

A divided Ukraine could see two radically different states emerge

It is increasingly difficult to predict what the future holds for Ukraine. One scenario sees the country becoming divided along roughly ethnic lines, with an ethnic Ukrainian western state and a more Russia-oriented eastern state comprising today's southern and eastern Ukraine. So what would the economies of these potential new states look like?

The most obvious question is where the borders between the two new states would be drawn. For simplicity, the subsequent analysis is based on the assumption that a future "East Ukraine" would comprise those regions (oblasts) where recently deposed leader Viktor Yanukovich received over half of the vote during the 2010 Presidential election. "West Ukraine" would include the other 17 of the total 27 oblasts.

This is, of course, an extremely crude assumption – it is certainly not a forecast – but it does allow us to imagine how Ukraine's current economic geography might shape the future of the two hypothetical states.

Town and country

In the event of a split, Ukraine's 45m inhabitants would be split fairly evenly between the two halves. West Ukraine would be relatively rural, with only 14.4m of its 24m inhabitants (57%) **classed as urban dwellers (<http://ukrstat.org/en>)**. By contrast, East Ukraine would be a less populous but more urbanised state, with 79% living in urban areas.

West would be poorer than East. The current unweighted average monthly income of western Ukrainian regions is US\$291, compared to **US\$320 in the east (<http://ukrstat.org/en>)**. These averages conceal significant regional variation, with Kiev and its surrounding region the only areas in the West with average incomes greater than the current Ukrainian average.

In East Ukraine, the average income is almost uniformly higher than in the West. Only Kherson, a sparsely populated region just north of Crimea, is poorer than the West Ukrainian average. The **unemployment rate (<http://ukrstat.org/en>)** is also higher in West Ukraine (8.5%) than in the East (6.8%).

Farms and factories

The economic structures of the two states could hardly be any more different. In West Ukraine, the economy is dominated by agrarian production and the huge service sector centred on the capital city of Kiev. Ukraine is currently the world's largest producer of sunflower oil, and a major exporter of other agricultural products, such as wheat, grain and sugar. Much of this production takes place in the West.

Many of the country's largest services – phone operator Kyivstar, say, or aerospace design companies – and energy companies such as Naftogaz Ukrainy or EnergoRynok are concentrated in Kiev. Western Ukraine accounted for just over 42% of total exports in 2013, with over half these exports registered to companies in Kiev alone.

However, given their links with industrial production in Eastern Ukraine, it is unlikely that these companies would continue to generate current levels of revenue in the event of any future split. What would happen, for example, to Kiev-based design bureaus working for Kharkiv-based aerospace firms?

Ukraine's industry centres on the East. Nearly all steel production and most arms manufacturing takes place in the region, and the country is currently one of the world's **leading exporters (<http://www.kyivpost.com/content/ukraine/ukraine-worlds-4th-largest-arms-exporter-in-2012-according-to-sipri-321878.html?flavour=full>)** in both sectors. Other higher value-added sectors, including the auto and aerospace industries, are also predominantly located in the East, although the competitiveness of enterprises in this region is patchy.

But cars don't build themselves, and all these energy-intensive factories use up a lot of power. It is likely that East Ukraine would continue to import large quantities of natural gas from Russia. West Ukraine's energy demands would be much lower.

The wildcards

Two other issues might define the respective economic futures of a divided nation: the future of Ukraine's large stock of public debt; and the potential transformative impact of shale gas.

The first key issue is how the large stock of existing Ukrainian public debt would be divided up. Ukraine currently has a public debt-to-GDP ratio of around 40%. That's a lower share than many advanced economies, like the US and the UK, but the fact that Ukraine has been unable to balance its budget for a number of years has caused its debt burden to grow rapidly.

Assuming that this stock of debt would be split evenly between the two states, it is clear that the debt-to-GDP ratio would increase even more in the poorer, more agrarian West, especially if it were unable to balance government expenditure and income. It is likely that West Ukraine would require significant external support to manage any future debt obligations. While the East would also inherit a relatively high debt burden, it would, by virtue of its greater export and productive potential, be better equipped to manage this debt.

The second area of uncertainty relates to Ukraine's two large deposits of shale gas - one in the western Lublin basin, and the other in the eastern Dnieper-Donetsk basin.

Large scale shale gas extraction has the potential to boost the fortunes of both states although at this stage the prospects for both deposits are uncertain. However, Royal Dutch Shell's decision last year to invest in a **US\$10 billion project (<http://uk.reuters.com/article/2013/01/24/uk-shale-ukraine-idUKBRE90N11S20130124>)** in the eastern Yuzivska field indicates that the prospects in East Ukraine currently look brighter.

Differing futures

Western Ukraine's economic powerhouse, the city of Kiev, would likely experience significant disruption in the event of a division. West Ukraine would require enormous levels of external assistance, both to manage its large public debt burden, and to generate the type of economic restructuring that would be required to increase income levels across the country. Without restructuring, West Ukraine would be one of the poorest countries in Europe. The financial assistance and open market for exports provided by the EU would be crucial to the economic future of the country.

East Ukraine, on the other hand, has the potential for a brighter future. It would inherit the richer, more urbanised and on the whole more productive sections of the Ukrainian economy. It is also further along in developing its shale gas resources. Consequently, East Ukraine would be more viable as an independent state and would possess the capabilities to compete in some areas of the global economy. In an alternative scenario, East Ukraine would also represent a significant and relatively modern addition to an enlarged Russian economy.

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