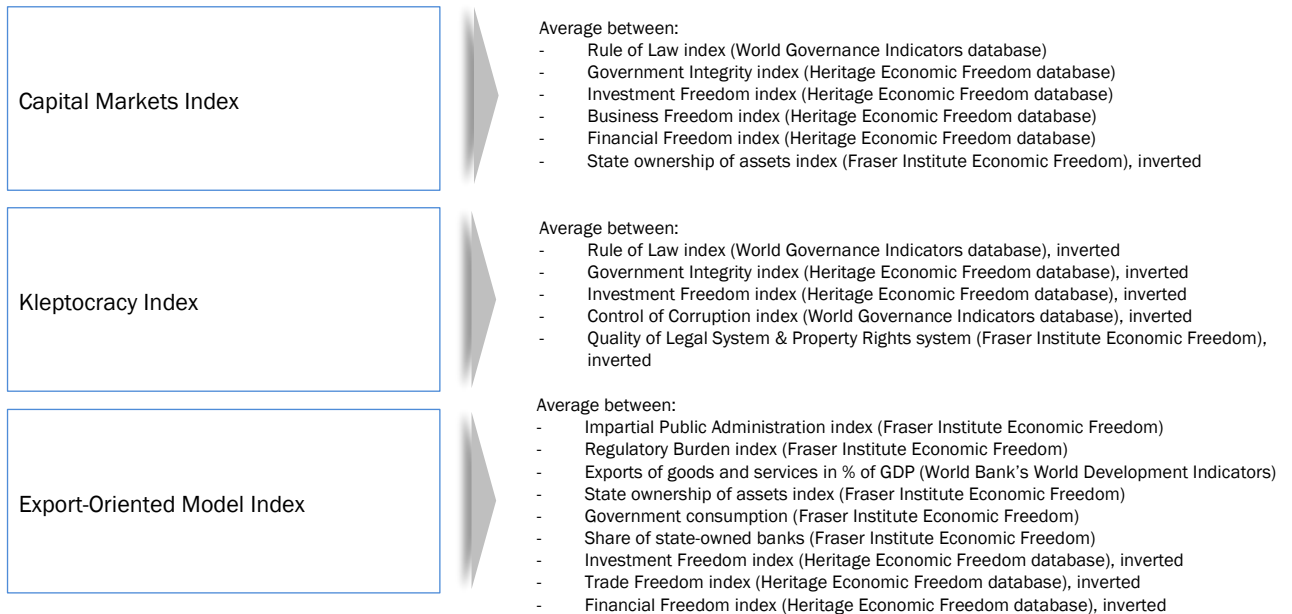
One of the conclusions resulting from our analysis of these questions is that a weak and fragmented society in Ukraine (in a combination with a weak State and significant influence of Russia) results in the volatility of Ukraine’s commitment to the “Capital Markets” model. We named a development based on such positioning as a “Muddle through” scenario.

Based on our analysis under this “Muddle through” scenario, we do not see the probability of sustainable political changes necessary for the transition from economic underperformance towards catching-up as high.

We have tried to analyze the long-term sustainability of the “Muddle through” scenario, but we have not found a reliable method of determining for how long the existing economic potential can support it (mostly based on milking the existing assets). What can be said with confidence is that Ukraine has a neighboring country with explicit imperial ambitions, which will highly likely play out if Ukraine comes closer to the failed state outcome.

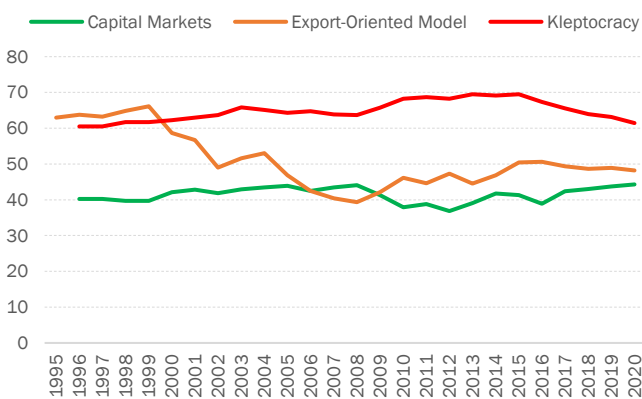
Question 1. How the commitment to different economic models has been changing in Ukraine?

To answer this question, we have developed three composite indices based on Ukraine’s ranking from different datasets. Each component was normalized on a scale between 0 and 100:

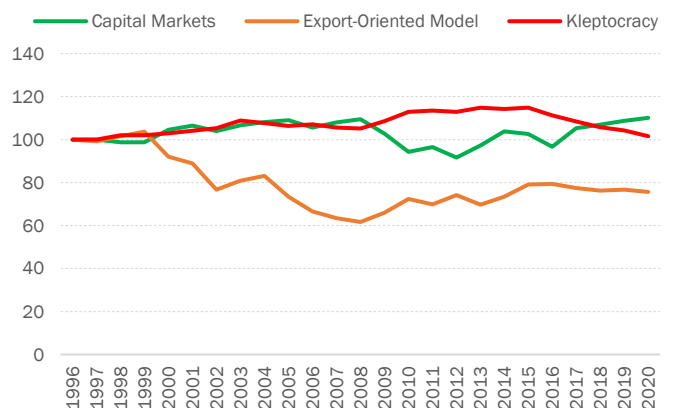


Based on the abovementioned composite indices, we see the following patterns:

Q1.1. Change in commitment to economic models in Ukraine (nominal indices)



Q1.2. Change in commitment to economic models in Ukraine (normalized indices: 1996=100)



Source: AYA estimates and calculations

Such an approach is simplified, and it requires further academic research, but these patterns lead us to the following answers to our first question:

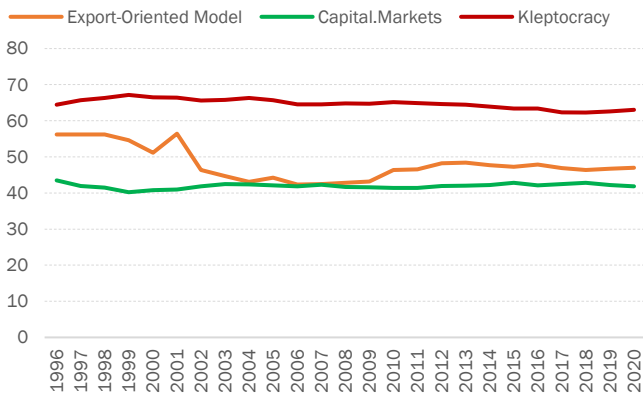
- Though there is a decline in inclination towards “Kleptocracy” from 2014, it is still a dominating model (with no significant changes of its role if compared with 1996, for example).
- Significant decline of the role of “Export-Oriented Model” in 2000-2007. There is also a reversal of this trend from 2007 as a reaction to the financial crisis and influence of “re-industrialization” supporters.

- Commitment to the “Capital Market” model is lagging behind the other two models; we see only marginal improvement if compared with 2013.

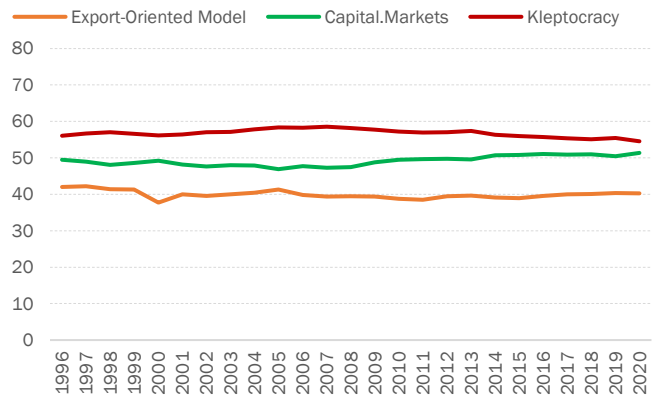
We provide a comparison with other countries based on this framework in the Appendix for the reader to evaluate this approach’s adequacy by himself. Comparison with other countries leads to another interesting observation: Ukraine’s profile closely resembles the average profile for countries from the low-income group. This could indicate the existence of some kind of “poverty trap” caused by such fundamental reason as a commitment to an inefficient socio-economic model.

On the contrary, both high-income and middle-income countries demonstrate a stronger commitment to the “Capital Markets” model (see Appendix for details).

Q1.3. Commitment to economic models in low-income group of countries (nominal indices)



Q1.4. Commitment to economic models in upper middle-income group of countries (nominal indices)



Source: AYA estimates and calculations

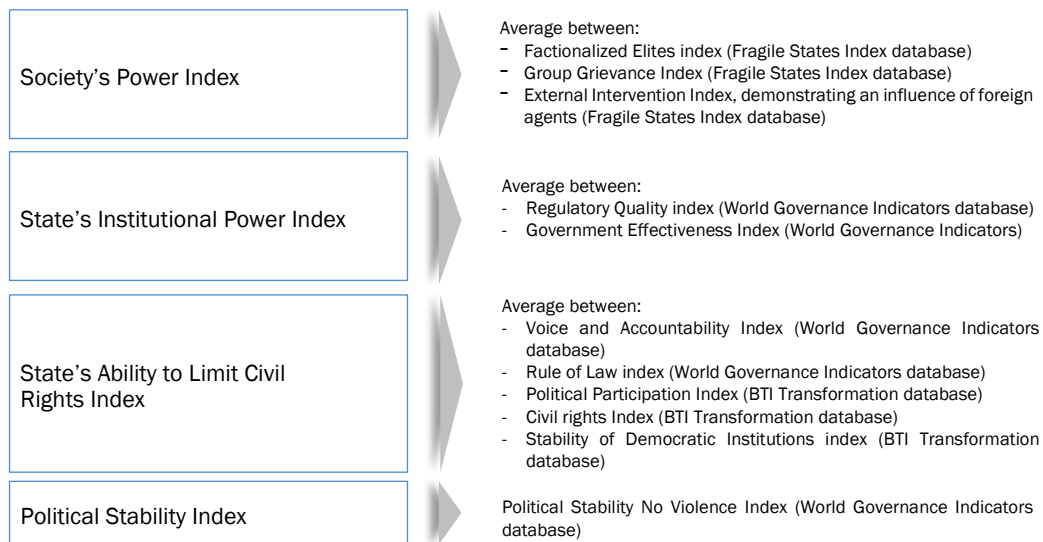
Question 2. If there were changes in inclinations towards specific models, what were the reasons behind such changes?

When answering our Question 1 above, we concluded that there has not been a sustainable transition towards any of the socio-economic model in modern Ukraine’s history. Such “volatility” should be explained, and to answer this question we have looked at socio-economic conditions in Ukraine based on the “Narrow corridor” concept, developed by D.Acemoglu and J.A.Robinson. According to this concept, liberty emerges only when a delicate and incessant balance is struck between a strong state and a strong society - between elites and citizens. This struggle becomes self-reinforcing, inducing both state and society to develop a richer array of capacities, thus affecting the peacefulness of societies, the success of economies, and how people experience their daily lives:

“The conflict between state and society, where the state is represented by elite institutions and leaders, creates a narrow corridor in which liberty flourishes. You need this conflict to be balanced. An imbalance is detrimental to liberty. If society is too weak, that leads to despotism. But on the other side, if society is too strong, that results in weak states that are unable to protect their citizens.”

The Narrow Corridor: How Nations Struggle for Liberty, D.Acemoglu and J.A.Robinson, 2019

We have developed several composite indices to measure the power and fragmentation of society and the power of the state. The latter is analyzed from two perspectives: one index demonstrates State’s capacity to develop pro-Western institutions, while the other one demonstrates whether the State is already able to limit civil rights. Index of political instability demonstrates the result of interaction between the society and the state.



Each component was normalized on a scale between 0 and 100

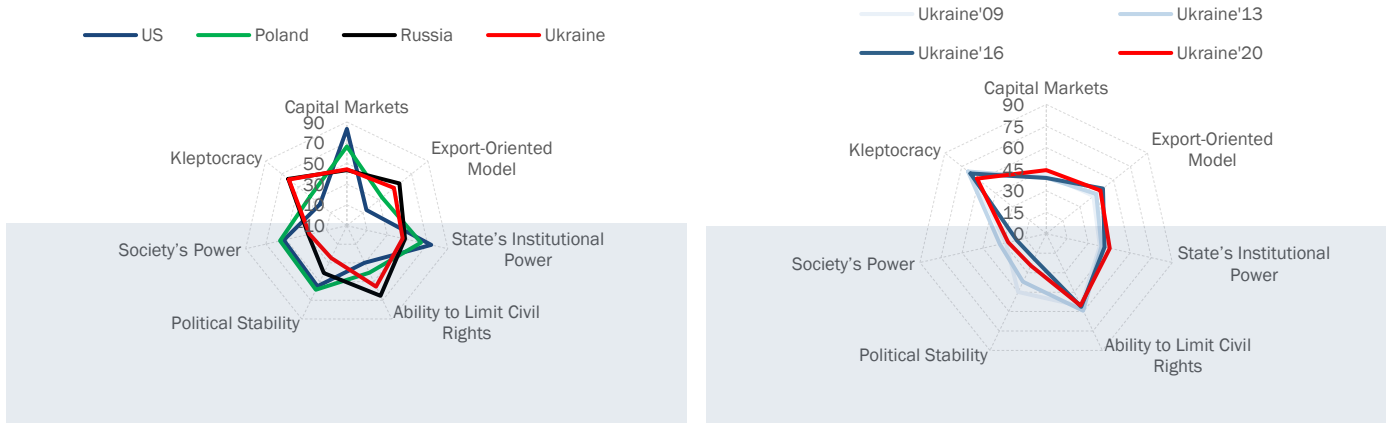
Based on the abovementioned composite indices, on the figures below we present a comparison between Ukraine and other countries, and a comparison between these indices for Ukraine in different years. We have the following observations on this basis:

- a) Both society and the state are significantly weaker in Ukraine than in developed markets. Therefore, a long way up the “narrow corridor” could be expected, because both the strength of the state and the strength of society should be gradually accumulated.
- b) At the same time, the way along the “narrow corridor” is a risky one. Fragmentation of society, aggravated by the presence of Russian influence, is impeding the growth of society’s strength: there was even a decrease in society’s strength if compared with 2009. Russia is also obviously not interested in the growth of the Ukrainian state’s power.
- c) Given Russia’s geopolitical goal of returning Ukraine to the status of the Russian quazi-colony, it would be naive to expect a decrease of such negative influence from the imperialistic neighbor in the nearest future. Empirical evidence of the significant influence of Russia, including through its culture, could be found in different areas: from the share of Russian-speaking people in Ukraine to the results of 2020 municipal elections (demonstrating significant support of pro-Russian parties) and results of recent opinion polls about people’s preferences in case of early parliamentary elections.
- d) The figures below demonstrate that Ukrainian society is weaker than the state (be also aware of noticeable similarities with Russia on the left chart). Thus, there are risks of transition to despotism in the long-term period. On the one hand, it may seem impossible now. On the other hand, one should remember the election of Yanukovych just 5 years after the Orange Revolution, and current frustration about post-Maidan ruling politicians in the society. This combination allows us not to rule out such a scenario.

These observations lead us to the following conclusion: **weak and fragmented society in a combination with a weak state and significant influence of external agents, results in the volatility of Ukraine’s commitment to the “Capital Markets” model.**

Q2.1. Comparison of socio-economic factors and commitment to economic models in Ukraine and some other countries

Q2.2 Comparison of socio-economic factors and commitment to economic models in Ukraine in selected years



Source: AYA estimates and calculations

Question 3. What are our current mid- and long-term expectations?

Based on the presented top-down analysis, the “Muddle Through” scenario remains our base-case scenario for now. This scenario means the absence of strong commitment to any of alternative economic models in the long run (caused, inter alia, by the malign influence of pro-Russian and pro-oligarchic forces) that results in marginal pro-Western changes against largely preserved status-quo.

We treat a “Muddle Through” scenario as a series of political and economic cycles with ups and downs in the development of Ukrainian institutions and cooperation with western institutions, periodical conflicts, and attempts to soften relations with Russia. In other words, this scenario lacks a sustainable determination in long-term geopolitical orientation and, subsequently, internal policies, though it is characterized by a marginal inclination towards cooperation with Western partners.

The expected results of this scenario are:

- Inability to catch up with Ukraine’s peers in terms of economic development.
- Highly impossible Ukraine’s integration into the EU.
- High risks of state’s failure in the next possible round of intensified conflict with Russia, especially in case of gradual losing of adequacy by the aging Russian President.
- Risks of transition to despotism in the long-term period: on the one hand, Ukrainian society is weaker than the state; on the other hand, weakness of the state (if compared with other countries) could potentially be substituted by the strength of the despotic leader.

Long-term sustainability of the “Muddle through” scenario

The “Muddle through” scenario is conditional on the ability of the Ukrainian economy to generate just enough economic growth to maintain the social stability and political status quo without major changes in the country’s institutional makeup. In turn, such ability is conditional on the productivity of capital assets to generate economic output. When economic growth is not sufficient to maintain the status quo, the increased social instability leads to political turbulence but does not necessarily lead to the change in the prevailing political-economic model. For instance, while the economic and political crisis of 2013-2015 created the possibility for a change in Ukraine’s economic model, this change did not follow through in a sustainable way. In other words, both cyclical economic and political instability are inherent characteristics of the “Kleptocracy” model and the “Muddle through” scenario.

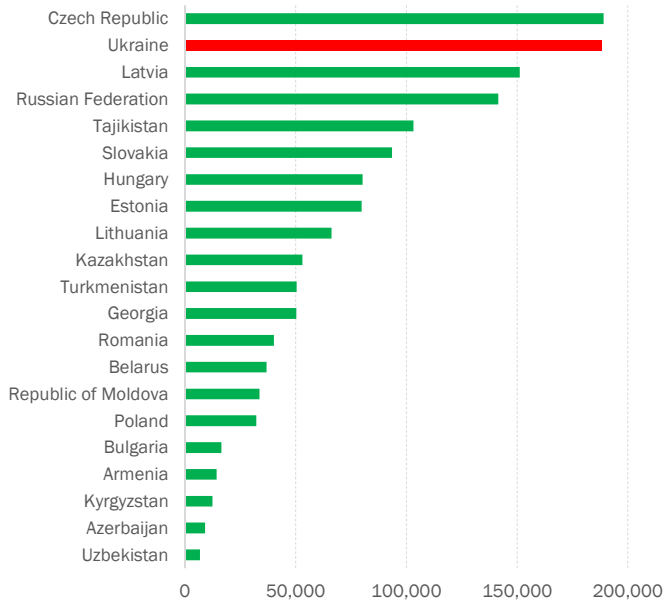
Therefore, the question we are interested in is the structural long-term sustainability of the “Muddle through” scenario. Specifically, we are interested to know if the Ukrainian economy can continue to generate (possibly subpar but positive) economic growth in the long term under the “Kleptocracy” model and “Muddle through” scenario, or the existing economic potential is exhausted.

At its birth, independent Ukraine was well endowed with capital stock. Figures below show that among the countries of the former Eastern block as of 1992, Ukraine had virtually the largest amount of capital per capita, on par with the Czech Republic (see Figure Q3.1). Interestingly, as of 2019, Ukraine remains among the leaders in terms of capital per capita (see Figure Q3.2). The latter fact partly reflects the decline in Ukraine’s population. However, negative demographic tendencies were also prevalent in many comparable countries, and, therefore, demographics remain rather a side factor.

At the same time, capital stock inherited from the Soviet times was inefficient. Indeed, Figure Q3.3 clearly shows that Ukraine’s ratio of GDP to the capital stock in 1992 was among the lowest in the peer group. In Ukraine, one USD of capital stock was generating only 8 cents of GDP in contrast to 24 cents in Belarus and 32 cents in Poland. While there is an obvious negative association between the availability of capital and its productivity (due to declining marginal productivity of capital), as of 1992 Ukraine represented a rather extreme case of a country with a large amount of unproductive capital.

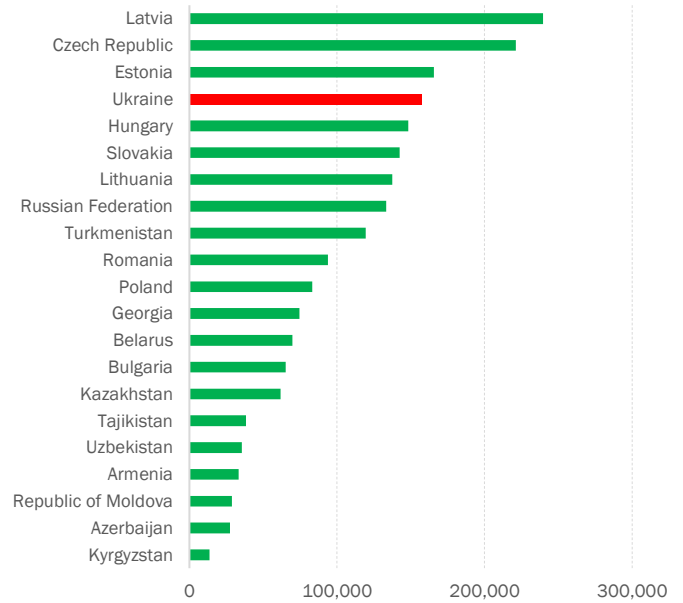
Q3.1. Capital stock to population in 1992

Capital stock to population at constant 2017 USD



Q3.2. Capital stock to population in 2019

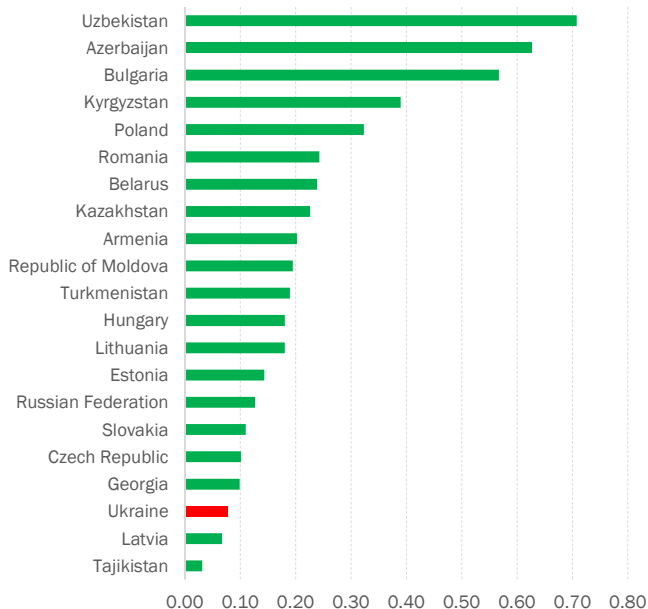
Capital stock to population at constant 2017 USD



Source: PWT 10.0, AYA estimates and calculations

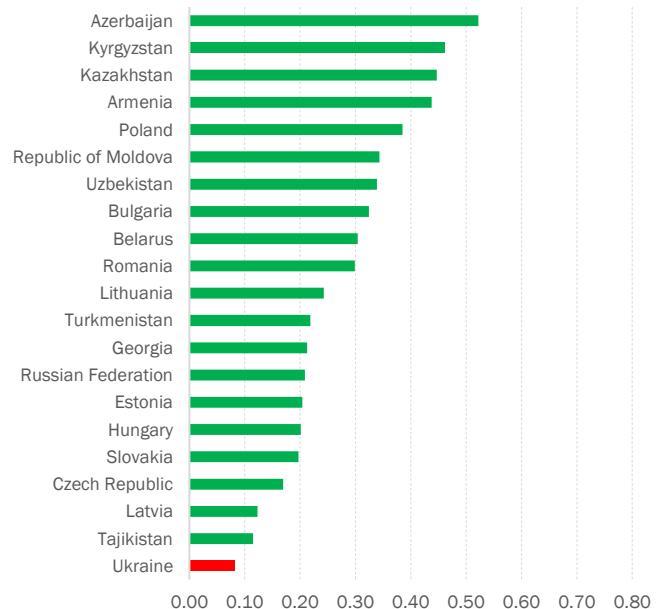
Q3.3. GDP to Capital stock in 1992

GDP to Capital stock at constant 2017 USD



Q3.4. GDP to Capital stock in 2019

GDP to Capital stock at constant 2017



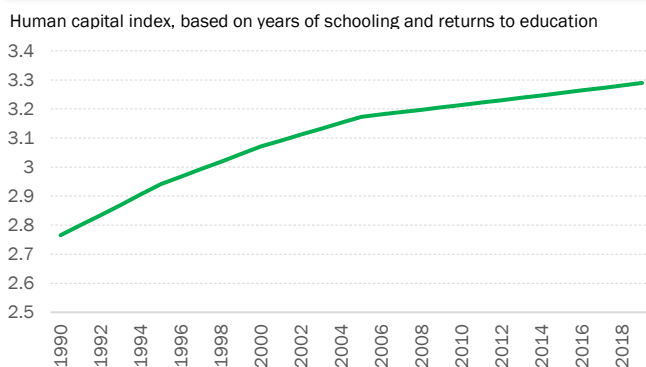
Source: PWT 10.0, AYA estimates and calculations

Most importantly, the productivity of capital after 30 years did not improve. In 2019, one USD of capital stock still generates 8 cents of economic output (see Figure Q3.4). At the same time, the amount of capital stock has declined by about 30% between 1992 and 2019. Therefore, the ability of the Ukrainian economy to generate economic growth

is declining as it has less capital stock that remains largely inefficient. On a positive note, the recent rapid decline of the labor force over 2013-2017 (about 20% decline) is unlikely to persist into the future if there is no outright war with Russia, and, thus, this factor will unlikely drag on economic growth as it did over the previous period. This should support economic growth in the medium term, at least in contrast to the experience of the 2010s. However, the absence of the additional drag on economic growth does not help in accelerating economic growth, and therefore, the conclusion remains unchanged: Ukraine is losing its capacity to generate economic growth.

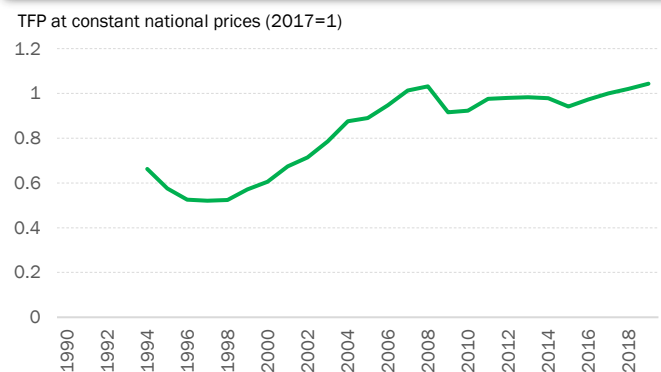
We believe that two main reasons explain the fact that the productivity of Ukraine’s asset base is not improving. Both explanations negatively affect investments, the only factor that can improve productivity. First, in the “Kleptocracy” model asset owners (who got control over the assets due to political connections and who either own or exert temporary control over the assets) are expected to prefer milking the assets instead of investing in productivity. Secondly, Ukraine’s chronic macrofinancial instability and problems with the rule of law clearly hinder private investments. Unfortunately, we cannot determine which among these two factors is the most decisive, as both factors reinforce each other. At the same time, a simple historical analysis provides a suggestive answer. In the mid-2000s Ukraine could be characterized as a combination of “Kleptocracy” and “Export-Oriented” models. And yet, against the favorable external conditions, Ukraine did experience the investment boom that led to substantial increases in both total factor productivity and human capital (see Figures Q3.5-6).

Q3.5. Ukraine: Human Capital index



Source: PWT 10.0, AYA estimates and calculations

Q3.6. Ukraine: total factor productivity (TFP) index



Therefore, a simple analysis indicated the primacy of macrofinancial stability and optimistic economic expectations. Given that Ukraine has recently achieved macrofinancial stability virtually for the first time¹, one can conclude that investments can support economic growth going forward even within the “Muddle through” scenario. But we should not forget that under conditions of the “Kleptocracy” model and “Muddle through” scenario, macrofinancial stability is not guaranteed. On the contrary, one of the key characteristics of the “Muddle through” scenario is the situational commitment to macrofinancial stability and the inherent motivation to trade it for short-term political gains. Therefore, we believe that the conclusion that Ukraine continues to slowly lose its ability to generate economic growth remains valid even despite recently achieved macrofinancial stability.

Unfortunately, we have not found a method of determining for how long existing economic potential can support the “Muddle through” scenario. The example of Latin American countries suggests that economic underperformance within a similar scenario can continue for decades. For instance, in both Argentina and Brazil economic efficiency is in decline since the beginning of the 1980s. In Brazil, total factor productivity over 1980-2019 declined by about 33%, while in Argentina it declined by 12%. Similarly, we should not forget about the existence of a neighboring country with explicit imperial ambitions, which will likely play out if Ukraine comes a few steps closer to the “failed state” condition.

¹ In contrast to 2016-2020, previous episodes (such as in the early 2000s) were characterized by high risks of accumulating macroeconomic imbalances.

Question 4. What could secure a commitment to the “Capital Markets” model in the future?

We have several hypotheses on when commitment to the “Capital Markets” model could be secured (with a withdrawal from the commitment to the “Kleptocratic Oligarchy” model). These scenarios could be realized either separately or in combination with one another:

A. Radical scenarios:

1. In case of outright war with Russia, the latter may occupy the industrial centers in Eastern and Southern parts of Ukraine, which are also key centers of oligarchs’ power and pro-Russian supporters. Though these losses will be severe, such a scenario could make the rest of society less fragmented and, definitely, more consolidated (i.e., the society will be stronger). On the other side, such actions by Russia are expected to result in more active technical assistance to Ukraine from the Western partners, rescuing the credibility and the strength of the Ukrainian state. Therefore, resulting strong non-fragmented society and strong state could provide the precondition of the development of the rest of Ukraine within the bounds of the abovementioned “narrow corridor”.
2. Ukrainian state’s attempts of direct confrontation with oligarchs could lead to a severe reaction from the latter. If this reaction will be cruel enough, society may re-think its attitude towards oligarchs in general and towards specific personalities, starting to perceive them as public enemies. That will make Ukrainian society more consolidated and inclined to fight “Kleptocratic Oligarchy”. This scenario have similarities with the Colombian state’s war against P.Escobar in the 1990s, but it’s hardly realizable in Ukraine because of (a) less explicit social costs from Ukrainian oligarchs from the perspective of the general public; (b) there is no such severe external pressure to fight Ukrainian oligarchs as in the case with US pressure on Colombia to fight drug lords in 1990s.

B. Evolutionary scenarios:

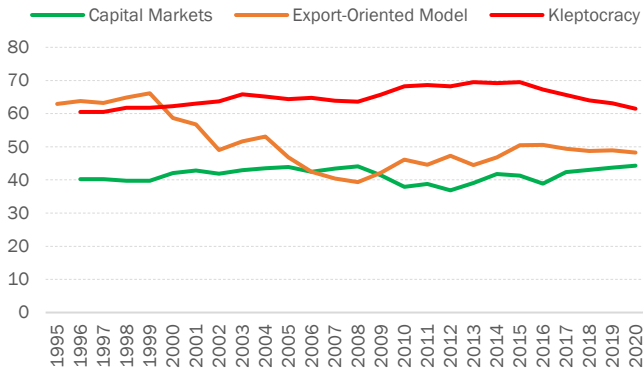
1. Severe loss of competitiveness and sustainability of key sectors, which traditionally form the core of oligarchs’ business, could provoke them to re-think their priorities of securing the “Kleptocratic Oligarchy” model and/or to sell their business to other business owners. For example, there is an opinion that [due to the decarbonization trend only “green” metallurgy will be competitive in future](#). It requires high capital spending (with low cost of capital) and a sustainable electricity market – but these preconditions cannot be achieved without a transition to the “Capital Markets” model. Another recent signal along this line is an announcement of the construction of the technical university by R.Akhmetov, presumably due to the problem with the efficiency (quality) of state technical education.
2. Fundamental disruption in the leadership of oligarchic groups (e.g., a transition of power to more pro-Western family successors) could lead to a more modern approach in the handling of oligarchic empires. For example, this scenario may also lead to re-thinking of a priority to secure the “Kleptocratic Oligarchy” model and/or to sell their business to other pro-Western or even Western business owners.
3. The urgency of securing participation of western strategic investors (with the political support of their countries) in oligarchs’ businesses could be created by an efficient communication campaign about consequences of “state capitalism” for Ukrainian oligarchs in case of war and nationalization of their assets by Russia (using “loss aversion” bias to shift oligarchs’ thinking). In turn, it is questionable whether the western strategic investor would like to buy a stake in such companies without a change in the rules of the game in Ukraine. Therefore, oligarchs could be motivated to change the rules to attract such investors.

4. Consolidation of key local stakeholders (state, society, and oligarchs) to achieve economic 'turnaround' based on the improvement of markets' efficiency and justice could be possible if the communication about resulting beneficial changes for the oligarchs is made efficiently. In other words, oligarchs could be motivated to change the rules of the game when they realize that this scenario will provide them with a larger value if compared with a scenario of 'milking the assets'. The problem of this scenario is that it resembles the classical prisoner's dilemma: one oligarch cannot be sure that other oligarchs and the state will keep their word.
5. Rise of new industries with enough power and commitment to change the rules of the game through the implementation of the "Capital Markets" model. One can say that the IT industry could be such a driving force, given that its share in Ukraine's GDP has increased to 4-5% for the last decade. But we see the following risks that decrease the probability of such scenario: (a) there is an opinion that the IT industry benefits from an uneven playing field (due to tax benefits), and they are not motivated to change the rules of the game; (b) we do not see that IT community is consolidated enough on the political scene (though there are several representatives from IT in the Parliament, they are in different parties as of now).

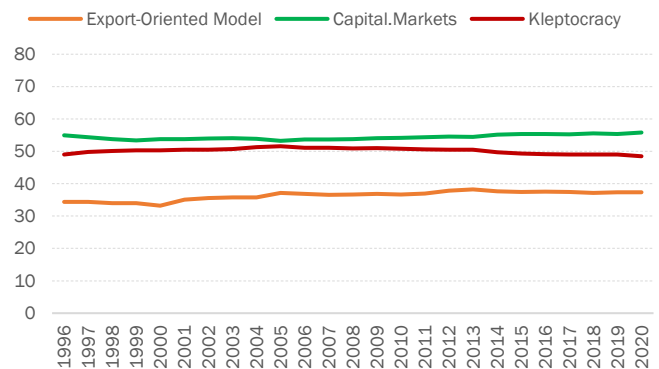
We could return to testing these hypotheses in the future but given that the probability of any of these preconditions/scenarios is rather low at the moment, we do not expect that the rules of the game and inclination towards the "Muddle Through" scenario will change any time soon.

Appendix. Commitment to Alternative Economic Models in Ukraine and other Countries/Regions

Ukraine

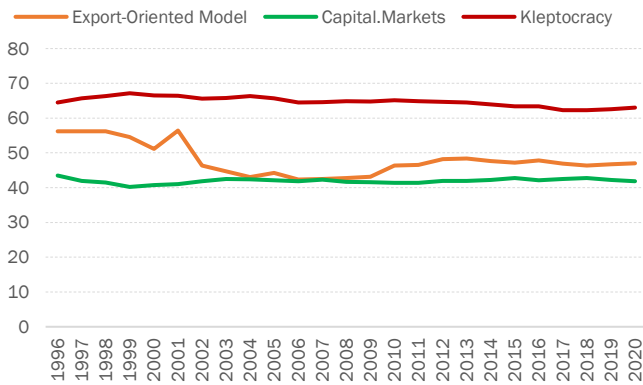


World's average

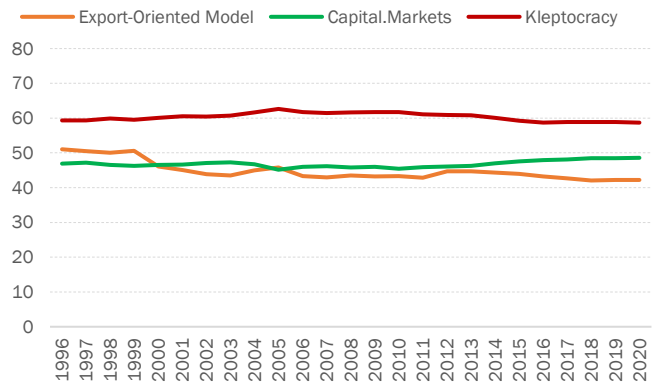


1. Commitment to Alternative Economic Models in Regions by income group:

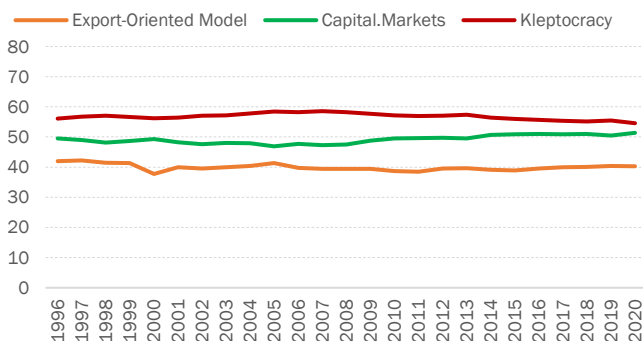
Low-income group of countries



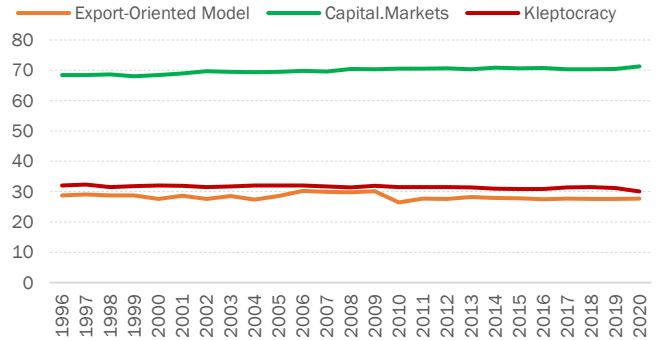
Lower middle-income group of countries



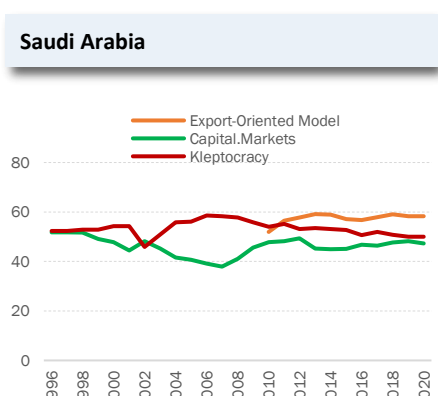
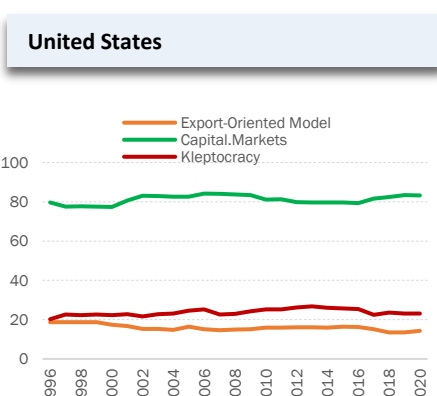
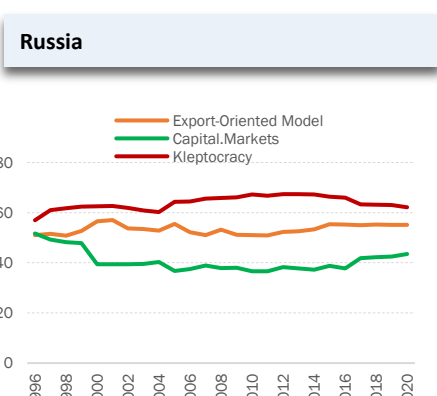
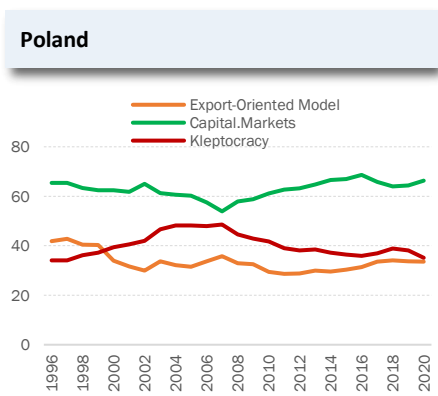
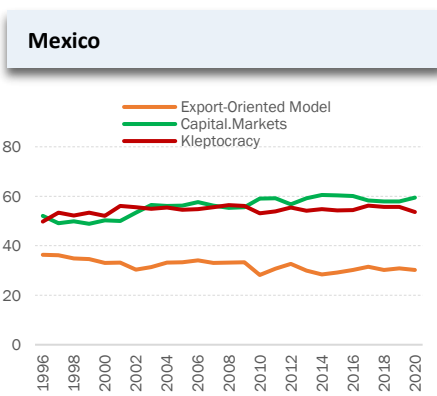
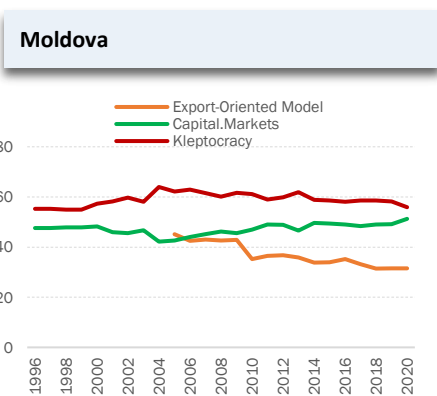
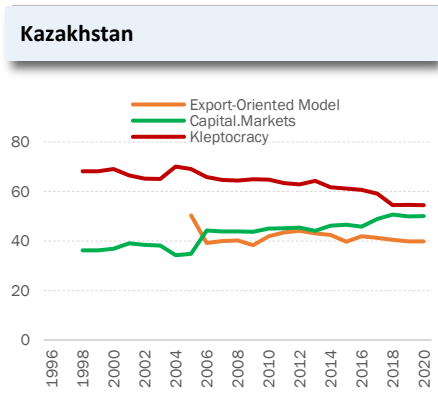
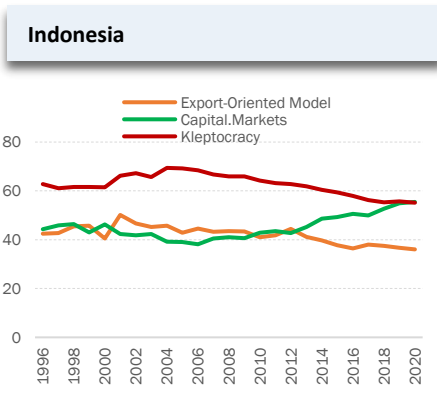
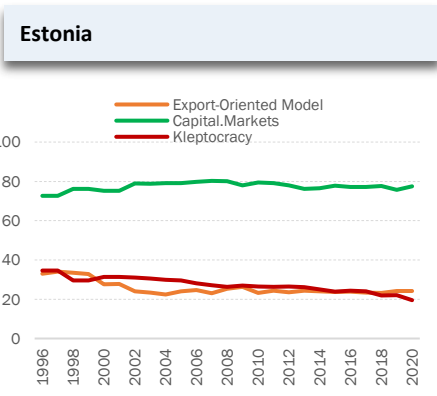
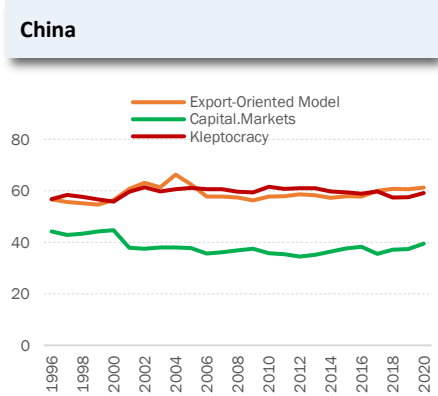
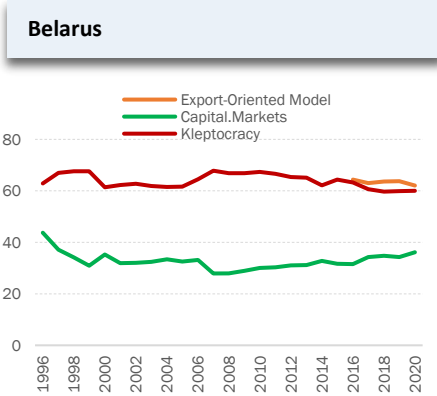
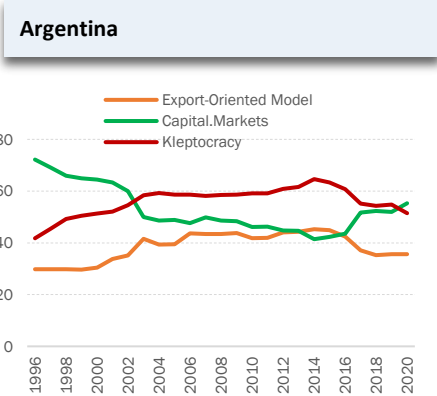
Upper middle-income group of countries



High-income group of countries

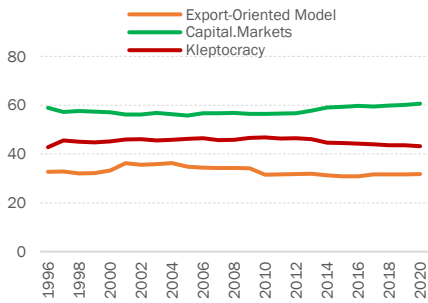


2. Commitment to Alternative Economic Models by Countries:

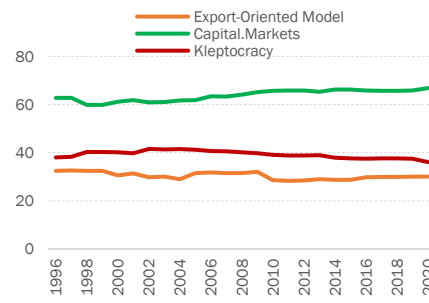


3. Commitment to Alternative Economic Models by Geographic Regions:

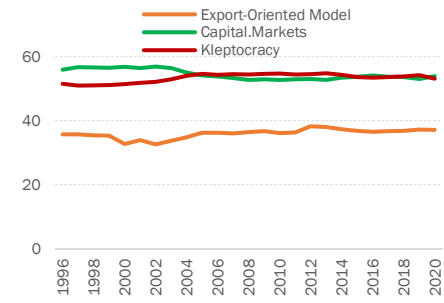
Eastern Asia & Pacific



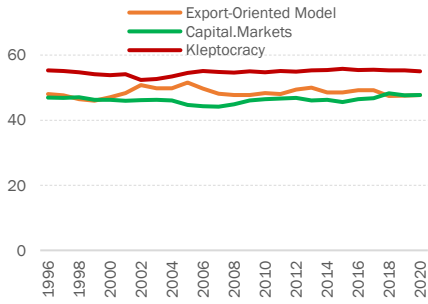
Europe & Central Asia



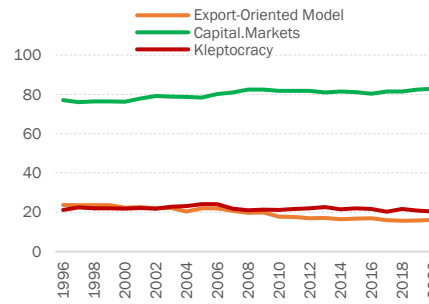
Latin America & Caribbean



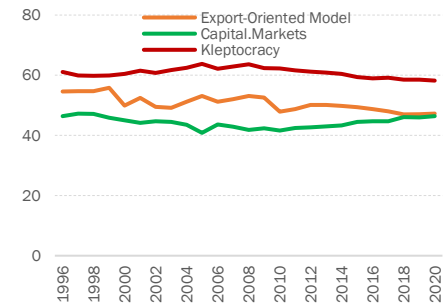
Middle East & Northern Africa



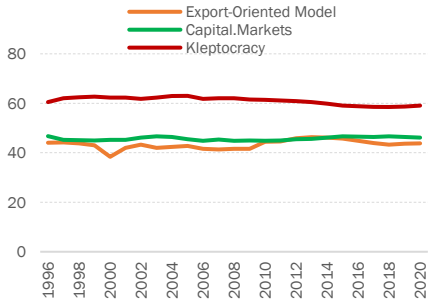
Northern America



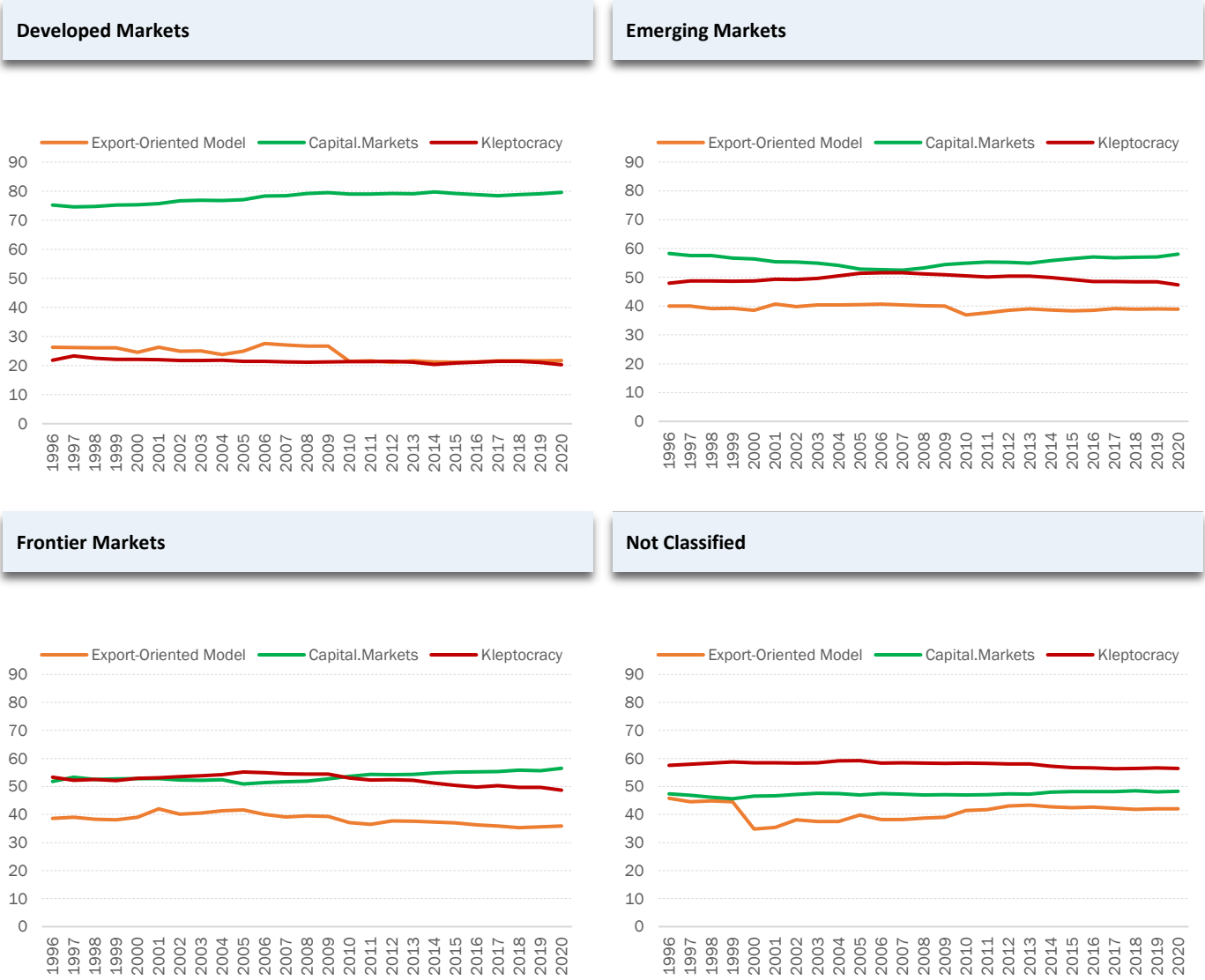
Southern Asia



Sub-Saharan Africa

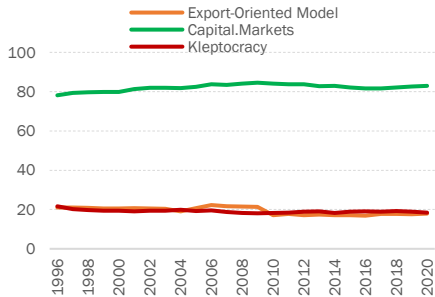


4. Commitment to Alternative Economic Models by MSCI's Market Classification:

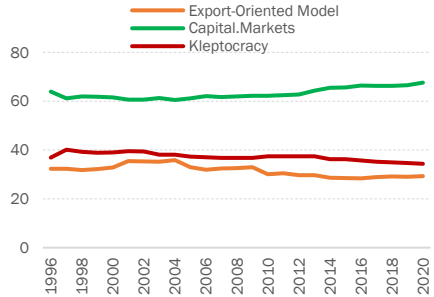


5. Commitment to Alternative Economic Models by MSCI's Cultural Regions:

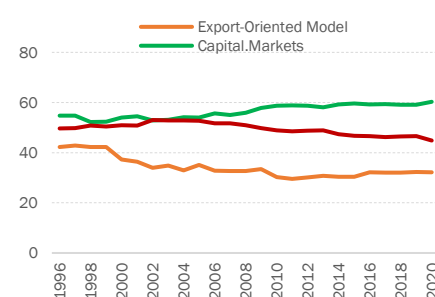
Anglo



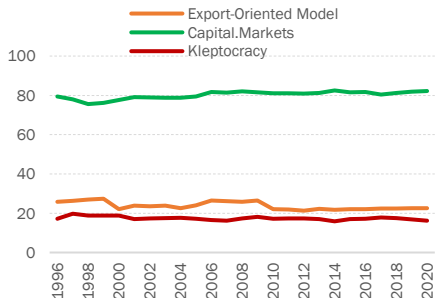
Confucian Asia



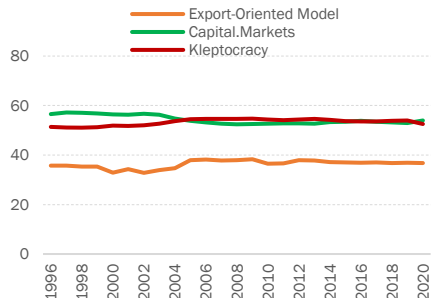
Eastern Europe



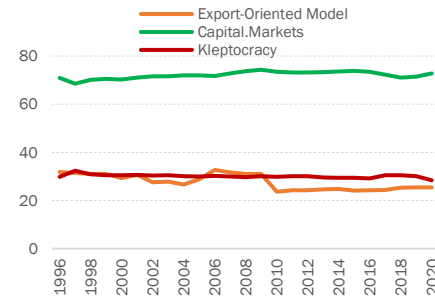
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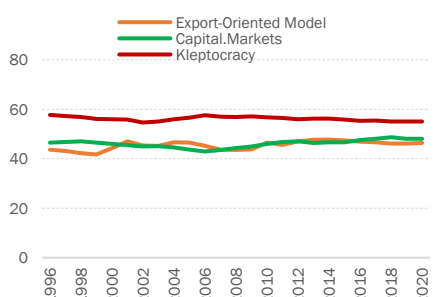
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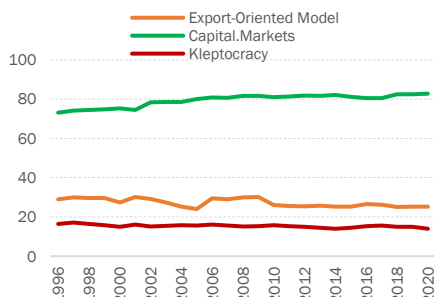
Latin Europe



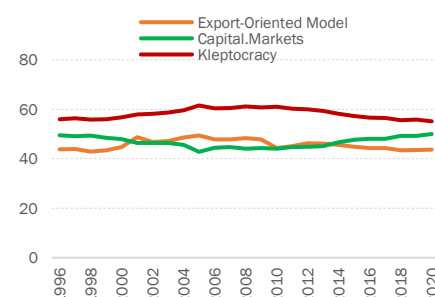
Middle East



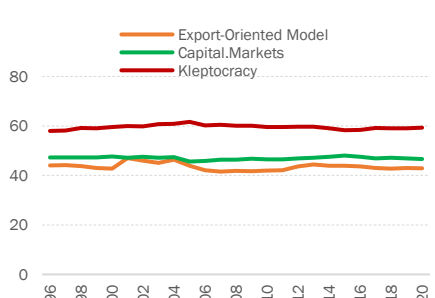
Nordic Europe



Southern Asia



Sub-Saharan Africa



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