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*European Urban and Regional Studies* 2010; 17; 141

DOI: 10.1177/0969776409357363

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# Ukraine's diverging space-economy: The Orange Revolution, post-soviet development models and regional trajectories

European Urban and Regional Studies  
17(2) 141–165

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## Abstract

This paper considers the evolution of Ukraine's space-economy from 1990 to 2009, paying particular attention to comparative regional economic performance during the country's expansionary phase from 1999 to 2008. This shows that Ukraine inherited from the Imperial and Soviet eras a space-economy that was amongst the most unbalanced in Europe. Furthermore post-Soviet regional trajectories intensified these territorial imbalances. The paper argues that these trajectories are linked to a wider political economy and especially to shifts in underlying development models and the characteristics of state power. The Orange Revolution marked a significant switch away from export-led industrial growth, which involved national accumulation towards a credit-fuelled consumption model that was reliant on importing foreign capital. The paper identifies three major types of specialized regional economy that persisted despite the change in development model. Nonetheless, their relative performance and contribution to national growth were affected by the shift in model. Centripetal tendencies were reinforced, which increased regional divergence. The paper argues that the Ukrainian space-economy is best understood as a series of historically rooted and relatively geographically bounded regional economies that are increasingly functionally integrated yet externally oriented.

## Keywords

comparative economic development, convergence, development models, divergence, employment, Europe, finance-led growth, inequality, Orange Revolution, productivity, transition, Ukraine

Comparative economic performance and uneven development have been a recurring theme in analyses of post-soviet economic development at the national (Smith, 1995; Sokol, 2001), the subnational (Dunford, 2005; Förster et al., 2005; Brown et al., 2007) and the pan-European scale (Dunford and Smith, 1998; Smith and Swain, 1998). It has been shown that the extensive model of economic development during the soviet era promoted decentralization, integration

mostly at the national scale, and regional convergence. In the cases of the USSR and Czechoslovakia, Dmitrieva (1996) and Smith (1998) have demonstrated how the soviet mode of regulation based around

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centralized planning steered the extensive regime of accumulation towards a vast relocation of productive forces away from the former economic core. This redistributed assets in favour of the periphery and significantly reduced regional disparities in both countries. The disarray and collapse of the soviet system led to the fragmentation of space-economies as disintegration at the national and international scale combined with the rise of regionalism and localism. Later the post-communist processes of 'transition' and 'structural adjustment' promoted recentralization in western and metropolitan regions (Surazska et al., 1997; Mykhnenko and Turok, 2008), reintegration mostly at the international scale, and regional divergence (Barjak, 2001; Ezcurra et al., 2007). Despite the dominant discourse of convergence in neoclassical economics and policy formulations (e.g. Mickiewicz, 2005; Rusinova, 2007), and contrary to high expectations in Eastern Europe of catching up with the West, most studies have been unable to substantiate anticipated convergence.

Dunford and Smith (2000) have examined the trajectories of economic development of European national and regional economies in the context of the pressures for greater integration and enlargement of the European Union. Across Europe, convergence and divergence coexisted in which less developed areas in Central and Eastern Europe (CEE) fell behind, while the most developed regions forged ahead. Focusing on the national and transatlantic scales, Dunford (2005) has compared the relative socioeconomic performance of continental European and Anglo-American economies with post-communist Europe and beyond. The study argued that the collapse of state socialism in Europe in the late 1980s and the subsequent enlargement of the European Union created new geopolitical rivalry for markets and neo-imperial influence between Europe, North America and East Asia. The end of communist party rule unlocked newly emerging markets and generated possibilities for Western Europe to incorporate parts of the former Soviet bloc into new pan-European divisions of labour. For CEE and the former Soviet Union (FSU), the transition to capitalism involved 'a transitional recession, demographic stagnation, increased social and territorial inequality, growth of the irregular economy, and the emergence of islands

of striking modernization' (Dunford, 2005: 172). The collapse of income in CEE and FSU, which constrained domestic market expansion, combined with the transfer of vast economic assets at extremely low prices to foreign capital, perpetuated the inherited disparities between the eastern and western halves of the continent. Thus, market-led models of transition produced extremely differentiated economic and social geographies in the former Soviet bloc.

This profound transformation of the new Europe has rendered the old taxonomy of Europe's regions redundant (Smith, 2004). In the context of global imperial rivalries, Agnew (2001) has argued that a profound shift has taken place within the European Union (EU), from concerns over social, territorial and economic cohesion to an increasingly singular focus on global economic competitiveness. The traditional goal of a single Europe characterized by relatively similar levels of economic development is being replaced by a new geographical taxonomy: 'an emerging threefold division of the continent into a "core" Europe (itself increasingly differentiated across policy areas), a "peripheral" Europe of potential eastern members perpetually on the road to full membership, and an "external" Europe excluded from membership but open to use by businesses from the core' (Agnew, 2001: 28; see also Amin and Tomaney, 1995). Agnew has claimed that this geographical taxonomy rested on the growing reliance of the EU on US free-market fundamentalism.

This paper focuses on one of the major 'external' European space-economies, namely Ukraine. Ukraine is the largest country in Europe by territory and is the second-largest post-Soviet country by population after Russia. Similar to Russia, Ukraine has been excluded from EU membership, but is being made increasingly 'open for business' for the Atlantic heartland (Sellar and Pickles, 2002; Gowan, 2009). Based on an extensive data set collected over 10 years, the paper examines comparative regional economic performance in post-Soviet Ukraine in a European context. From 1989 until 1998 Ukraine's annualized average GDP growth rate was -6.7 percent, but from 1999 until the end of 2008 the country's economy expanded by an average of 9 percent a year. Conventionally, it is argued that this expansion was underpinned by an oligarchic economic

model based on rent-seeking and an authoritarian yet brittle political system (see e.g. Kubicek, 2000; Åslund, 2001, 2009). The almost decade-long expansionary phase was punctuated by an episode of major (geo)political upheaval in late 2004, known either as the Orange Revolution (Wilson, 2005) or as a 'revolutionary coup' (Lane, 2008), which highlighted as well as reinforced the country's complex regional divides (Swain, 2005). Prior to the Orange Revolution, Ukraine's economic growth rate was 9.9 percent per year, thereafter almost halving to 5.3 percent p.a., before declining to -14.0 percent in 2009.

This paper has three aims. First, we examine the long-term post-Soviet trajectory of the Ukrainian economy from 1990 to 2009, paying particular attention to comparative regional economic performance. In so doing, we identify three major types of specialized regional economy: a series of agricultural, peripheral economies in the west and centre of the country, which are falling behind the national average; a group of industrial economies towards the east of the country; and five islands of service-sector-oriented economies led by Kyiv. The analysis shows Ukraine to be the most regionally unbalanced country in Europe, and that economic growth has been built upon inherited regional specializations and has exacerbated territorial disparities. Second, we contend that the Orange Revolution marked a significant change in the country's development model away from national accumulation towards dependence on importing foreign capital. Under President Kuchma, the economic growth that took place after 1999 was underpinned by industrial production for external markets, whereas the election of President Yushchenko in 2004 resulted in a shift towards consumption-based growth fuelled by external credit. Whereas the Orange Revolution was driven by marked complex social, regional and cultural differences, paradoxically the explosion of foreign credit-led consumption and associated finance and business services since has accelerated regional divergence to levels amongst the highest on the continent. Third, we examine the relationship between the changing development model and the country's sub-national uneven development. In so doing, we seek to determine how the shift in the country's model of development has affected Ukraine's increasingly differentiated economic geographies.

The paper is organized in the following way. In the next section, we outline our conceptualization of comparative regional performance and development models. The following section highlights the political implications of the way Ukraine's space-economy has hitherto been understood. We then examine comparative regional economic performance, focusing particularly on the expansionary phase between 1999 and 2008 and paying attention to regional development in a wider European context. The paper then argues that the evolution of Ukraine's space-economy is best understood as a shift from one model of development to another after the Orange Revolution. The paper ends with some broader conclusions that emerge from the analysis.

## Convergence, divergence and models of development

Traditionally, the study of comparative regional performance was dominated by neoclassical growth theory (Meade, 1962; for a historical overview of convergence, see Van Ark and Timmer, 2003). In the context of economic growth, modern economics starts from the so-called aggregate production function, which expresses the relation between the factors of production and a region's total output:  $GDP = f(L, K, H)$ . In its most basic form, neoclassical economists postulate that economic growth depends on a positive change in the supply of labour and in the physical capital stock and on continuing improvements in technology. The theory assumes decreasing returns to a single factor, in particular, decreasing marginal returns to capital, and constant returns to scale resulting in convergence in the long run: 'regions or countries with lower starting values of the capital-labour ratio are predicted to have higher per capita growth rates, and tend thereby to catch up or converge to those with higher capital-labour ratios' (Barro and Sala-i-Martin, 2003: 45). The absolute convergence claims are, thus, based on the assumptions that the mobile factors of production move from one region to another in search of higher returns in the form of profits, wages, etc., and follower regions are able to catch up by productively exploiting a large build-up of previously untapped

technology. Significantly, technology and knowledge are treated as public goods and, as a result, the benefits of technological progress can be accumulated by any potential user freely and/or at no extra cost. Since the 1980s, the concepts of convergence as homogenization (or sigma-convergence) and catching-up (or beta-convergence), and those of divergence processes (primarily through falling behind by follower regions) have been re-formulated and further developed (Abramovitz, 1986; De Long, 1988; Baumol et al., 1994). The concept of 'conditional' convergence was introduced to recognize that the per capita income gap between countries or regions may persist in the long run; however, provided the economy's starting conditions are recognized, the conditional convergence hypothesis means that living standards still tend to grow faster in poorer regions than in richer regions. An additional caveat was put by Baumol (1986), who introduced an idea of a convergence 'club', arguing that convergence may take place between some subsets of countries, e.g. a group of Western capitalist economies, centrally planned economies, or a group of mid-income developing countries.

Despite having recognized the traditional neoclassical growth model as an 'extremely simple general-equilibrium model of the economy', and with the empirical data having firmly rejected the unconditional convergence hypothesis, contemporary neoclassical theorists continue to maintain that the traditional model possesses 'considerable explanatory power for economic growth across countries and regions' (Barro and Sala-i-Martin, 2003: 47). As one young economist exclaimed 40 years ago, even 'if the distribution of wealth appears in the short run to be becoming more uneven, do not lose hope in the capitalist system. Eventually (which may be a long time), the economy may lead to an equalitarian state, by its own accord' (Stiglitz, 1969: 388). Hence, it is hardly surprising that, to most critics, neoclassical growth theories not only 'appear as sterile, unrealistic descriptions of conditions that never exist in reality', but also appear ideological, 'by reaffirming their faith in ... [a] balanced equilibrium growth [which] is the logical result of the forces of the free market' (Kregel, 1972: 86–7; see also Birch and Mykhnenko, 2010). In the last 20 years, a large number of studies have

indicated a growing gap in social and economic prosperity between the EU's advanced and less favoured regions (Amin and Tomaney, 1995; Balchin et al., 1999: chapter 2; Heidenreich, 2003; Hudson, 2003; Dunford, 2005). However, some studies found evidence of either beta- or sigma-convergence between European regional living standards (European Commission, 2007, 2008; Mykhnenko and Birch, 2009). Yet the pace of catching-up has remained extremely slow by historical standards. With one study verifying beta-convergence in the 1980s–1990s for European regions at a meagre annual rate of 1 per cent (Rombaldoni, 1998), the time needed to eliminate three-quarters of an initial gap from the steady-state position at such a speed would be about 140 years, or four human generations.

A number of new growth theories, including various export demand models, new economic geography models, increasing returns theories, Kaldorian models of agglomeration and cumulative growth processes, have provided more realistic accounts of persistent territorial imbalances on the continent (see Dunford and Smith, 2000; Harris, 2008). Dunford (2003: 844) has summarized five major sets of factors suggested by this theoretical literature as explanatory for strong centripetal tendencies that may increase developmental gaps in Europe:

Scale economies measured perhaps by average firm/plant size; the size and relative location of the market which itself depends on the distribution of footloose industries and people and on differences in expenditure structures; the strength, intensity and geography of vertical linkages between firms which depend on the share of intermediate goods in production; and [non-pecuniary] external economies. To these factors one can add the more traditional explanations in terms of factor intensities, reflecting the Heckscher-Ohlin view that places specialize in those activities that use intensively resources that are relatively abundant in that place and Ricardian views concerning the role of technologically-induced differences in productivity, although it is important to emphasize that an aim of cumulative causation models is precisely to explain the *historical creation* of resource endowments. Together these factors suggest that market-led development may strengthen core–periphery relationships.

It is widely recognized that regional economic performance not only is an expression of the aggregate production function or the competitive performance of businesses located therein, but also reflects wider structural factors. Drawing on *régulation* theory, it has been argued that regional convergence and divergence express the characteristics of development models that temporarily stabilize the crisis tendencies inherent in capitalist development (Altwater, 1993). Models of development are ‘the conjunction of an accumulation regime and a type of *régulation*’ (Boyer and Saillard, 2002: 341). The regime of accumulation is a means of value creation, ‘a dynamic compatibility between production, income distribution and the generation of demand’ (Boyer and Saillard, 2002: 44), whereas modes of regulation are ‘codifications of social relations that (1) give a contingent material expression to social conflicts, and (2) allow strategic conduct that expresses the contradictions but that transforms them into simple differences and that mediates, normalises, and regulates them’ (Dunford, 1990: 301). Accordingly, the characteristics of economic growth and the configuration of social forces that underpin them vary over time and space. In particular, the contribution of investment, exports and domestic consumption to economic growth can vary markedly:

In the first case a large share of income is invested in infrastructures or in capital goods. The dominance of domestic demand implies the distribution of a large share of national income in ways that increase the purchasing power of consumers. A leading role for exports implies that economic performance depends on the dynamism of international markets and the competitiveness on global markets of domestic output. (Dunford, 2003: 852)

Thus, it has been argued that the national variation in post-soviet economic trajectories is explained by the characteristics of development models and their associated politics (Dunford, 1988; Altwater, 1993; Drahokoupil, 2008). Moreover it is contended that subnational regional economies not only shape and in turn express those national models but also reproduce forms of international integration (Smith, 1995, 1998; Altwater, 1998).

## The politics of understanding Ukraine’s space-economy

The idea of ‘models of development’ is deployed here to expose the uneven regional development of the Ukrainian space-economy and its implications for the territorial integrity and social cohesion of the country. The identification of different models of development enables us to refute conventional arguments about the evolution of the post-soviet economy and to re-frame conventional understandings of Ukraine’s space-economy.

The conventional account of the evolution of the Ukrainian economy since independence has most recently been presented by Anders Åslund (2009), who is probably the most influential market fundamentalist in the FSU (see Woodruff, 2009). According to Åslund, on independence, the political elite concentrated on state- and nation-building, delaying market reform until late 1994, by which time the country’s economy had collapsed. Partial market reform produced a cadre of oligarchic rent-seeking traders, who were able to prevent further reform by colluding with the former communist nomenklatura politicians. By the end of the 1990s, the transitional system had been stabilized, yet the country was locked into a ‘partial reform equilibrium trap’ (see World Bank, 2002). The threat of default following the 1998 Russian economic crisis persuaded the elite of the need for further market reform under Prime Minister Viktor Yushchenko, which resulted in economic growth and Åslund’s recognition of the country as a ‘market economy’ in 2000. (It should be noted, however, that in a conference paper presented in June 1999 Åslund declared: ‘Ukraine has not had a single year of growth but a significant decline in GDP has continued every single year. Ukraine is the only country with such a poor performance. *Nor is Ukraine likely to turn to growth soon*’ – (Åslund, 1999: 1; emphasis added.) The new market economy produced a new wave of oligarchs, whose wealth was derived from the steel industry. This resulted in a competitive oligarchy, which continued until the Orange Revolution, when the country became a ‘democracy’. Whereas Åslund with hindsight has sought to advance a position in which the oligarchs are regarded as both a force for corruption and

criminality (Swain et al., 2010) and a force for modernization, most other conventional commentators have emphasized the former. They argue that the lack of separation between 'the economy' and 'the polity', between business and government, has bedevilled the country (Havrylyshyn, 2006). In this way, the conventional accounts have eroded the legitimacy of the various forms of economic development that took place prior to the Orange Revolution. Our identification of a growth model prior to the Orange Revolution is intended to legitimize economic development during that period. Not least, it emphasizes that economic development is always embedded in forms of state power, implying that state–economy relations are inexorably legitimate.

As with the economy, Ukraine's regions have also been identified as a problem, with constant references to the 'regional factor' and the associated 'Russian factor'. In particular, understandings of Ukraine regions have focused on the geography of ethnicity and language(s) spoken, of voting and other markers, such as religious and occupational affiliations, of identity. Recognition of the country's complex regional divides has resulted in a barren academic debate about the precise effect of regions per se as opposed to other aspects of the social world (for a test, see Mykhnenko, 2009) and an exercise in regionalization and region identification (Birch, 2000; O'Loughlin, 2001; Barrington and Herron, 2004; Arel, 2006; Katchanovski, 2006). Through the prism of nationality, ideology and geopolitics, the country is divided into an 'east', supposedly dominated by an anti-market nomenclatura influenced by the legacies of anti-Western Soviet ideology and the Russian Orthodox Church, and a 'west', supposedly the crucible of Ukrainian national identity and dominated by pro-reform, pro-Western and anti-establishment politics (e.g. see Nastych, 2003). More fruitfully, there has been a debate between those who argue that regional divisions are destabilizing and could possibly result in the country's fragmentation (Wilson, 1997) and those who argue that regional divisions represent a de facto form of pluralism that underpins beneficial political and economic competition (Sasse, 2001). However, despite some examination of the impact of transition on the Ukrainian space-economy (Maruniak, 2007; Swain and

Mykhnenko, 2007), the country's growing territorial economic disparities have remained largely ignored (see e.g. Heyets', 2003; Novak, 2007; Khomiakov and Bakum, 2008).

These conventional understandings of the economy and the country's regions have concealed as much as they have revealed, whereas the introduction of the idea of models of development makes Ukraine's space-economy intelligible in a new way. The continuity in territorial administration and statistical collection since the onset of the post-communist transformation permits a long-term evaluation of the impact of the collapse of the Soviet system on Ukraine's space-economy using time-series and panel data. In the remainder of the paper we examine the regional development impacts of the expansionary period between 1999 and 2008. This is based on comparative statistical analysis of Ukraine's 27 standard statistical regions (comprising 24 *oblasti*, 1 autonomous province, and 2 special status cities) equivalent to the European Nomenclature of Territorial Units for Statistics Level 2 (NUTS-2 regions). Data are primarily drawn from the 'Regions of Ukraine' data set of Derzhkomstat (the State Statistics Committee of Ukraine) and its Ukraine statistical yearbooks for various years. Following the well-established Eurostat convention, we use the current names of the Ukrainian regions in their original transliteration.

## Uneven development in post-Soviet Ukraine

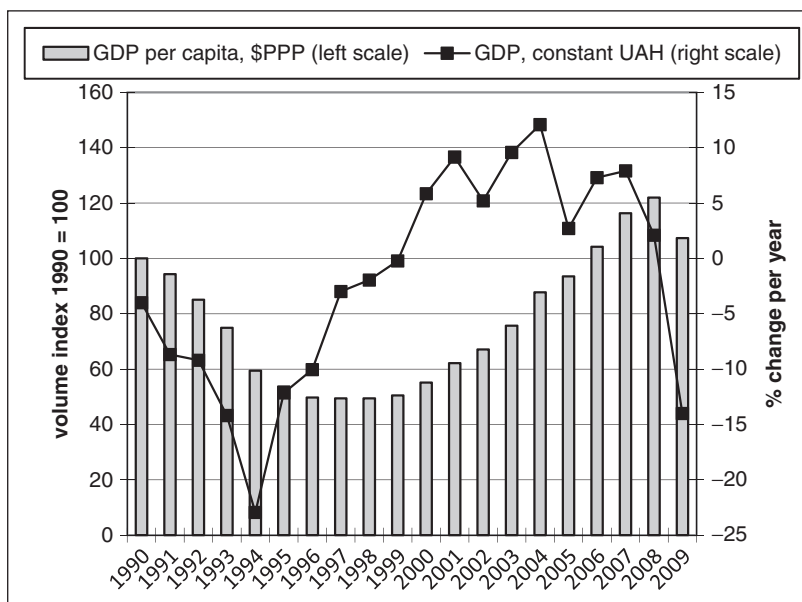
In this section we examine comparative regional economic performance since 1990 and, in particular, during the growth phase beginning in 1999. The analysis shows that, in contrast with other parts of the USSR (Dmitrieva, 1996), Ukraine inherited significant regional imbalances from the Soviet era, which were exacerbated after independence. Moreover, growth was driven primarily by productivity gains, although these were uneven between different sectors. This challenges conventional explanations that typically attribute Ukraine's economic growth primarily to rent-seeking, asset-stripping and the re-commissioning of previously idle or underutilized assets (Åslund,

2001; Berengaut et al., 2002). Nonetheless, Ukraine's recovery after the 'great transitional depression' reinforced historically rooted and relatively geographically bounded regional economies that are increasingly functionally integrated yet externally orientated.

The disintegration of the Soviet Union and Ukrainian independence resulted in a profound depression in the economy beginning in 1990 and lasting until the mid-1990s. After Leonid Kuchma's election to the presidency in late 1994 and the subsequent introduction of a macroeconomic stabilization package, the rate of decline decelerated (Figure 1). In the 1990s, the economy measured by real GDP (constant prices in Ukrainian hryvnia, UAH) shrank by 59 percent. At the end of 1999, the economy returned to positive growth, which lasted until 2009. Overall, in the 2000s, Ukraine enjoyed an annual economic growth rate of 5.6 percent, registering a 9.0 percent growth rate p.a. between the nadir point of 1999 and the peak of 2008. Nonetheless, even before the beginning of recession in late 2008, real output remained below the pre-transition period level. The post-Soviet depression resulted in a

continuous decline in Ukraine's population, thus boosting per capita income levels. The trajectory of Ukraine's GDP per capita in purchasing power parity (international dollars) is more positive: it shows that the 1990 level was surpassed in 2006 and remained above it even after the recession of 2009.

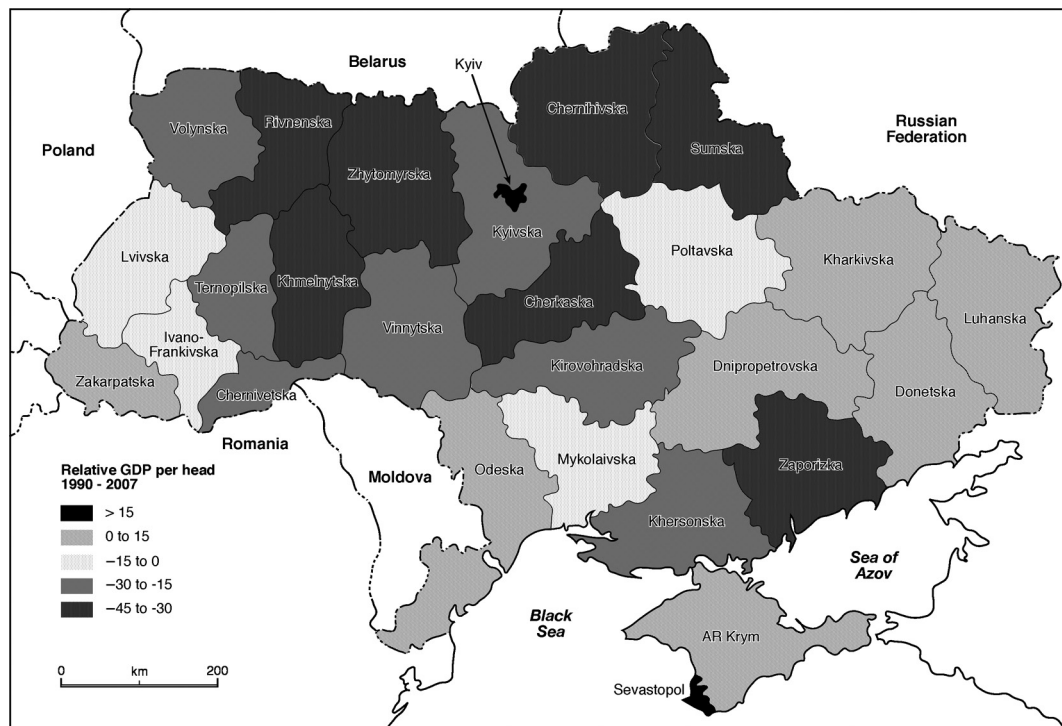
The collapse of the integrated Soviet national economy and the resultant disorganization, reallocation and restructuring (Blanchard, 1997) had an uneven impact on the space-economy of Ukraine (Figure 2). The regional pattern of income change between 1990 and 2007 shows that economic collapse was most pronounced in the centre and west of the country. Whereas one-third of Ukraine's regions gained relative to the national average, two-thirds lost. The biggest losers were the two adjacent central Ukrainian regions of Chernihivska and Sumska. Broadly, central Ukraine, lacking industry and cross-border activities, experienced the largest relative decline under post-communism. The east and south performed better, but Kyiv was the biggest gainer in terms of percentage point change (+168 percent), while Sevastopol and AR Krym were the biggest gainers by rank.



**Figure 1.** Ukraine's post-communist income and output change trajectories, 1990–2009

Note: 2009 is an estimate.

Source: Derived from IMF (2009) and World Bank (2009).



**Figure 2.** Percentage point change in relative GDP per head, 1990–2007 (Ukraine = 100)

Source: Elaborated from World Bank (2003), Derzhkomstat (various years) and Derzhkomstat 'Regions of Ukraine' data set.

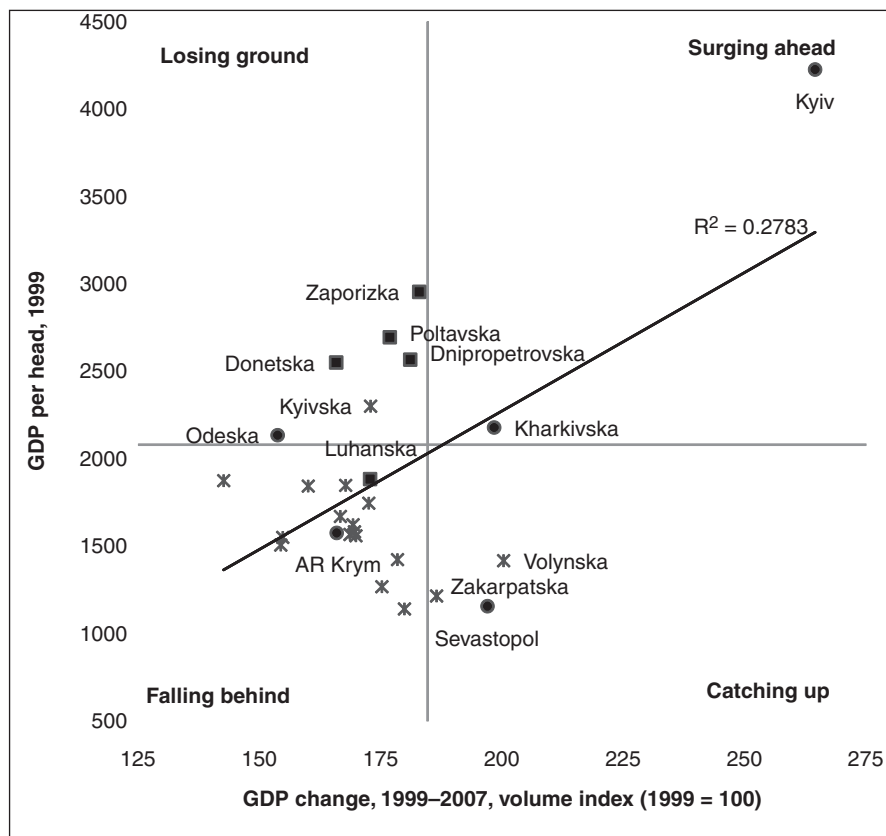
Regional divergence rather than 'catch-up' growth was the major outcome of the recovery period, which refutes the neoclassical convergence hypothesis (Figure 3). Following Dunford and Greco (2006), a scatter-plot correlation between regional GDP per head at the onset of economic growth and the respective regional growth rates during the expansion of 1999–2007 groups Ukraine's regions into four categories: surging ahead regions (in which GDP per capita and growth rates are both above the national average), catching-up regions (with lower-than-average GDP per head but higher-than-average growth rates), losing ground regions (with GDP per capita higher than the national average but with a growth rate lower than the national average), and, finally, falling behind regions, which are lower on both GDP per head and growth rates. Centripetal mechanisms played the dominant role during this period, with just 3 out of 27 territories catching up, 6

regions losing ground, and 16 regions, mostly in the west and centre of the country, falling behind. Regional *divergence* was driven by market consumer services and finance and business services concentrated in Kyiv and Kharkivska, as well as by industrial sectors in the east of the country. Kyiv's exceptional performance was partly a function of its capital city status and the concentration of public and private sector management functions. The reconstruction of territorial production complexes through newly formed, regionally based and vertically integrated companies in the east of the country preserved the relatively higher value-added industrial economic activities (Zimmer, 2004; Swain, 2007; Kuromiya, 2008). Strong centripetal tendencies meant the country's prosperity was increasingly dependent on two large, fast-growing, diversified metropolitan economies, and four large, slow-growing specialized industrial economies (Figure 4).

The capital region (Kyiv plus Kyivska) contributed 22.5 percent of national output and, together with the four eastern regions of Donetska (12.8 percent), Dnipropetrovska (9.9 percent), Kharkhivska (6.1 percent) and Zaporizka (4.6 percent), comprised well over a half of Ukraine's space-economy. By contrast, 16 central, southern and western regions contributed less than a quarter of total output.

Economic *growth* was predominantly driven by finance- and credit-fuelled consumption in the country's two largest cities, by the two western-most border regions of Volynska and Zakarpatska, and by the city of Sevastopol, the home base of the Ukrainian navy as well as the Russian Black Sea

fleet. Growth in Sevastopol is partly explained by the re-designation of previously military economic activities as civilian (Figure 3). Economic growth in Zakarpatska is explained by the recent integration of its clothing industry into the pan-European outward processing model of production (Kalantarides et al., 2003, 2008; Smith et al., 2008). The region has also benefited from close links to politicians and officials since the late 1990s who lobbied on behalf of the region (Matsuzato, 2002). However, trans-border petty trading and labour flows affecting western Ukraine have retarded long-term regional development (Williams and Baláz, 2002).

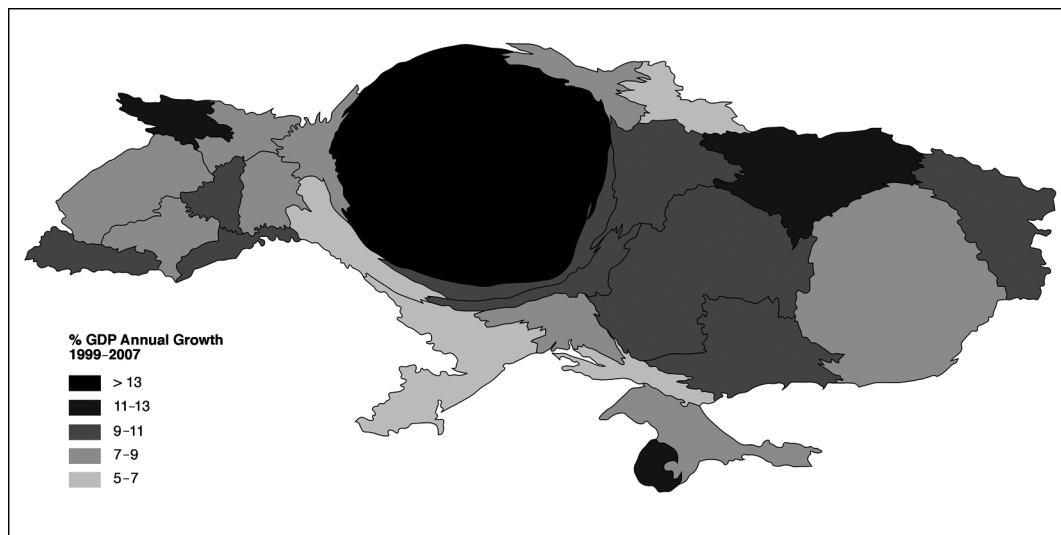


**Figure 3.** Regions with different levels of GDP per head in 1999 and GDP growth in 1999–2007

Legend: cross = agriculture-oriented regions, circle = service-oriented regions, square = industry-oriented regions.

Note: Grid lines represent the Ukraine average figures. Regions are classified as either agriculture-oriented regions, service-oriented regions or industry-oriented regions on the basis of their respective location quotients.

Source: Elaborated from Derzhkomstat 'Regions of Ukraine' data set.



**Figure 4.** Ukraine's territorial GDP distribution (as percent of total), 2007, and regional GDP growth trajectories (annualized percentage change), 1999–2007

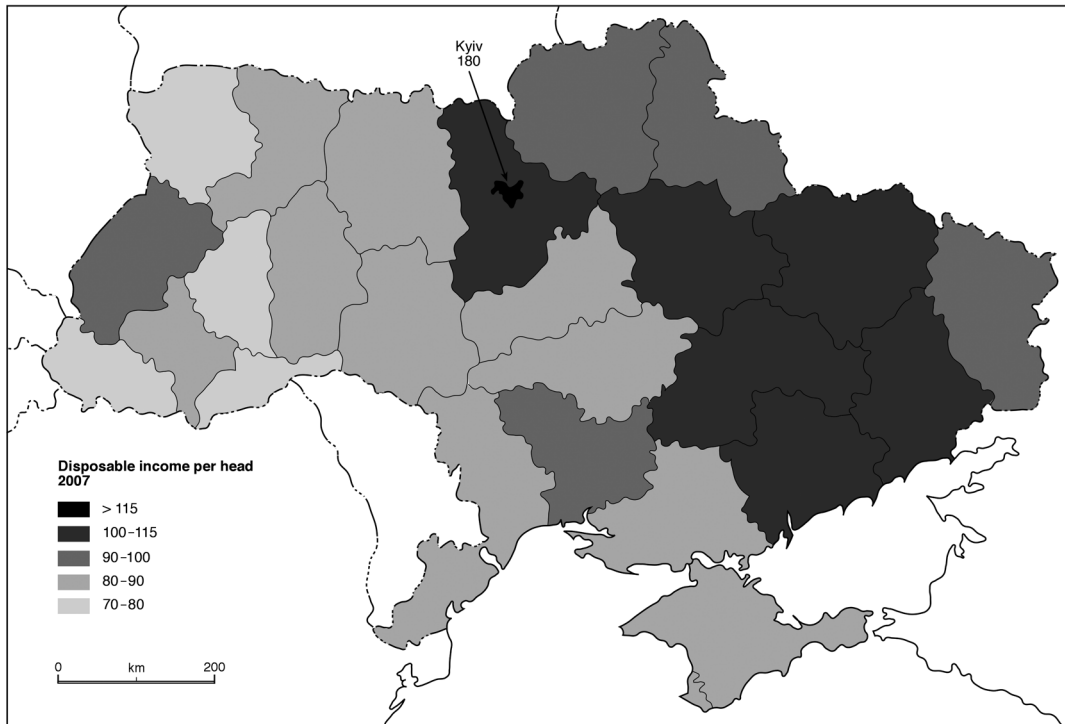
Note: In this contiguous cartogram the geographical size of each region is proportionate to the region's contribution to the national GDP. The regional economies of Kyiv (18.9 percent of Ukraine's total) and Kyivska (3.6 percent) are combined because the city is entirely surrounded by a territorially larger yet economically smaller region, meaning it was technically impossible to map the two regional economies separately.

Source: Elaborated from Derzhkomstat 'Regions of Ukraine' data set.

Economic growth between 1999 and 2008 was accompanied by a significant yet uneven decline, on average by 5 percentage points, in unemployment. The unemployment rate, as defined by the International Labour Organization (labour force survey-based), halved and fell in every region during the expansionary period. However, even in 2007 Ukraine's unemployment rate stood at a relatively high 6.4 percent, ranging from 9 percent in Rivnenska to 3.1 percent in Kyiv (data derived from Derzhkomstat). The largest reduction occurred in Sevastopol, dropping from 16.6 percent to 3.3 percent, owing to its expanding urban economy, while the smallest reduction took place in Volynska, from 8.9 percent to 8.1 percent. Here, even though Volynska was the second-fastest-growing region in the country in terms of output, the agricultural sector did not generate sufficient employment opportunities. Moreover, the jobs in agriculturally oriented economies were much lower paid than the jobs in industrially oriented regions and the adjacent metropolitan economies (Figure 5). Seven contiguous, out-performing regional economies that underpinned the growth in domestic consumption included four

regions (Donetska, Dnipropetrovska, Poltavska and Zaporizka) that were involved in exporting industrial goods, earning foreign currency and driving recovery. In contrast, growth in Kyiv capital region and in Kharkivska was primarily driven by inward investment in services and the government sector.

Ukraine's uneven and combined regional development between 1999 and 2008 is explained by the changes in productivity and employment, the performance of individual sectors and the spatial division of labour. Increases in productivity rather than expansion of the labour force underpinned economic growth (Figure 6). Thus Ukraine's growth was driven by the intensification of the economy, rather than by rent-seeking, asset-stripping and the re-commissioning of underutilized equipment. Labour productivity increased in all 27 regions, and especially strongly in Kyiv, Volynska, Kharkivska and Dnipropetrovska, where the increase was above the national average between 1999 and 2007. The overwhelming majority of regions experienced a job-rich recovery; however, in some regions increased productivity was the result of labour shedding.

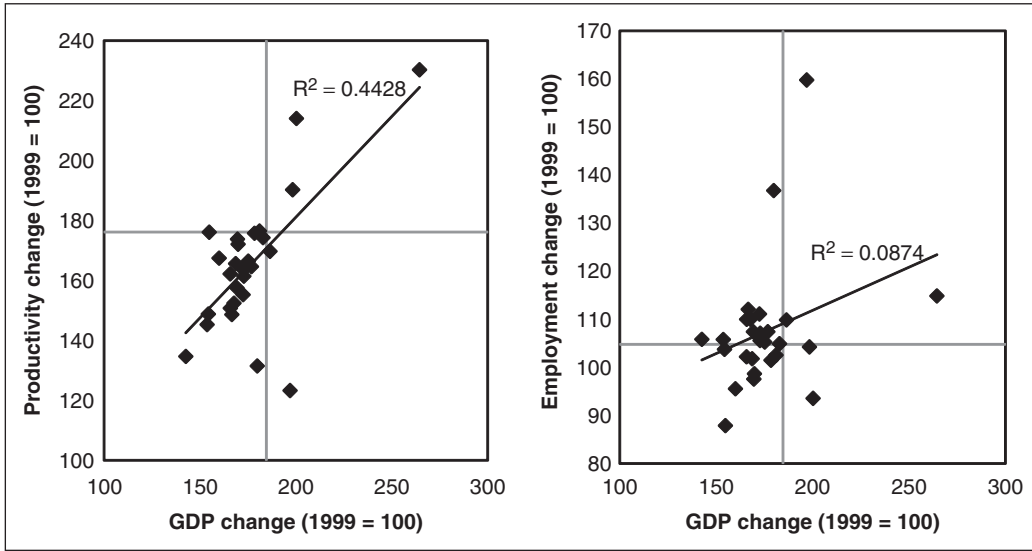


**Figure 5.** Disposable income per head, 2007 (Ukraine = 100)

Source: Elaborated from Derzhkomstat 'Regions of Ukraine' data set.

Productivity and employment trends were different across the sectors of the economy. Output in all branches of the economy, with the exception of fishing, grew between 2001 and 2006. Seven 'high-growth' sectors, in particular market services and manufacturing, expanded faster, thereby driving economic recovery, whereas eight 'low-growth' branches, dominated by agriculture and public sector activities, lagged the economy as a whole (the latest comparable data available in Figure 7). Regional sector specialization explains comparative economic performance. This reinforced and even intensified the highly fragmented space-economy inherited from Imperial and Soviet rounds of industrialization (on similar developments in Slovakia, see Smith, 1995). Gross Value Added (GVA) location quotients of different sectors reveal three types of regional economies: rural agriculture-oriented economies in the west, centre and south of the country; specialized, industrial economies in the east; and five islands of service-oriented economies. Within the

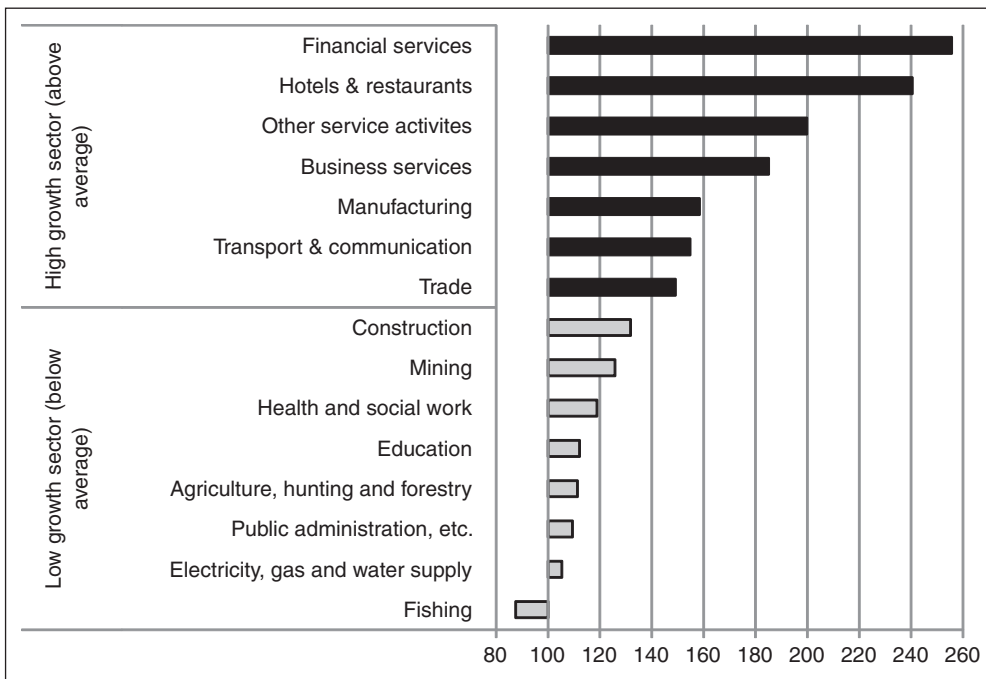
services category, a further distinction exists between two regions that are oriented towards market consumer and finance and business services (Kyiv and Kharkivska) and the three remaining southern regions, specializing in transport and public social services. Although Ukraine inherited a highly unbalanced space-economy, the evolution of these three types of region has increased regional imbalances still further (Figure 8). During the transitional depression, the degree of regional imbalances in Ukraine fell as all regions were affected by the downturn. As the economy bottomed-out and then began to rebound, the geographical concentration of economic activities began to increase. As industrial and market services-based regions recovered earlier and more rapidly than the rural agriculture-oriented regions, regional imbalances dramatically accelerated. In comparison with other European countries, by the mid-2000s the level of economic divergence in Ukraine had become the highest on the continent, followed by Latvia, Estonia, Hungary and Slovakia.



**Figure 6.** Impact of labour productivity and employment on growth: GDP, labour productivity and employment changes, volume index, 1999–2007 (1999 = 100)

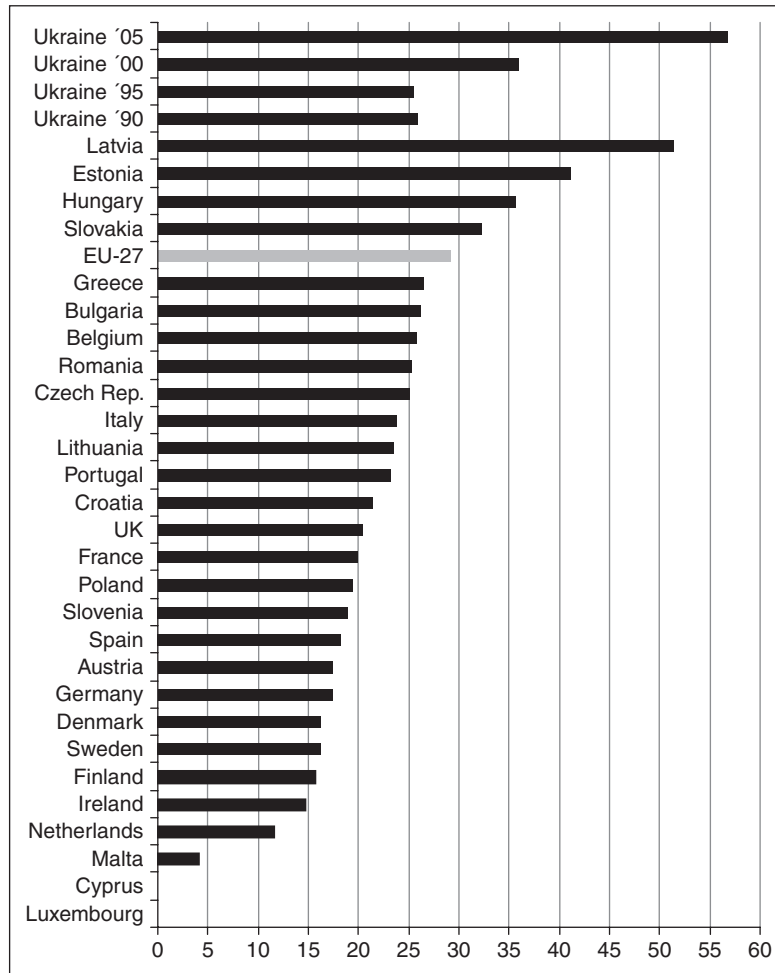
Note: Grid lines represent the Ukraine average figures.

Source: Elaborated from Derzhkomstat 'Regions of Ukraine' data set.



**Figure 7.** Ukraine's growth sectors, output change, volume index, 2001–6 (2001 = 100)

Source: Elaborated from Derzhkomstat 'Regions of Ukraine' data set.



**Figure 8.** Dispersion of regional GDP per inhabitant in Ukraine, 1990–2005, and across Europe in 2005 (percent of national GDP)

Notes: 0 = complete dispersion based on weighted coefficient of variation. NUTS-2 regions, except for NUTS-3 regions in Cyprus, Estonia, Latvia, Lithuania, Luxembourg and Malta.

Source: Derived from Eurostat (2009) and elaborated from World Bank (2003), Derzhkomstat (various years), and Derzhkomstat 'Regions of Ukraine' data set.

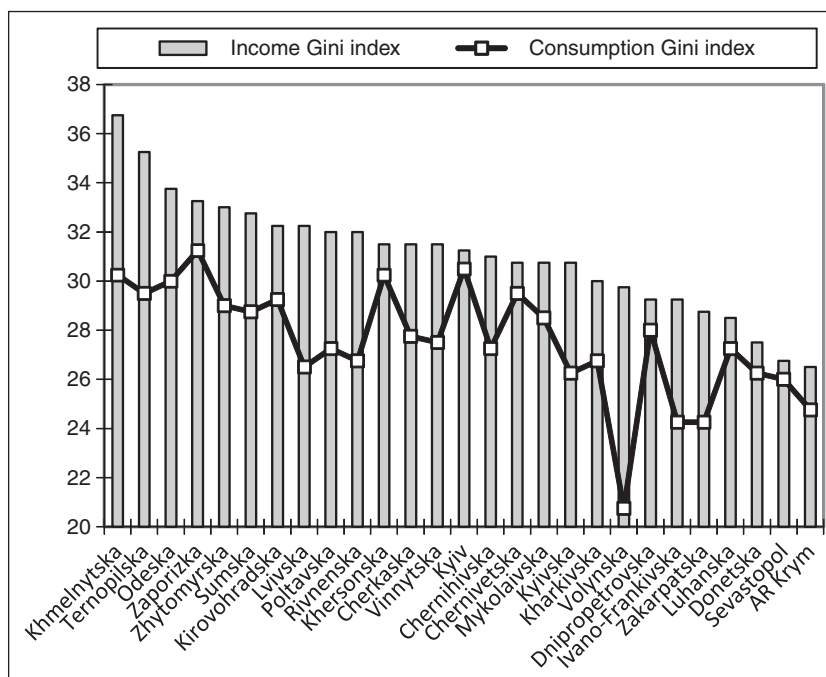
Ukraine's individual income and consumption distribution patterns – its *intra*-regional disparities – were not much higher than the corresponding continental European indicators. Prosperous regions that relied on industrial and services activities had the lowest levels of income and consumption inequalities. In agriculture-oriented regions, there was a discrepancy between income and consumption Gini

coefficients (Figure 9). This suggests that these economies exhibited a high degree of non-monetary consumption, primarily through self-provisioning of food items in rural areas, and reliance on the shadow economy and on unrecorded workers' remittances (see Williams et al., 2001; Williams and Baláz, 2002). Social transfers from richer towards poorer regions also contributed to the observed discrepancy

between income and consumption inequalities in the latter regions (Figure 10). In 2007, all of the agriculture-oriented regions and those that specialized in public services and transport depended on income transfers (including pensions, stipends, living allowances, in-kind assistance, and social security benefits). The state thus played a bridging role between the relatively self-contained regional economies and maintaining territorial cohesion. It compensated for the increasingly divergent performance of the three types of regional economy by transferring income away from the seven contiguous out-performing regions, stretching from Kyiv to the Sea of Azov.

In summary, agriculture-oriented regions exhibited low levels of productivity, persistently high levels of unemployment, slow economic growth, very low levels of disposable income, high levels of unreported economic activities, a highly uneven pattern of individual income distribution, and reliance on central

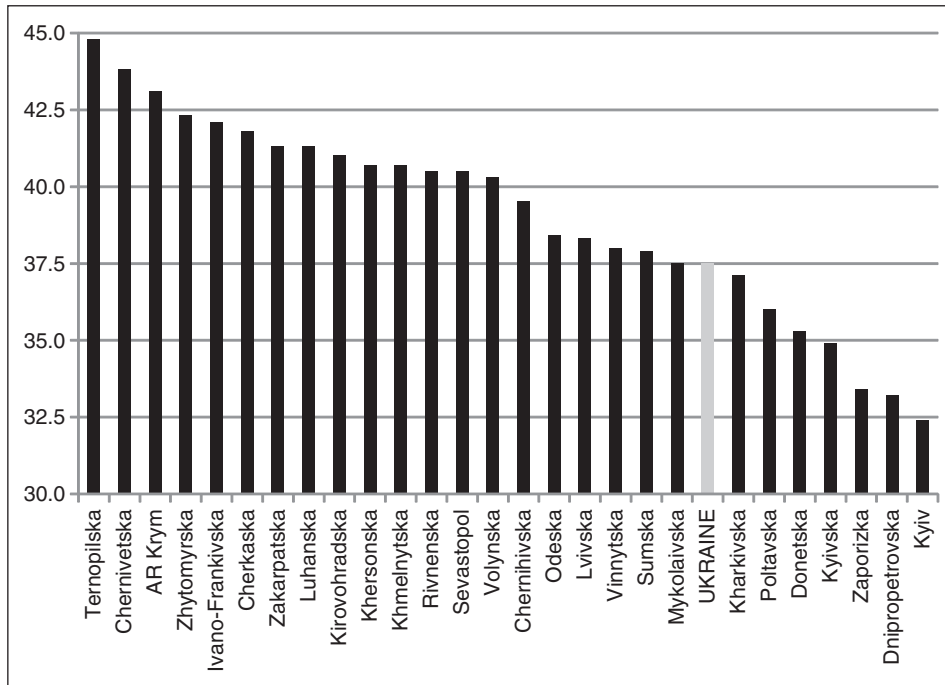
government transfers (Figure 11). Industry-oriented regions exhibited higher levels of productivity, higher levels of employment, historically low levels of unemployment, high disposable income, a smaller shadow economy, moderate economic growth, and relative equality of household income distribution. They were also net income contributors to the rural agricultural regions. Finally, service-oriented regions were characterized by rapid economic growth, very low unemployment, high job growth, relatively equal distribution of household income, and low levels of unreported economic activities. Within this category, producer and consumer market services-oriented economies exhibited the highest productivity growth and the highest disposable income levels; they were also net contributors to the public redistribution of income. Social and transport service economies were characterized by very low productivity growth, below-average disposable income levels, and dependence on government transfers.



**Figure 9.** Income and consumption distribution patterns, 2001–4 (average Gini index, percent)

Note: 0 = perfect equality.

Source: Derived from Derzhkomstat 'Regions of Ukraine' data set.



**Figure 10.** Current social transfers as a proportion of total regional income, 2007 (percent)

Source: Derived from Derzhkomstat 'Regions of Ukraine' data set.

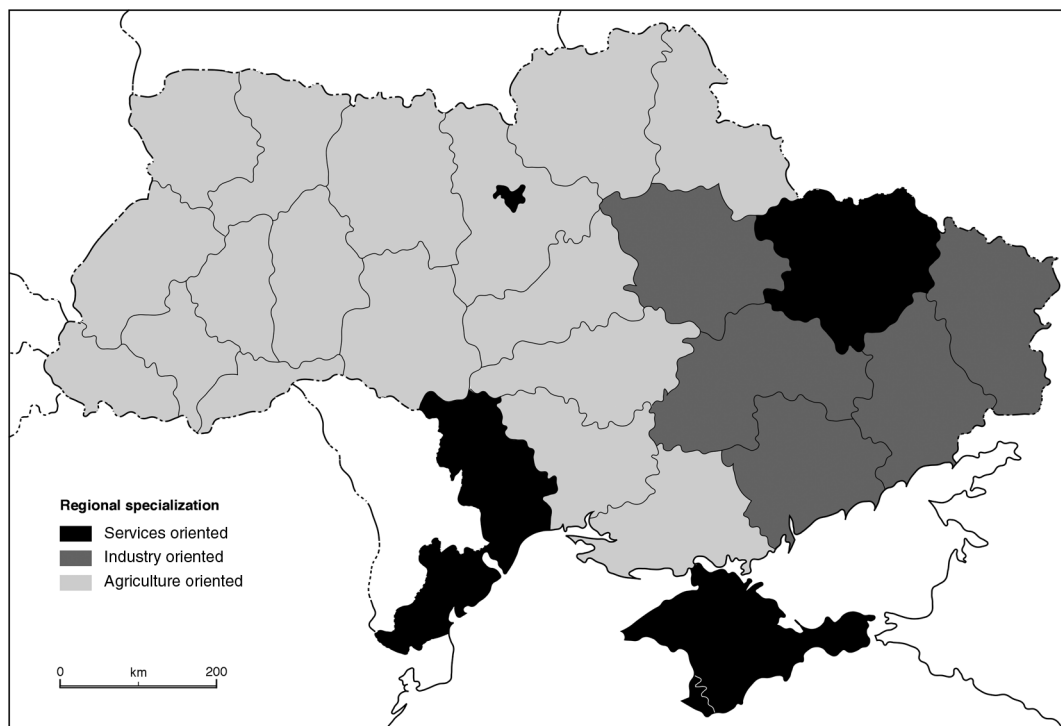
## Ukraine's development model: from national capitalism to financialization

Regional divergence increased following the Orange Revolution in late 2004, revealing that the relative performance of the three types of regional economy was closely related to the national model of development and in particular to political projects and forms of state power (Figure 12). From 1999, when growth commenced, until the Orange Revolution, Ukraine's development model comprised a particular combination of economic and political strategies that has been termed *Kuchmanomics* after the then president, Leonid Kuchma. Following the Orange Revolution, when Viktor Yushchenko was elected president, there was a fundamental shift towards a finance-led development model, which culminated in the financial and economic crisis that reached Ukraine in the late summer of 2008 (Smith and Swain, 2010). Whereas service sector regions expanded after 2004,

industry-oriented regions lost ground and agricultural regions fell further behind. Amongst them, the rate slowed at which the three best-performing agricultural regions were catching up (Figure 12).

### *Kuchmanomics: national capitalism and a weak developmental state*

Several factors underpinned the rapid economic growth from 1999 until the Orange Revolution. President Kuchma's state strategy was intended to create a cluster of large national industrial capitalists and not, in Kuchma's own words, 'a nation of petty shopsters'. *Kuchmanomics* involved maintaining a highly competitive and stable exchange rate to the dollar (around UAH5.36 per US\$ over 2000–4), which was accompanied by a decline in interest rates (from 44 percent p.a. in 1999 to 8 percent in 2003) and a fall in inflation (from 19.2 to



**Figure 11.** Threefold typology of Ukraine's space-economy, 2006

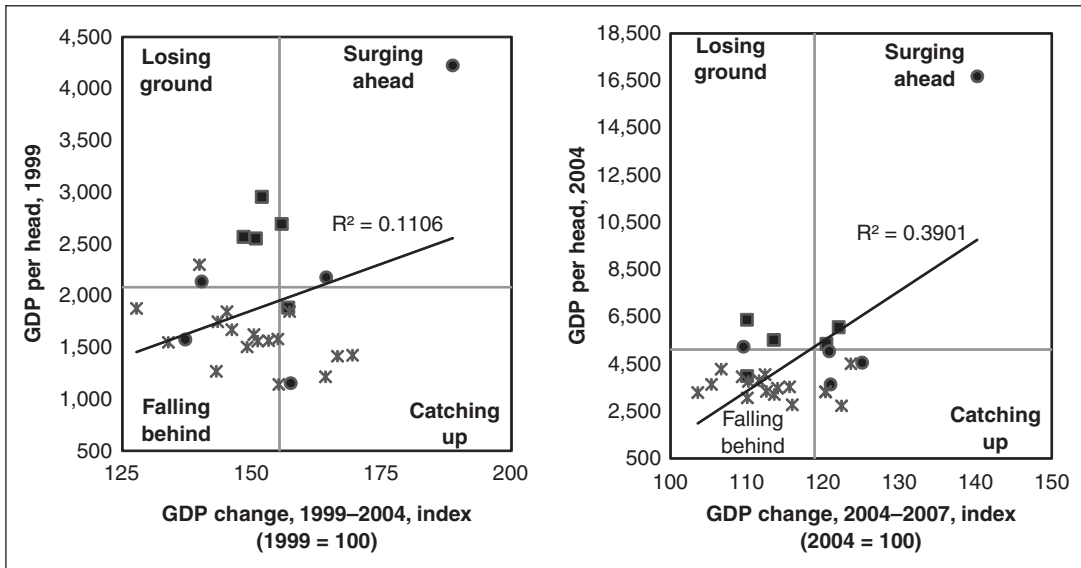
*Note:* Agriculture includes agriculture, forestry, hunting and fishing; industry includes mining and quarrying, manufacturing, electricity, gas and water supply and construction; market consumer services include wholesale, retail trade and repair, hotels and restaurants, and other personal and community services; services include financial intermediation, business, real estate, and R&D services; public services include public administration, education, and health and social care.

*Source:* Elaborated from Derzhkomstat 'Regions of Ukraine' data set. The GVA location quotient data are available from the authors upon request.

8.2 percent). The stable macroeconomic regime was characterized by relatively balanced government budgets and low, and declining, total gross external debt (30.1 percent of GDP in 2003). This encouraged household savings, which were recycled through domestically owned banks to the corporate sector (insofar as the corporate sector engaged in commercial borrowing). Before the arrival of foreign banks in around 2003, foreign debt fell, in part because World Bank and IMF loans dating from the 1990s were repaid. State-owned industrial assets were privatized to domestically owned business groups, which were encouraged to pursue geographically diversified export-led corporate strategies (Paskhaver and Verkhovodova, 2007; Pleines, 2008). The success of this strategy was proclaimed by the chairman of the State Property Fund in 2003:

Five [financial-industrial] players have emerged on Ukraine's business field. The five players have not only reached the level of Masters but also of International Grand Masters. We would like the rest to catch-up with them. We should also not allow foreign penetration into strategic sectors [as] foreign penetration could threaten the state's national economic interests. (*Ukrains'ka Pravda*, 26 December 2003)

This export-led model depended on iron, steel and metal products, which benefited from cheap energy inputs provided by the state-owned coal industry (Swain, 2006) and Russian gas, priced at US\$50 per thousand metric cubic metres (mcm) in 1999–2004 (Pirani, 2007). This resulted in the development of a private equity economy in which the capitalization of the main stock market remained low, reaching only 7.4 percent of GDP by the end of 2003. There was also a



**Figure 12.** Ukraine's uneven expansion: GDP per head and GDP growth, 1999–2004 and 2004–7

Legend: cross = agriculture-oriented regions, circle = service-oriented regions, square = industry-oriented regions.

Note: Grid lines represent the Ukraine average figures. Regions are classified as agriculture-oriented, service-oriented or industry-oriented on the basis of their respective location quotients.

Source: Elaborated from Derzhkomstat 'Regions of Ukraine' data set.

relatively low level of foreign direct investment (FDI) stock, which stood at US\$1.7 billion in 2004. The growth in exports meant that in 2000 the trade balance became positive, peaking in 2004 at US\$3.7 billion. The current account balance (which includes all capital flows in and out of the country) remained positive until 2005. The development model was maintained politically through a semi-presidential system of government in which the president used a form of corporatism to broker between rival regionally based business groups and deployed machine politics to co-opt their local political associates (Kubicek, 2000; Matsuzato, 2001; Zimmer, 2006; D'Anieri, 2007). The emergence of dissident oligarchs as Kuchma's term in office came to an end resulted in a highly competitive 2004 presidential election. This led the incumbent prime minister – who was Kuchma's favoured successor – to increase spending and cut taxes to build electoral support, which resulted in a budget deficit of –4.4 percent of GDP in the election year. In summary, by the mid-2000s Kuchmanomics had emerged as a coherent model of development arranged around a coordinated market economy (Table 1).

### *Orangeism: financialization and a weak competition state*

Although economic growth continued, the election of President Yushchenko in December 2004 resulted in the dismantling of the existing development model and its replacement with a financialized growth regime. Ukraine's largest integrated steel works, which had been privatized to a consortium of the country's largest industrialists in June 2004, was re-nationalized and subsequently re-privatized to AcelorMittal. This contributed to increasing the country's stock of FDI from US\$1.7 billion in 2004 to US\$7.8 billion in 2005 (cumulative FDI reached US\$10 billion by 2008). The revenue from this privatization, combined with higher tax receipts, funded large increases in public spending (from 32.4 percent of GDP in 1999 to 43.7 percent in 2007), primarily in the form of raised minimum wages, pensions and social transfers. Although this was achieved at the same time as maintaining a low budget deficit (–1.9 percent of GDP on average over 2005–7), real wage growth (about 17 percent annually

**Table 1.** Major characteristics of successive growth models in Ukraine, 1999–2008

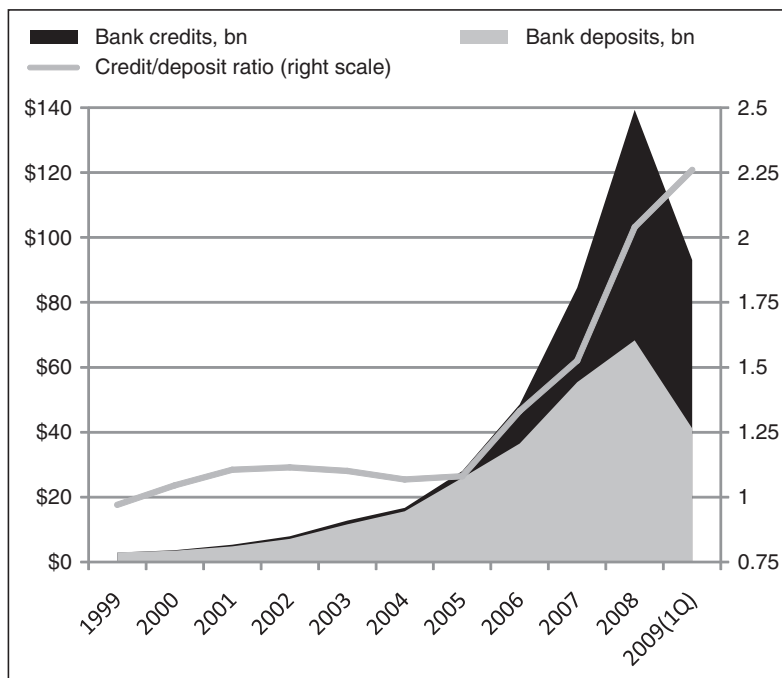
Institutional forms	Kuchmanomics (1999–2004)	Orangeism (2005–8)
Growth regime	Export-led national capitalism	Finance led, increasingly transnational
Wage–labour nexus	Coordinated/regulated labour market combined with internal bureaucratic flexibility	Towards external market flexibility
Form of competition	By commodity market prices	Increasingly on financial markets
Monetary regime	Targeted towards price and exchange rate stability	Oriented towards domestic consumption
State–society relations	Mercantilism combined with weak developmental state	Proactive and market-enhancing state combined with populism
Insertion into international regime	Rise of the Brazil, Russia, India, China (BRIC) economies	Globalization of financial system
Coherence and dynamic of the growth regime	Strong exposure to external disturbances	Risk of systemic financial instability

Source: Inspired by Boyer (2000) and Mykhnenko (2007a, 2007b).

over 2005–7) continued to outpace GDP growth, contributing to double-digit inflation, which peaked at 22.3 percent in 2008.

The Orange development model depended on importing capital not only as FDI but also primarily through the European banking system, and to a lesser extent through remittances (which increased from US\$411 million in 2004 to US\$4,503 billion in 2007). From 2005 onwards there was significant growth in financial intermediation and the commercial banking sector (including both corporate and retail banking) (see Figure 13). This established Kyiv and Kharkivska as financial centres that attracted domestic capital flows from other regions. This was encouraged by the central bank, which adopted a loose pro-cyclical monetary policy, effectively setting negative interest rates from January 2005 until October 2008. In dollar terms, commercial bank credit grew from US\$17 billion in 2004 to US\$139 billion in 2008 (the corresponding figure for 1999 was US\$2.9 billion). Moreover, although bank deposits also increased, they did not keep pace with the growth of lending, with the result that the ratio of bank credits to bank deposits deteriorated from 0.96 in 1999 (i.e. deposits were slightly higher than credits) to 2.26 in 2009 (i.e. credits were 2.3 times higher than deposits). Foreign investment underpinned the growth of the banking sector. By April 2009, seven of the ten largest banks measured by assets were foreign

owned, comprising two Austrian banks (Raiffeisen Bank Aval and Ukrsotsbank/UniCredit Bank), two Russian banks (Vneshekonombank and Alfa-Bank), a French bank (Ukrasybbank/BNP Paribas), a Hungarian bank (OTP) and a Cyprus offshore-registered bank (Nadra) (NBU, 2009). In less than five years, foreign-owned banks managed to capture 51.1 percent of Ukraine's total banking assets, and the share of state-owned banks remained well below one-eighth of banking assets (EBRD, 2009). To arbitrage interest rates, foreign banks engaged in intra-company capital transfers from their headquarters to their Ukrainian subsidiaries and borrowed capital on the wholesale money markets. The growth in externally sourced credit creation, primarily through the foreign banks, increased gross external debt from 47 percent to 57 percent as a share of GDP between 2004 and 2008, with the private share of foreign debt growing from 27 percent to 47 percent as a share of GDP in the same period. Combined, these financial flows transformed the current account balance from a surplus of 10.6 percent of GDP in 2004 to a deficit of 7.2 percent in 2008. The importation of capital generated an asset price bubble; the capitalization of the stock market as a percentage of GDP increased over nine times, from 8.6 percent to 78.3 percent between 2003 and 2007. This increased consumer price inflation from 10.3 percent p.a. in 2005 to 22.3 percent p.a. in 2008. To counter this negative



**Figure 13.** Commercial banking sector: total (US\$ billion) and bank credit to deposit ratio, 1999–2009

Note: The UAH/US\$ currency exchange rate used is the annualized average NBU official rate.

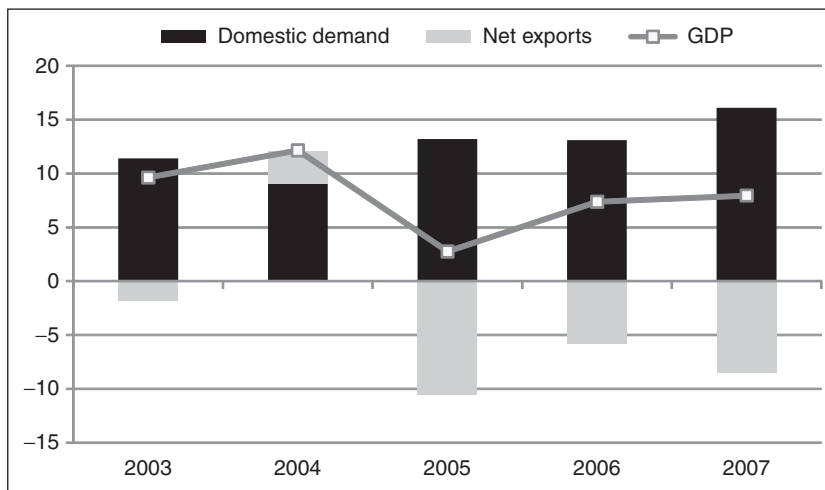
Source: Elaborated from Derzhkomstat (various years) and NBU (2009).

development, the central bank allowed the hryvnia to appreciate against the dollar by 10 percent, from UAH5.32 in 2004 to UAH4.84 in July 2008.

The growth of credit and the appreciation of the national currency encouraged imports, which transformed the trade balance from a surplus of US\$3.7 billion in 2004 to a deficit of US\$14.5 billion in 2008. This also affected Ukraine's foreign trade with its two main trading bloc partners, the Commonwealth of Independent States and the EU27, which approximately accounted for 90 percent of the country's total foreign trade turnover. While CIS imports declined dramatically from 2004, imports from the EU27 continued to increase. The decrease in the share of CIS imports was more remarkable considering the increase during this period in the price of gas, from around US\$50 per thousand mcm to almost US\$180 (Pirani, 2007). With respect to exports, after 2004 there was a reorientation away from the EU27 to the CIS. Hence Ukraine had been turned into a

market for West European producers, while exporting primarily to the CIS, especially Russia.

The change in the development model, and in particular the explosion of credit, was reflected in the sources of economic growth (Figure 14). The relative contribution of both private and public consumption to GDP growth increased during this period, while the previously positive contribution of net exports was reversed; this in turn reduced the rate of growth after 2004. Paradoxically, the Orange model was politically maintained through a divided and weak state apparatus. Constitutional change introduced following the Orange Revolution divided responsibility for macroeconomic policy-making between the central bank, with responsibility for monetary policy (and whose head was selected by the president), and the government, with responsibility for fiscal policy, which had to command a parliamentary majority. Although both the president and the government sought to harness the political dividends of a



**Figure 14.** Composition of GDP growth by final use category, 2003–7 (percent per year)

Source: Derived from IMF (2007, 2008).

consumer boom, neither wished to be identified with restraining policies. The president used control of the central bank to maintain an exchange rate favourable for domestic business groups while the populist government, which faced perennial electoral jeopardy, adopted a loose fiscal policy. As a result, the level of dependence of the population on the welfare state was steadily increasing. After the Orange Revolution, the share of current social transfers in average disposable income increased to 43.1 percent in 2009, compared with 34.9 percent in 2000.

## Conclusions

Ukraine's divergent space-economy contradicts the neoclassical model of spatial convergence (see also Harris, 2008). However, there are a series of regional development drivers that can explain regional divergence and its relationship to prevailing models of development. The predominance of centripetal over centrifugal drivers of regional development explains the persistence and divergence of the country's space-economy. The contemporary Ukrainian space-economy is best understood as comprising a series of historically rooted and relatively geographically bounded *regional* economies – what might be termed

subnational modes of regulation (see Peck and Tickell, 1992; Jonas, 1996). These regional economies are functionally integrated yet externally oriented: they exhibit a degree of sector and/or commodity chain specialization and depend on either exporting commodities and manufactures or importing external capital. Indeed, it would appear that post-Soviet economic development promoted even greater regional specialization (Šabić, 2004; Lyakh, 2007).

Cumulative causation, which emphasizes the path-dependent and self-perpetuating qualities of economic growth, explains the persistence of these regional economies and especially of the industrially oriented regions. Whereas marketization eroded most industrial regions elsewhere in CEE (Smith, 1995; Birch and Mykhnenko, 2009), in Ukraine these regions have proved resilient and have underpinned the national economy. It is clear that the recycling of export revenue to fund increased consumption within these regions generated economic growth. Cumulative processes also explain the rapid growth of the market consumer and finance and business services-oriented regional economies. Previously repressed demand for capital to fund investment and consumption resulted in the attraction of flows of capital from savers in the richer industrial regions in the east of the country as well as from abroad.

Although cumulative causation explains the persistence of these distinctive types of regional economy, other centripetal forces particularly related to scale economies and market access explain their divergence (on 'new economic geography' models, see Dunford, 2003). The geographical concentration of industrial activities reflects scale economies (i.e. increasing returns to scale at the level of the plant and further agglomeration through the establishment of new plants) consequent on the large size of export markets, as well as the existence of local supplies of coal, iron ore and other inputs, and access to competitive rail and sea transport infrastructures. Equally, the clustering and agglomeration of market consumer and finance and business services sectors found in the two largest cities, Kyiv and Kharkiv, can be explained by a series of beneficial non-pecuniary external economies and localized knowledge interactions (Lewis et al., 2002; Crescenzi et al., 2007). Moreover, as found elsewhere, the emergence of national capital markets reinforced the notoriously strong centripetal tendency for savings capital to be sucked into the core region from all the other regions (Bayoumi and Rose, 1993; Martin and Minns, 1995). The increased mobility of labour has further augmented the process of agglomeration and concentration of highly paid service employment in established core cities (Turok and Mykhnenko, 2008: 55–6).

However, these drivers of regional development cannot in themselves explain the increase in regional divergence following the Orange Revolution. National and regional growth trajectories depended on the characteristics of the country's underlying development model. The two successive national development models favoured different types of regional economy. Kuchmanomics promoted industrial production concentrated in the east of the country for expanding albeit potentially volatile external markets. This resulted in rapid national economic growth and a relatively balanced pattern of regional development. In turn, the Orange model promoted service sector activities in large metropolitan and tourist regions, which were ultimately dependent on importing capital; this ceased when the global financial crisis reached Ukraine in August 2008. Moreover the incoherent state that was the result of the Orange Revolution eroded its capacity to maximize industrial

development in the east of the country. Consequently, Ukraine became increasingly locked in to the performance of peripheral, low-growth agricultural regions, and the country's citizens became ever more reliant on the state for income support. This development model resulted in lower rates of overall growth, a more uneven pattern of regional development and imbalances in the financial system. Thus the Orange Revolution had a profound impact both on Ukraine's development model and on its territorial cohesion. The explosion of foreign credit-led consumption and finance and business services following the Orange Revolution accelerated the country's regional divergence to the highest recorded levels in Europe.

### Acknowledgements

Parts of this paper are based on work undertaken by Adam Swain within the context of a Nuffield Foundation-funded project on the regional development implications of FDI in Donetsk Oblast (award number SGS/32553). An earlier version of this paper was presented at the BASEES Annual Conference, Fitzwilliam College, Cambridge (March 2009); the Annual Symposium 'Reflections on the Spaces of Economy and Society Twenty Years after the Collapse of State Socialism', Queen Mary, University of London (May 2009); and to the 3rd CRCEES Annual Research Forum, University of Glasgow (May 2009). We are grateful to the participants for their comments and are indebted to Elaine Watts and Gemma Polmear for drawing the maps. We also thank two anonymous referees and Adrian Smith for their very helpful comments on earlier drafts.

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