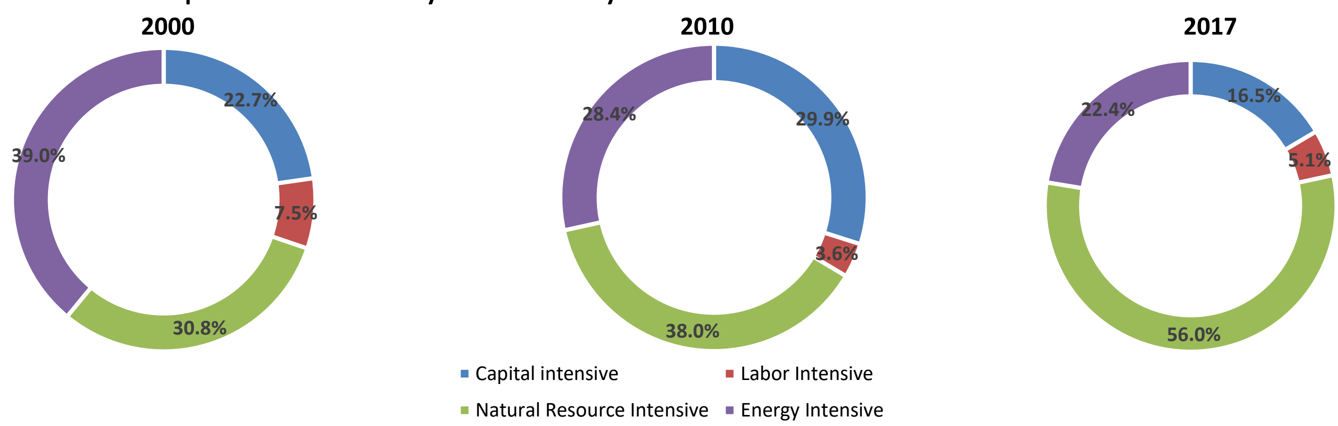
Ukraine
Special Focus Note on Trade
Tapping Ukraine's trade potential
October 4, 2018

- **Ukraine has tremendous potential to boost exports of higher-value added products, but this potential has not yet been realized.**
- **Ukraine's export structure remains concentrated in metals and cereals. Boosting exports integrated with Global Value Chains (GVC) is a major opportunity to for Ukraine to leverage its access to the EU market and benefit from technological and knowledge spillovers.**
- **Reforms to attract Foreign Direct Investment (FDI) and an efficient and competitive logistics system will be important in boosting Ukraine's export and growth potential.**

Ukraine's export structure remains concentrated in primary products

Ukraine has tremendous potential to tap European and international markets to boost exports and economic growth, but this potential has not yet been realized. Ukraine has a strategic geographic location at the crossroads of Europe and Asia, the largest endowment of fertile agricultural land in Europe, a large population of educated workers, and an Association Agreement with the European Union since 2015, which includes a Deep and Comprehensive Free Trade Area (DCFTA). These endowments offer a tremendous opportunity for Ukraine to boost exports of higher value-added and diversified products. International experience has shown that sustaining strong economic growth over an extended period of time requires vigorous growth of the sectors producing higher value-added tradable goods and services. Over the last decade, however, Ukraine's share of world exports has declined marginally—from 0.35 percent in 2008, 0.34 percent in 2013, and 0.28 percent in 2017. The total value of goods and services Ukraine exported was 48 percent of GDP in 2017, but the benefits associated with trade openness, such as technological externalities and knowledge spillovers, have remained limited. While trade has been redirected from CIS countries to the rest of the world, Ukraine's export structure remains highly concentrated in a small number of basic commodities—either metals or farm products. In 2017, iron and steel remained Ukraine's top export category accounting for 20 percent of total exports, followed by cereals which accounted for 15 percent of total exports.

Figure 1: Ukraine's Export Product Shares by Factor Intensity



Source: World Bank Staff calculations based on United Nations Comtrade. Energy intensive products include iron and steel. Natural resource intensive products include agriculture. Capital intensive goods include technology and skill-intensive goods.

Ukraine's export structure remains concentrated in metals and cereals but has experienced a shift from energy-intensive metals toward agricultural products over the last decade. The share of energy intensive exports—iron and steel— has declined, reflecting the realignment of energy import prices. Over the last two decades, Ukraine's economic transformation has been held back by the legacy of underpriced energy that provided short-term benefits to select sectors, but delayed much needed industrial restructuring. The Ukrainian steel industry continues to be highly energy intensive, with about a quarter of its output using open-hearth furnaces which have been replaced in nearly every other country in the world. Second, natural resource intensive goods—primarily agriculture products—accounted for more than half of export value and have become an important pillar of Ukraine's exports. Third, the share of capital intensive exports continues to decline. Constrained by the lack of investment, the share of capital intensive exports has declined to just about 16 percent in 2017. Finally, the share of labor intensive products—an endowment which Ukraine has as one the largest countries in Europe—has remained very low.

Ukraine has not yet become a major participant in Global Value Chain (GVC) exports, although it has latent potential to integrate into such international production networks. Global production today is highly integrated across multiple countries, with a single finished product often resulting from manufacturing and assembly lines spread across multiple countries, with each step in the process adding value to the end product. Through such global value chain (GVC) exports, countries not only exchange products but also technology, knowledge, and networks. For Ukraine, however, the share of such GVC products in exports has been low at 5.7 percent in 2014, much lower than 27 percent for Poland, 38 percent for Romania, 38 percent for Turkey, and 59 percent for Vietnam. Expanding the share of GVC products would be a major opportunity for Ukraine to boost its exports. In fact, Ukraine has demonstrated latent potential on this front through the exports of automotive ignition wiring sets which grew from $21 million in 2000 to $1.2 billion in 2017, one of the fastest growing product categories of Ukraine's exports in recent years.

As Ukraine looks for new ways to integrate into the global economy, export of services is another area with great potential for growth. Over the last 10 years Ukraine has maintained and increased its comparative advantage in transport services—in 2016 transport services accounted for about 60 percent of total services exports ($5.2 billion). However, Ukraine has also developed comparative advantage in telecommunications and ICT services which accounted for about 16 percent of services exports in 2016 ($1.4 billion).

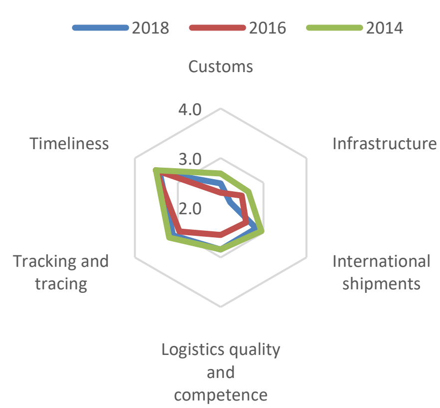
Reforms to attract FDI and create an efficient logistics system are critical to boost exports

Reforms to attract Foreign Direct Investment (FDI) are an important driver of exports and integration into Global Value Chains (GVCs). In fact, the success of automotive ignition wiring sets in Ukraine was facilitated by FDI from Japanese auto wiring companies including Leoni, Fujikura and Yazaki, which shifted production to Ukraine from central and eastern European countries where labor costs have increased. The international experience has also shown a strong relation between FDI and sustained export growth. Significant reforms are needed to attract FDI in Ukraine, which remains low at $2.6 billion (2.1 percent of GDP) in 2017. One of the most important factors in attracting FDI is the rule of law and the protection of property rights. Ukraine's ranking on the Rule of Law in the Global Governance Indicators was 25th percentile in 2017 compared to 87th percentile for Estonia, 68th percentile for Poland, and 52nd percentile for Bulgaria. Clearly, much more needs to be done to create a level playing field for FDI in Ukraine. This will not only require strengthening the anticorruption architecture and the judiciary, but also further streamlining the regulatory environment, strengthening competition policy, and reforming state owned enterprises, and making progress on privatization. Another important factor in attracting FDI is macroeconomic stability. With Ukraine experiencing two macroeconomic crises in the last ten years, it will be important to build on the progress made since 2015 in safeguarding fiscal and financial sector stability. Enabling efficient financial intermediation and boosting credit growth will also require reducing the footprint of the state on the banking sector and cleaning up the high share of non-performing loans.

Ukraine also needs an efficient and competitive logistics system to boost exports and its integration into the global economy. At present, this is not the case. Due to low population density, geography, and the structure of output (heavy reliance on metals, basic industry, and agriculture), transport volume per unit of GDP is much higher than in other countries in Europe. For example, the costs of logistics in grain exports are affected by the underutilization of river transport, inefficiencies in rail transport, high share of road transport, deficient storage management and port fees. Weaknesses in Ukraine's logistics are also reflected in a low ranking in the Logistics Performance Index. Five key drivers of current high logistics costs are: (i) lack of regulatory clarity and sub-optimal management of public assets that create barriers to private investments; (ii) underutilization of river transport; (iii) underinvestment in rail transport; (iv) inefficiencies in storage management; and (v) excessive use of road transport.

Figure 2: Logistics Performance Index and its components in Poland, Germany and Ukraine

Figure 3: Logistics Performance Index and its components Ukraine in 2014, 2016 and 2018



Source: World Bank's Logistics Performance Index.

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