

# *Economic connectivity across the line of contact in Donbas, Ukraine*

September 2017

*An under-utilised  
resource for conflict  
resolution*

Natalia Mirimanova

# Credits

HD expresses its appreciation to Global Affairs Canada for its generous support for the conduct of this study.

## About the author

**Natalia Mirimanova** is a conflict resolution scholar and practitioner and has over twenty years of experience in Russia, South Caucasus, Central Asia, Moldova, Ukraine, Western Balkans and Eastern Europe advising various leading multilateral institutions and international NGOs. She received her Ph.D. from the Institute for Conflict Analysis and Resolution, George Mason University, USA and has been published widely in English and Russian.

## Centre for Humanitarian Dialogue

114, Rue de Lausanne  
1202 Geneva | Switzerland

t: +41 22 908 11 30

f: +41 22 908 11 40

[info@hdcentre.org](mailto:info@hdcentre.org)

[www.hdcentre.org](http://www.hdcentre.org)

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# Table of contents

<b>List of figures</b>	<b>2</b>
<b>Executive summary</b>	<b>4</b>
Business dynamics	4
Economic connectivity	4
Political connectivity	5
Future outlook	5
<b>Introduction</b>	<b>6</b>
Assessing connections across the divide	6
Scope and research methods	7
<b>1. Business size and operational basis</b>	<b>9</b>
1.1 Business size and sector	9
1.2 Business dynamic since the beginning of the conflict	11
<b>2. Economic connectivity</b>	<b>15</b>
2.1 Changes in markets	15
2.2 Changes in supply chains	15
2.3 Need for supplies across the line of contact	16
2.4 Freedom of movement	18
2.5 Difficulties in maintaining economic relations	19
2.6 Conclusions	20
<b>3. Political connectivity</b>	<b>22</b>
3.1 Business nature and registration	22
3.2 IDP entrepreneurs in Ukraine (before February 2017)	24
3.3 Preferred political–territorial status of NGCAs in Donbas	25
3.4 Conclusions	26
<b>4. Economic and political connectivity: future outlook</b>	<b>28</b>
4.1 Conditions for improvement of the business environment	28
4.2 Investment patterns before and after the conflict	28
4.3 Reasons to stay in business	29
4.4 Prospects for the next six and twelve months	30
4.5 Conclusions	32
<b>Endnotes</b>	<b>33</b>

# List of figures

1. Business profile: Donetsk SME sample
2. Business sector: IDP SMEs from Donetsk sample
3. Business profile: Luhansk SME sample
4. Business sector: IDP SMEs from Luhansk sample
5. Business profile: IDP SME sample, combined
6. Dynamics of manufacturing and industry, Donetsk SME sample, before the military conflict
7. Dynamics of manufacturing and industry, Donetsk SME sample, since the military conflict
8. Dynamics of retail trade, Donetsk SME sample, before the military conflict
9. Dynamics of retail trade, Donetsk SME sample, since the military conflict
10. Dynamics of services, Donetsk SME sample, before the military conflict
11. Dynamics of services, Donetsk SME sample, since the military conflict
12. Dynamics of manufacturing and industry, Luhansk SME sample, before the military conflict
13. Dynamics of manufacturing and industry, Luhansk SME sample, since the military conflict
14. Dynamics of retail trade, Luhansk SME sample, before the military conflict
15. Dynamics of retail trade, Luhansk SME sample, since the military conflict
16. Dynamics of services, Luhansk SME sample, before the military conflict
17. Dynamics of services, Luhansk SME sample, since the military conflict
18. Dynamics of manufacturing and industry, IDP SME sample, since the military conflict
19. Dynamics of retail trade, IDP SME sample, since the military conflict
20. Dynamics of services, IDP SME sample, since the military conflict
21. Reasons for the decline in business, SME samples
22. Markets for businesses (%) before the conflict and at present, Donetsk SME sample
23. Markets for businesses (%) before the conflict and at present, Luhansk SME sample
24. Markets for businesses (%) before the conflict and at present, IDP SME sample
25. Supply chains (%) before the conflict and at present, Donetsk SME sample
26. Supply chains (%) before the conflict and at present, Luhansk SME sample
27. Supply chains (%) before the conflict and at present, IDP SME sample
28. Need for supplies across the line of contact: Donetsk, Luhansk and IDP SME samples (%), 2016
29. Need for supplies across the line of contact: Donetsk, Luhansk and IDP SME samples (%), 2016
30. Need for specific supplies across the line of contact: Donetsk, Luhansk and IDP entrepreneurs, Ukraine samples (%), 2015
31. Need for supplies across the line of contact: Donetsk, Luhansk and IDP SME samples combined (%), 2015 and 2016
32. Engagement in economic relations with NGCAs: IDP entrepreneurs, Ukraine sample (%)
33. Difficulties in maintaining economic relations with NGCAs: IDP entrepreneurs, Ukraine sample
34. Place of registration and company type: Donetsk SME sample

- 35. Place of registration and company type: Luhansk SME sample
- 36. Place of registration and company type: IDP SME sample
- 37. Attitude to economic blockade: IDP SME sample (%)
- 38. Conditions for improvement of the business environment, 2016
- 39. Conditions for improvement of the business environment, 2015
- 40. Borrowing history, Donetsk, Luhansk and IDP SME samples (%)
- 41. Source of loans, Donetsk, Luhansk and IDP SME samples (%)
- 42. Taking out a loan: an ideal bank: Donetsk, Luhansk and IDP entrepreneurs, Ukraine samples
- 43. Taking out a loan: a realistic bank: Donetsk, Luhansk and IDP SME samples
- 44. Reasons to stay in business, Donetsk, Luhansk and IDP SME samples
- 45. Prospects for the next six months, Donetsk, Luhansk and IDP entrepreneurs, Ukraine samples
- 46. Prospects for the next twelve months, IDP SMEs sample
- 47. Plans for the next 12 months, Donetsk and Luhansk SME samples
- 48. Plans to return, IDP SMEs sample (%)

# Executive summary

Escalating political and military manoeuvres on both sides of the conflict in Eastern Ukraine led, in early 2017, to a full commercial cargo blockade across the line of contact. As a result, several industrial, energy production and transport cycles that spanned the conflict divide were disrupted, and hundreds of thousands of jobs have been jeopardised on both sides. Support for the incorporation of Donbas' industry into Russia from some public figures in Russia has deepened uncertainty and fears of further military escalation and a potentially creeping annexation.

Nevertheless, political imperatives often override economic concerns. The war economy is both a consequence and a driver of the conflict in Ukraine, which should be understood as part of the larger conflict analysis. To understand the manner in which economic drivers of conflict function in Donbas one first needs to look at the (restricted) economic connectivity in the region as mirrored by weakened political connectivity of economic actors and political centres across the conflict divide.

This study builds on previous research from 2015<sup>1</sup> on economic connectivity between small and medium businesses from Non-Government Controlled Areas (NGCAs) and their suppliers, customers, and partners across the line of contact. The present report is expanded to include larger businesses and additional variables of economic activity, such as bank loans and longer-term business plans. The data was collected between July 2016 and January 2017, employing surveys, focus groups, and semi-structured in-depth interviews and presents a baseline analysis of economic and political positions of private businesses beginning with the introduction of the full blockade between Kiev and NGCAs.

## Business dynamics

- Interviewees unanimously assessed the conflict as harmful to their ventures.
- Large industrial exporters in NGCAs were hit most severely by the conflict, with many ceasing operations and others on the verge of non-profitability. The railway restrictions with the rest of Ukraine have led to dramatic declines in productivity of large enterprises, which can no longer export their products via Ukraine. The uncertain legal status of enterprises that cannot leave NGCAs, and difficulties in keeping or obtaining legal status for international

transactions, have hampered exports to all destination, including Russia.

- Those small and medium-sized enterprises (SMEs) that reported sharp declines in operations cited the following as major reasons: physical departure and reduced purchasing power of customers, destruction of physical assets, and disrupted supply chains.
- Medium-sized enterprises which are easier to operate, such as pharmacies, supermarkets, and petrol stations have changed ownership and been expropriated, largely by force, by individuals in NGCAs, but continue their operations.
- Some businesses have relocated and re-registered in Government Controlled Areas (GCAs) and many continue to serve customers in NGCAs through complex arrangements and intermediaries, while others have remained in NGCAs to operate at significantly lower profits. Other entities have ceased operating in the NGCAs, or in both NGCAs and GCAs.
- Initial lack of access to markets in other parts of Ukraine dramatically decreased profits for business entities in NGCAs as well as for 'internally displaced businesses', however beginning in January 2016 SMEs began replacing inaccessible supplies with new ones, and restructured their operations to cater to a shrunken local market.

## Economic connectivity

- Donetsk and IDP SMEs have been more averse to severing business relations for political reasons. However, Luhansk SMEs have become more willing to actively boycott Ukrainian supplies and markets and to substitute them with Russian alternatives.
- Nearly half of all IDP SMEs retain business links with both NGCAs and GCAs.
- Several large industrial enterprises from NGCAs have re-registered in the GCAs and are on a list of companies exempt from the ban on commercial activities with the NGCAs, allowing them to transport their products across the line of contact, to the GCAs and export destinations (including Russia). They pay taxes in Ukraine.
- As a business destination, Russia is not seen as an ideal substitute for Ukraine by private enterprises in Donbas, as newly established links with Russia have led to a virtual

monopoly of Russian supplies in NGCAs, have incurred reputational costs, and may trigger future legal consequences under Ukrainian law.

- Personal links between business partners have often counter-balanced political rifts, enabling continued economic connections which could help restore economic connectivity.
- A lack of freedom of movement and of a framework for legal business transactions are seen as central barriers to retaining or restoring business links.

## Political connectivity

- Decisions regarding the place of registration for SMEs were largely based on an admixture of political, economic, and security-related considerations: nearly one third of Donetsk-based SMEs retain their sole registration in Ukraine (while some combine it with registration in the NGCAs). No Luhansk-based SMEs have retained their registration in Ukraine. Meanwhile, the vast majority of IDP SMEs have re-registered in Ukraine, apart from around 15% who operate without any legal registration.
- Registration in the self-proclaimed republics is incompatible with export operations, unless an exemption is granted by Kiev. Many large industrial exporters considered the procedure of securing an exemption from the commercial ban to be non-transparent and corrupt. Companies not exempt from the export ban, but needing legal ways to continue exporting, have either re-registered in Russia or operate through 'grey intermediaries'.
- Luhansk-based SMEs expressed overwhelming support for the emergence of a Luhansk People's Republic that would be independent from Ukraine or integrated with Russia. This is reflected in their attitude to abandon economic ties with Ukraine.
- Donetsk-based SMEs expressed a range of preferences for the political status of their self-declared republic, which is partially mirrored in their economic pragmatism (support for freedom of movement across the line of contact, legal and administrative transparency) as well as their willingness to (re-)enter into economic relations with Ukraine.

## Future outlook

- For the time being, the majority of SMEs are focusing on operating in their respective local markets, however around 15% of Luhansk SMEs are considering expansion into Russian markets. Of Donetsk SMEs, 15% have expressed a willingness to expand into the Ukrainian market, whereas only 5% expressed a desire for the Russian market.
- Donetsk-based SMEs are less optimistic about near-term economic prospects than IDP and Luhansk-based SMEs, however they are generally more optimistic about long-term perspectives. They generally take a more economically pragmatic approach, hoping for minimal legal and security improvements to be able to re-engage with markets and suppliers, irrespective of the final political solution of the conflict.
- Luhansk-based SMEs are equally uncertain about the long-term political solution, but have nevertheless limited their business operations to local markets and suppliers, given their inability to enter the Russian market or compete with Russian supplies.
- Very few IDP entrepreneurs who left the NGCAs and settled in government-controlled territories plan to return to the NGCAs – in marked contrast to the results of the author's 2015 research.
- Luhansk-based SMEs exclude the prospect of moving out of NGCAs, while a minority of Donetsk-based SMEs are considering a variety of destinations for their operations, including the GCAs.
- Businesspeople in NGCAs expect that economic relations will resume sooner and faster than personal relations between residents of NGCAs and the rest of Ukraine.
- Big businesses and SMEs alike consider Donbas industry to be an asset to Ukraine, and integral to certain global markets, such as coal and metals. Developing diversified destinations for industrial outputs is regarded as the most viable policy – including for sustaining peace and security.

# Introduction

## Assessing connections across the divide

While the first draft of this report was being prepared, rapid developments on both sides of the conflict culminated in the full blockade of commercial cargo across the line of contact between Russia and Ukraine. Since late December 2016 Ukrainian activists have been attempting to block railway transport of coal, metal and other commodities to and from enterprises in the non-government controlled areas (NGCAs) formerly exempt from the ban on commercial transactions.<sup>2</sup> After the de facto authorities of the self-proclaimed republics expropriated (or 'nationalised') the industrial assets under Ukrainian jurisdiction, the Ukrainian president made the blockade official.<sup>3</sup> As a result, industrial and energy cycles that transcended the conflict divide were disrupted and hundreds of thousands of jobs on both sides were jeopardised.

Meanwhile, irrespective of Russia's official position regarding the political status of the self-proclaimed republics within the Ukrainian state fixed within the Minsk and Normandy formats, Russian political and public figures have expressed support for the incorporation of Donbas industry into Russia's economic and administrative space. Media leaks on the discussion about specific plans at the level of the Deputy Prime Minister<sup>4</sup> deepen uncertainty and stir fears of military escalation and creeping annexation.

Diametrically opposed evaluations of the economic value of Donbas are abundant in the media and political fora and seem to be inflated or deflated according to political expediency.<sup>5</sup> In these circumstances, rigorous economic forecasts based on reliable data and robust methodology are rare and very much needed. According to an assessment published in May 2017 by the German Advisory Group,<sup>6</sup> the recent blockade has had a negative impact on Ukrainian GDP and trade balance as the seized coal mines and steel plants were predominantly exporters. However in macro-economic terms and for the sectors thought to be most affected (energy and metallurgy), the shock can be absorbed relatively quickly. This is partly due to the steady decline in the importance of commodities from the Non-Government Controlled Areas (NGCAs) for the industry and energy sector in the Government Controlled Areas (GCAs), and slow but sure re-arrangement of the sectors immediately concerned. Railways and ports would require serious upgrades to handle increased volumes of imported raw materials.

In sum, the impact of the full economic blockade of industry in the NGCAs is negative, but tolerable for the Ukrainian

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state. The impact on the economy of the NGCAs is more difficult to forecast. One reason for this is the lack of reliable data, and another is the uncertainty about Russia's plans to manage the industrial enterprises there. However, in a protracted conflict economy, economic regularities apply only to a degree. Emotional economy is a particular phenomenon observed across various deep-rooted conflicts. Coupled with political imperatives overriding economic ones, a war economy is both a consequence and a driver of the conflict<sup>7</sup> and has to be integrated into conflict analysis and scenario building.

In order to assess economic drivers of conflict and peace effectively in the case of the Donbas it is important to understand whether and how restricted economic connectivity is paralleled by weakened political connectivity of economic actors across the conflict divide. Political connectivity is the ultimate measure of isolation or rapprochement of the conflict parties.

The present study maps economic and political connectivity across the line of contact before and up to January 2017. Our previous study analysed economic and political connectivity to 2015.<sup>8</sup> In combination, the two studies show the dynamic of the relationships between business communities across the line of contact and between entrepreneurs in the NGCAs and the Ukrainian state as the context in which the recent full blockade and complete rupture of economic ties has been unfolding.

The status quo is not stable by any means – in fact, both sides make clear that the current ad hoc arrangements are temporary. We need timely and serious assessment before further moves are taken to factor in political and human consequences of the economic splitting of Donetsk and Luhansk.

Individual and collective behaviour and attitudes in conflict are defined by an array of factors – of which economic



connectivity across the conflict line is just one. Private enterprises from the NGCAs were selected as the subject of this research as independent economic actors whose decisions about the conflict are driven by economic considerations and have macro- and micro-economic implications. Given the numerous variables that may affect economic and political connectivity, we have compared economic behaviour and political attitudes of businesses with similar profiles, in terms of size, sector, location and primary market. We have also looked across different profiles to discern the relative weights of economic and political motivations pertinent to individual categories of business without claiming general applicability. This is important in view of the design of targeted and tailored conflict-resolution measures that best factor in economic motivations, interests and capabilities of different types of business actors across the line of contact.

- **Economic connectivity** is defined in the present study as the degree of business interconnectedness across the conflict divide. (Some authors include relations between private-sector and state institutions within economic connectivity;<sup>9</sup> in the present study, this aspect of connectivity is included within 'political connectivity'.)
- **Political connectivity** is defined as the strength of the connection between private entrepreneurs and the political and administrative centres, such as the Ukrainian state, the self-proclaimed republics or Russia.
- **Optimism, resilience and political and social agency** were assessed on the basis of the determination and motivation to stay in business, planning horizon and scope of ambition with respect to business growth, assessment of the conditions necessary for business development, and readiness to engage in political, civic or humanitarian activism.

## Scope and research methods

The present study is a continuation of the 'Business opportunities lost. . . and found' research completed in December 2015. The previous (2015)<sup>10</sup> and present (2016/17) studies focused on economic connectivity between businesses from the NGCAs and their suppliers, customers and partners across the line of contact. The two studies cover the dynamic of business and political imperatives that determined decisions of businesses from the NGCAs to stay or leave, retain or cut off business ties across the line of contact, their actual and preferred legal and administrative framework as well as

their assessment of the 'Donbas in' and 'Donbas out' scenarios from May 2015 to January 2017.

In 2016 the analysis expanded to include big businesses and additional variables of economic operation, such as attitudes to bank loans and future business plan. We have also assessed political connectivity between businesses from the NGCAs and Ukraine. The data in the present study cover the period from June 2016 through January 2017 and include small, medium and big private enterprises<sup>11</sup> which have remained in areas not controlled by the Ukrainian Government (NGCAs) and those which have left those areas because of the conflict and settled in the adjacent GCAs and in nearby regions.

We employed both quantitative and qualitative methods: surveys, focus groups and in-depth interviews. Surveys were carried out between July and October 2016, focus groups in October and November 2016, and in-depth interviews during December 2016 and January 2017.

The survey respondents were entrepreneurs from the NGCAs who had either left to various destinations in Ukraine or stayed in Donetsk and Luhansk. We used a 'snowball' technique to construct the sample. This is a non-probability sampling technique when a subject in the study is asked to help identify other subjects of the same type – businesspeople in this case. This technique is particularly useful where it is difficult to locate people to form a random representative sample. Interviewers from different social circles were recruited to reach out to politically and ideologically diverse groups. The surveys, focus groups and interviews were conducted under strict confidentiality rules, and access to and openness of the respondents and interviewees were facilitated by the credibility of the Centre for Humanitarian Dialogue, lead researcher and the team of field interviewers. No state authorities were involved at any stage of the data collection.

The survey sample consisted of:

- 167 small and medium-sized enterprises (SMEs) that left Donetsk and Luhansk and settled in the adjacent government-controlled areas (GCAs) of the two regions, including 25 in Kramatorsk, 10 in Artemovsk, 4 in Starobelsk, 18 in Severodonetsk, 3 in Lysychansk, 30 in Mariupol, as well as in other regions of Ukraine, including 27 in Kharkiv, 25 in Dnipro, 25 in Zaporizhzhia.
- 64 SMEs in Donetsk and 40 SMEs in Luhansk.<sup>12</sup>

Among the surveyed 135 were males and 136 females.

Qualitative data were collected through:

- focus groups with IDP SMEs in Kharkiv (6 males), Kramatorsk (4 males and 4 females) and in Severodonetsk (4 males and 3 females)
- in-depth interviews with SMEs in Donetsk (4 males and 4 females) and Luhansk (7 females and 3 males); with IDP entrepreneurs in the GCAs of the Donetsk and Luhansk region and in the adjacent regions (2 males and 2 females) and with SMEs from Severodonetsk (1 male and 1 female), Kharkiv (2 males and 2 females), Melitopol (1 male) and Zaporizhiia (1 female) that used to have business ties with partners, suppliers or clients from the current NGCAs
- in-depth interviews with big businesses that are or were fully or partially operational in the NGCAs of Donetsk (2 males), Kramatorsk (1 male) and Luhansk (5 males) regions.

In a situation of great polarisation, fear, insecurity and mistrust, responses to direct questions are often not genuine and hence have low validity. Instead, questions aimed at eliciting business-related reflections were posed and respondents were encouraged to think in terms of scenarios and dilemmas pertinent to the past, present and future of their business regarding political, security, geopolitical and geo-economic dynamics. Respondents were asked to assess the best political-territorial framework for their business and economy, in general, in relation to the status of the NGCAs.

All surveys, interviews and focus groups were anonymous, and no references to names or enterprises are made in this report.

# 1. Business size and operational basis

## 1.1 Business size and sector

Micro-enterprises, employing fewer than 10 people, are dominant among IDP SMEs (75%) compared to the Donetsk (48%) and Luhansk (45%) samples (Figures 1, 3 and 5). This may be due to their greater mobility but also because of personnel leaving for different destinations. Some enterprises have registered new entities in the GCAs with a small staff, hence their micro-enterprise category, while their facilities and all or part of the previous business remains in the NGCAs. The remaining businesses are either re-registered as a new company under the self-proclaimed republics' rules or operate without any registration.

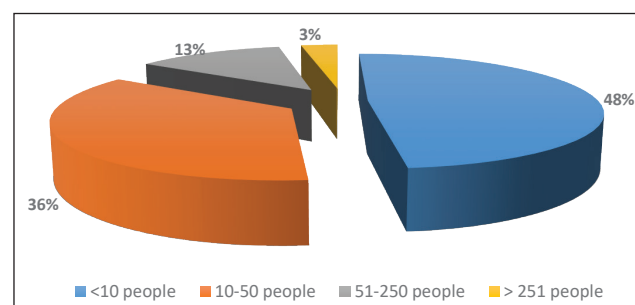
In all SME samples, retail trade and services were the dominant sectors (Figures 1, 2, 3, 4 and 5).

Manufacturing and industrial SMEs that stayed in Donetsk make up 30% of the sample (Figure 1), while in Luhansk this proportion is only 10% (Figure 3). Manufacturing and industrial enterprises constitute 32% of all IDP SMEs that left from Donetsk (Figure 2) and 24% of IDP SMEs that left from Luhansk (Figure 4). Moving manufacturing facilities and hardware is undoubtedly more difficult than moving a trade or a service business to a new place. However, the alternative of retaining business in the war-affected area may be yet more difficult. Severely constrained supplies and deliveries of the produced goods across the line of conflict or even within the war-affected area, plus diminished and depopulated internal markets, may have been considered worse than relocating for SME manufacturers. Many industrial and manufacturing SMEs in Donbas worked within the production chain of big industrial enterprises and lost important clients after many big industries suspended production. Besides, to sell their products, manufacturers need a bar code and all the necessary documentation which can be obtained at the designated Ukrainian institutions.

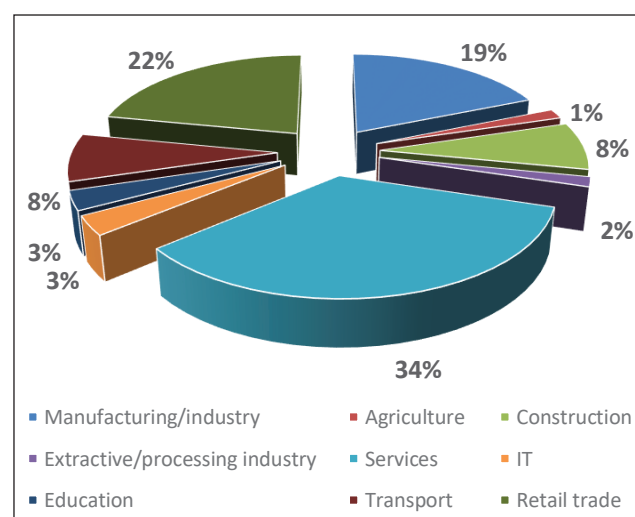
IDP entrepreneurs said that it was still possible to take equipment relatively safely from Donetsk and Luhansk before the full-scale military escalation, although the majority had hoped the situation would be resolved within weeks. Many left for Crimea via mainland Ukraine to wait out a storm. However, by the end of summer 2016, the chances of relocating industrial facilities or even of carrying out a proper move were already slim and people started to leave in a rushed manner in response to imminent security threats from military action and banditry.

**Figure 1.** Business profile: Donetsk SME sample

Business size



Business sector



Business sector grouped

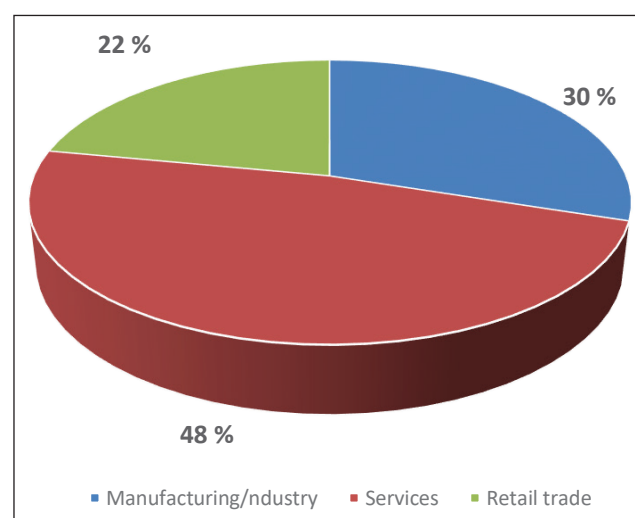


Figure 2. Business sector: IDP SMEs from Donetsk sample

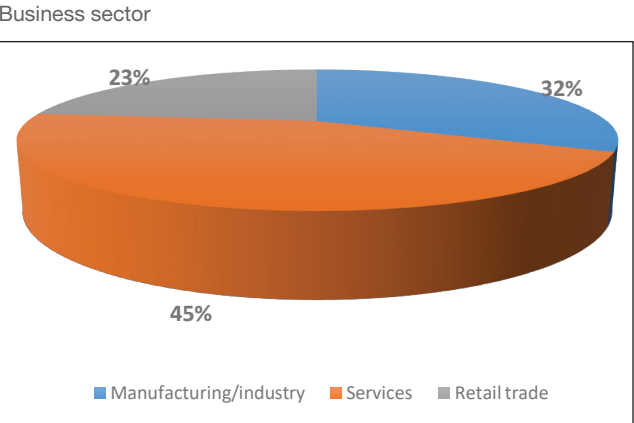
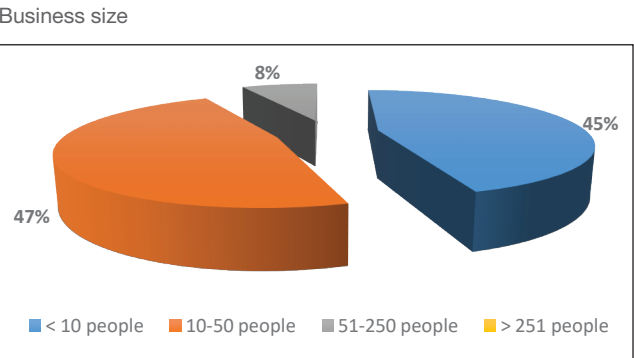
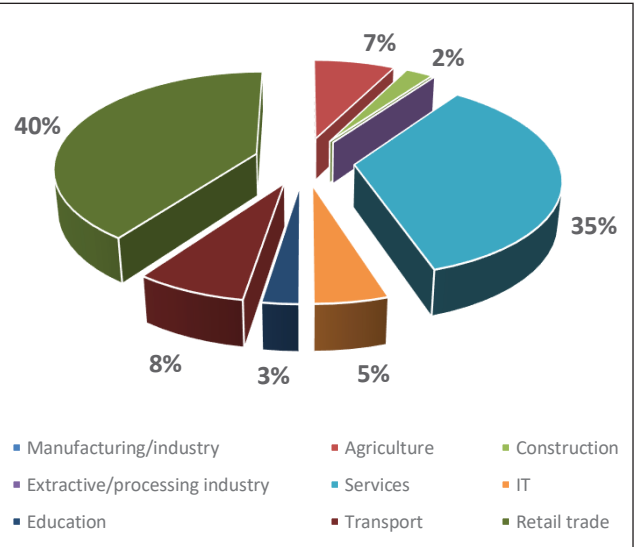


Figure 3. Business profile: Luhansk SME sample



Business sector



Business sector grouped

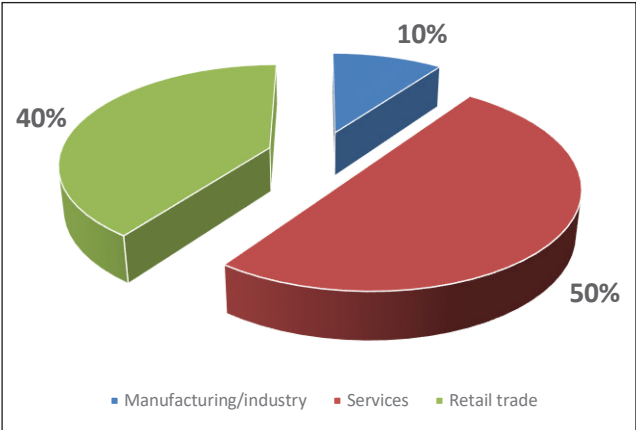


Figure 4. Business sector: IDP SMEs from Luhansk sample

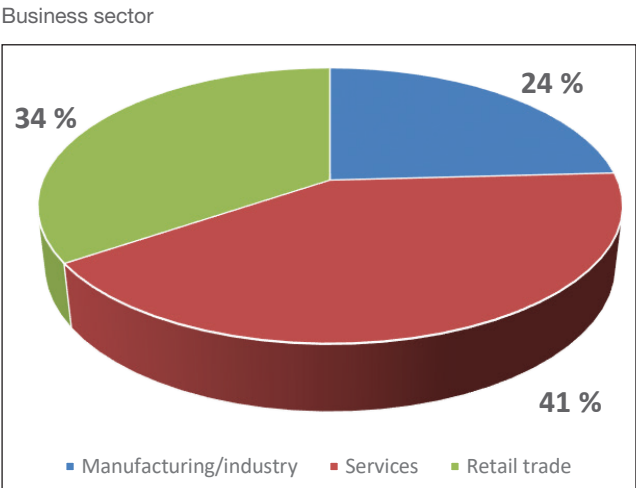
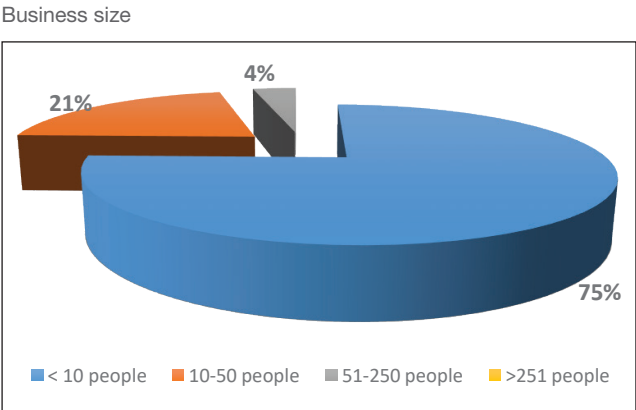
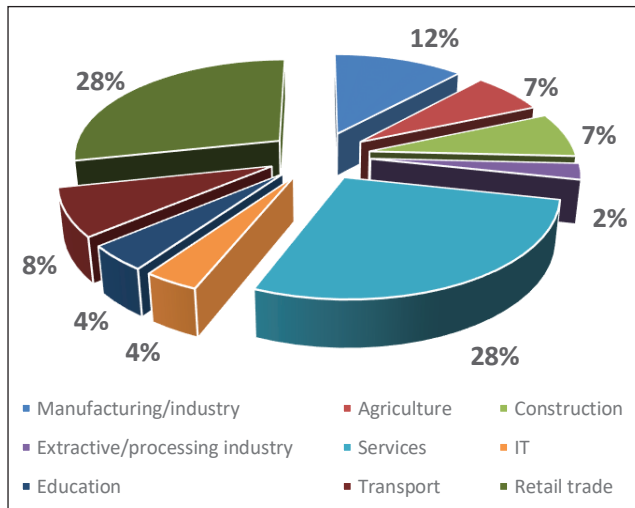


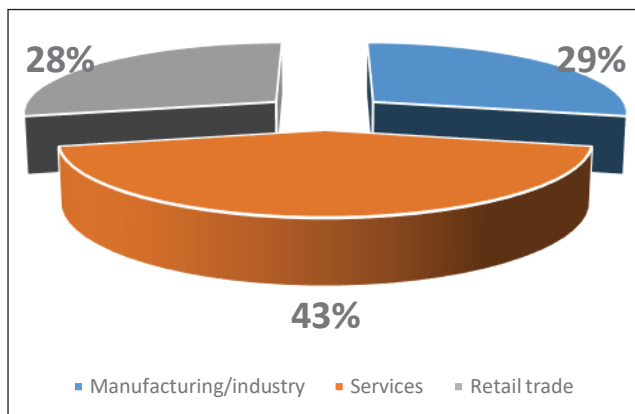
Figure 5. Business profile: IDP SME sample, combined



Business sector



Business sector grouped



Some businesses split their operation between the two territories, leaving some personnel in the NGCAs to keep the business afloat and with a smaller IDP business re-registered in the GCAs. Others had to start their business anew and lack the financial means to recruit personnel. Big industries retained their industrial, manufacturing or extractive facilities, staff and management in the NGCAs. Some continue their operation and others have suspended production,<sup>13</sup> depending on the owners' and shareholders' political attitudes, and on markets and export destinations. Some businesses have remained operational under the Ukrainian jurisdiction, like DTEK and other companies belonging to Rinat Akhmetov, and the Industrial Union of Donbas. Some have re-registered with the self-styled authorities or acquired a new Russian legal entity to continue their export, mostly to Russia.

## 1.2 Business dynamic since the beginning of the conflict

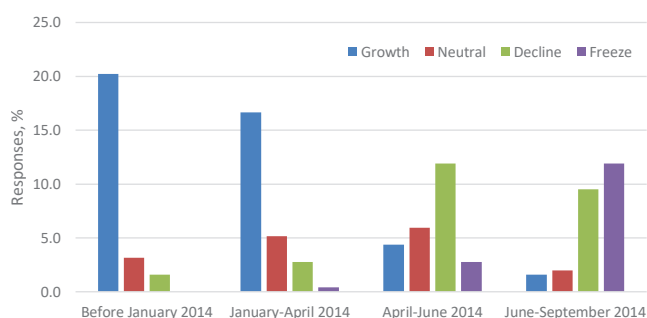
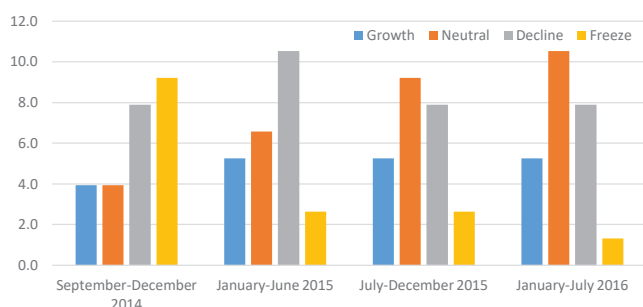
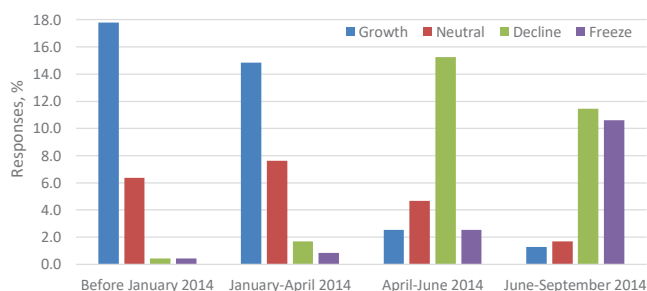
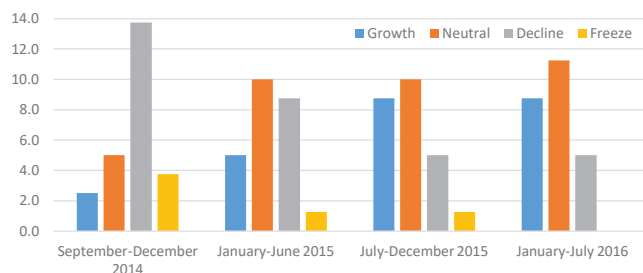
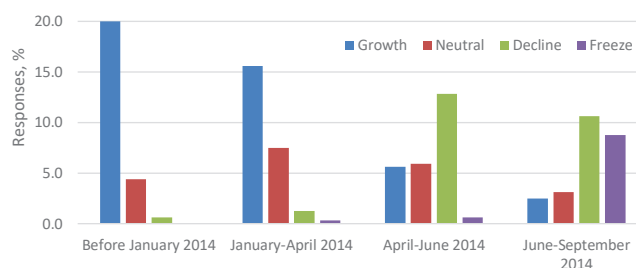
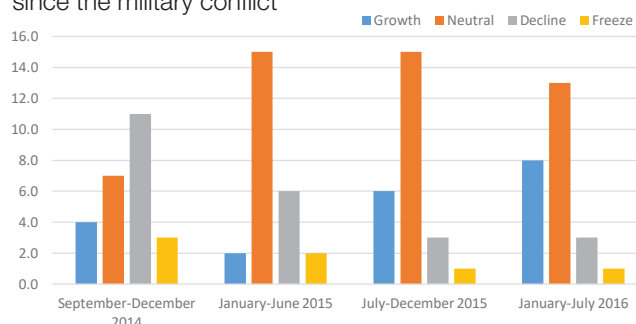
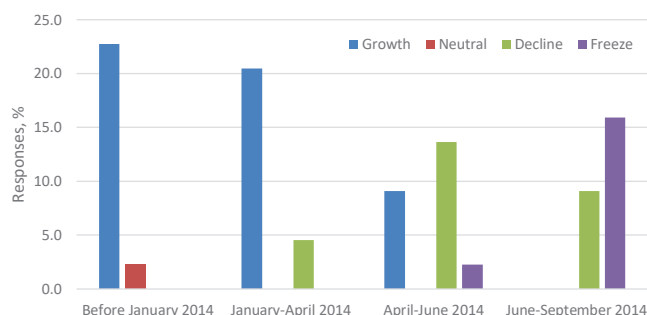
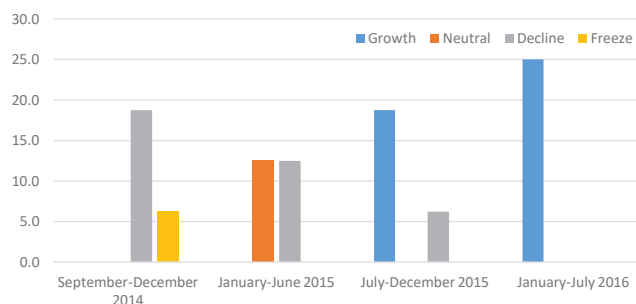
Business dynamic was assessed for two different periods:

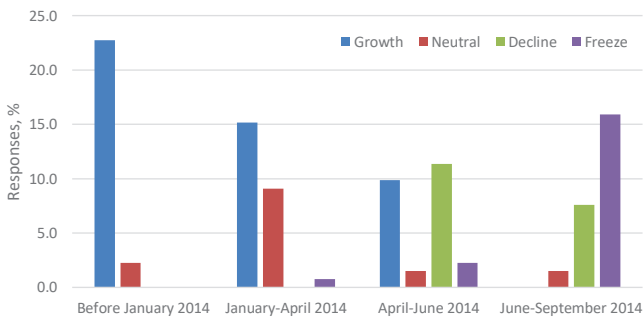
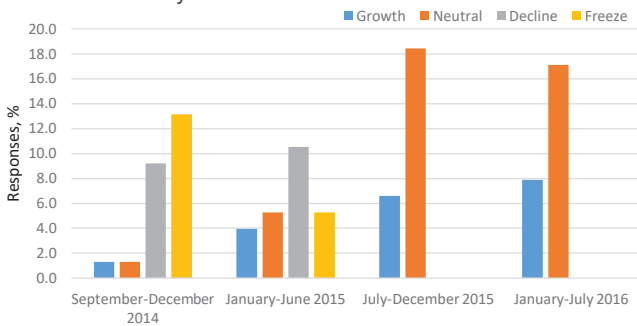
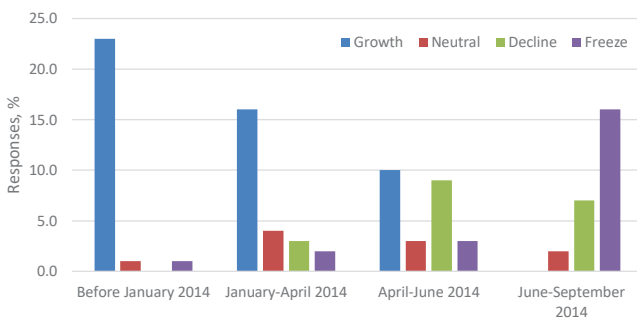
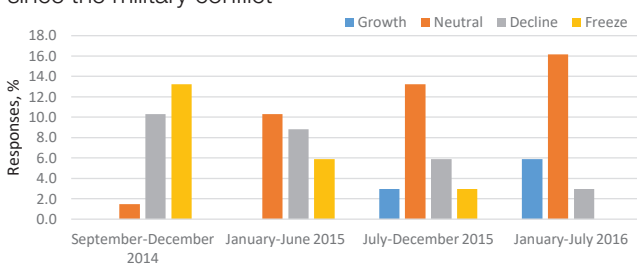
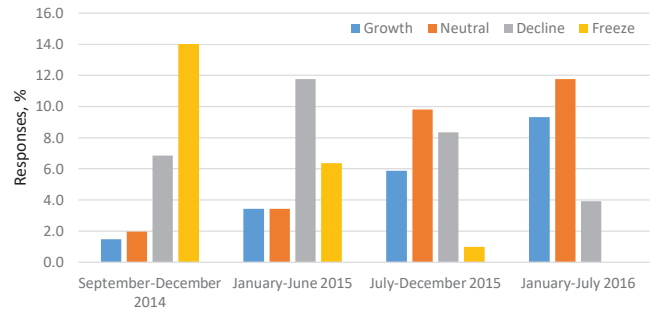
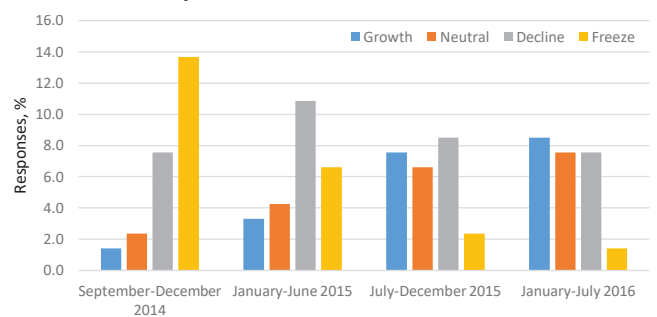
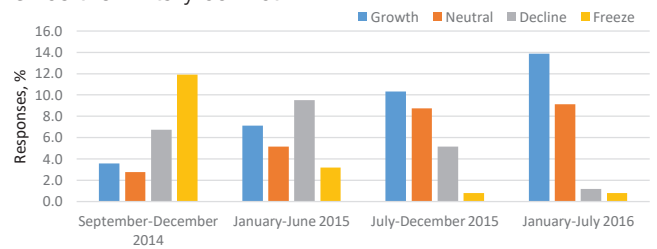
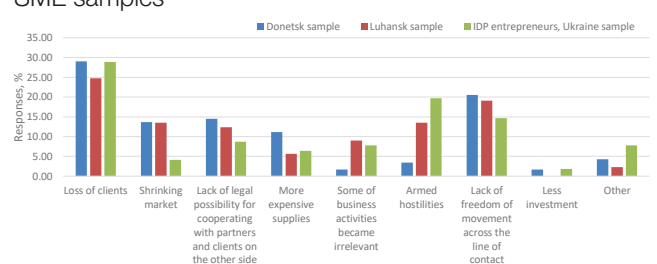
- before August 2014 (before a full-scale military conflict erupted and the majority of IDPs in the sample left Donetsk and Luhansk),<sup>14</sup> and
- from September 2014 onward.

Expanding the timeframe to include months before the military escalation in the Eastern Ukraine was important in order to get a baseline of the normal business dynamic and elicit specific conflict-related turning points in the business dynamic. Changes in the three sectors – manufacturing and industry, retail trade, and services – were analysed separately to discern specific trajectories of each sector that may have been affected by the conflict in different ways and to a different degree (Figures 6 to 21). Percentage of the number of responses for each business dynamic category (growth, neutral, decline and freeze) per sector (manufacturing/industry, retail trade and services) were calculated as the ratio of the total number of the identical category-sector responses to the total size of the sample.

The overall dynamic of the SMEs surveyed is universal across the three sectors and across the geographic samples. All businesses started from a relatively high ground in January 2014. Business activity began spiralling down reaching a low point in the summer and autumn of 2014 but started going upward from July–December 2015. Slow but steady growth continued in January–June 2016. This points to the adaptability and resilience of SMEs from the Donbas NGCAs. Overall, conflict was unanimously assessed as bad for business. Cases of emerging monopolies due to the departure of competitors were rare and short-lived until a new equilibrium of supply and demand was established.

The conflict led to dramatically decreased business activity in Donetsk and Luhansk as well as of the IDP businesses in their new locations. Entrepreneurs in Donetsk and Luhansk report an average loss of 30–40% of clients. Some of those who relocated have lost their entire business, while others managed to move their equipment across the line of contact and re-assemble production facilities. Yet others continue shuttling between the two territories taking advantage of the 'negotiated' passage of banned commercial items through the Ukrainian checkpoints.<sup>15</sup> Despite the losses, lack of security and inaccessibility of proper banking and investment in the NGCAs, after 18 months businesses seem to have partly

**Figure 6.** Dynamics of manufacturing and industry, Donetsk SME sample, before the military conflict**Figure 7.** Dynamics of manufacturing and industry, Donetsk SME sample, since the military conflict**Figure 8.** Dynamics of retail trade, Donetsk SME sample, before the military conflict**Figure 9.** Dynamics of retail trade, Donetsk SME sample, since the military conflict**Figure 10.** Dynamics of services, Donetsk SME sample, before the military conflict**Figure 11.** Dynamics of services, Donetsk SME sample, since the military conflict**Figure 12.** Dynamics of manufacturing and industry, Luhansk SME sample, before the military conflict**Figure 13.** Dynamics of manufacturing and industry, Luhansk SME sample, since the military conflict

**Figure 14.** Dynamics of manufacturing and industry, Luhansk SME sample, since the military conflict**Figure 15.** Dynamics of retail trade, Luhansk SME sample, since the military conflict**Figure 16.** Dynamics of services, Luhansk SME sample, before the military conflict**Figure 17.** Dynamics of services, Luhansk SME sample, since the military conflict**Figure 18.** Dynamics of manufacturing and industry, IDP SME sample, since the military conflict**Figure 19.** Dynamics of retail trade, IDP SME sample, since the military conflict**Figure 20.** Dynamics of services, IDP SME sample, since the military conflict**Figure 21.** Reasons for the decline in business, SME samples



recovered, replaced old suppliers with new ones, reformat-  
ted their businesses and some even started new businesses.  
Profitability is still lower than before the conflict, but a steady  
tendency towards growth is evident.

The manufacturing and industry sector appears to be the  
fastest growing after the cessation of active military activities  
in Luhansk (Figure 13), compared to retail trade and services,  
and reached its pre-war level of growth by July 2016. This  
can be explained by the inclusion of the construction business  
into this category: reconstruction of buildings and infrastruc-  
ture paid by the money transferred by Russia kept construc-  
tion services in high demand.

The services sector was the fastest growing among the IDP  
SMEs (Figure 20), possibly due to the relative ease of resum-  
ing services in a new place as no equipment or initial capital  
was required. Retail trade was regaining growth more slowly  
than other sectors among IDP SMEs (Figure 19) because  
competition is high, owners' financial resources were depleted,  
which also makes borrowing from banks risky, and previous  
supply chains involving sources in the NGCAs were disrupted.

Big enterprises reported dramatic decline in productivity, and  
also in exports due to the severely restricted railway connec-  
tion with GCAs. Exports from the Luhansk-based big  
enterprises fell to one thirtieth of their former value accord-  
ing to the estimates of the respondents. Coal mines reduced  
coal extraction up to 2.5 times and instead were emptying  
out their storage due to the difficulty of taking coal to enter-  
prises in the rest of Ukraine or to the Ukrainian sea ports for  
export. Railways run only during daylight and not after dark  
because of security concerns and curfews in the NGCAs.  
In addition, carrying capacity is reduced due to the lack of  
cargo wagons.

Enterprises formerly part of the internal Ukrainian industrial  
and manufacturing cycles as well as exporters to the Russian  
market suffered significant losses during the first months of  
the military conflict due to disrupted transportation routes,  
trade wars launched by Russia, and destruction and damage  
caused by heavy fighting. Enterprises exporting to Russia were  
hit by Russia's sanctions against Ukrainian produce after the  
signing of the Deep and Comprehensive Free Trade Agree-  
ment (DCFTA) in 2016. As a result, interlocutors say, exports  
to Russia from industries in the NGCAs fell by up to 70%.

Eventually the enterprises made a strategic choice with regard  
to market orientation. Both political convictions and economic-

pragmatic considerations were factors. Manufacturing oper-  
ations, such as those making machinery, with high-value-  
added outputs and which used to serve the internal Ukrainian  
market, Russia and CIS, Iran and other non-European mar-  
kets see Russia as a more promising political-economic  
space due to high competitiveness of Ukrainian industry of  
this type.

This finding is in line with the proposed economic theory of  
rebellion in different areas of Donbas that places the struc-  
ture of local economy and priority markets as the defining  
factor of the success of and popular support for the insur-  
gence. Machinery production locales appeared to be more  
supportive and active in the rebellion compared to the locales  
where extractive or metallurgic enterprises were dominant.  
The underlying fear of losing important markets – predomi-  
nantly non-EU in the former case and predominantly EU in  
the latter – was shown to be the driver of support for insur-  
gency against Kiev.<sup>16</sup> Extractive industries and metallurgic  
enterprises, that are less competitive in the Russian market  
and export to Europe, opt for the re-integration of the NGCAs  
into Ukrainian political and economic space.

Overall, those who retain their industry and other assets  
operational in the NGCAs report zero profitability or even run-  
ning at a loss. The following reasons were given for keeping  
businesses afloat: social responsibility for tens of thousands  
of employees, disastrous technical consequences of the  
disruption of certain industrial processes, such as in metal-  
lurgy or coalmining, the risk of terminally losing a business  
niche in a highly competitive global market.

Losses of equipment, office space, vehicles, staff and part-  
ners have dealt heavy blows to all SMEs and big businesses.  
Inaccessibility of old markets and disruption of supply chains  
due to the blockade has aggravated these conditions. Enter-  
prises engaged in smaller-scale production have managed  
to evacuate their dismountable equipment, carry it across  
the line of contact in a hand luggage and then re-assemble.  
Larger-scale industrial and production enterprises, includ-  
ing construction and extractive companies with heavy and  
immovable equipment key to their operation, did not have  
the opportunity to move easily. They either stayed and con-  
tinued their work or disrupted business activities and left.  
Many of those who ended up either staying or completely  
disrupting their business activities alike had not anticipated  
the long duration of turbulent times. Hence, they did not  
evacuate, sell or rent out their equipment when transport and  
banking links were still in place.<sup>17</sup>

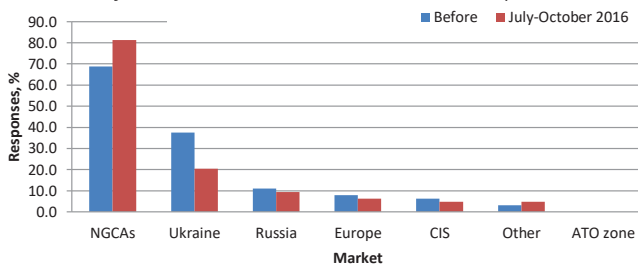


## 2. Economic connectivity

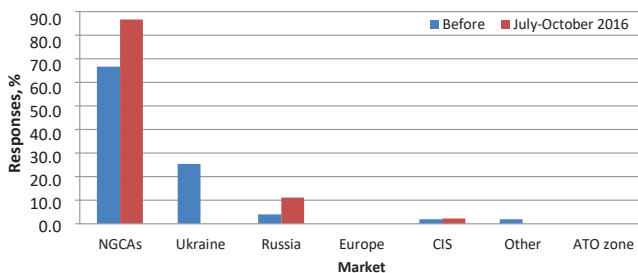
### 2.1 Changes in markets

The tendency observed in 2015 was also seen in 2016: small and medium-sized enterprises (SMEs) from the NGCAs mostly catered to the local market before the conflict. Before the conflict, the NGCAs accounted for around 65% of markets for businesses in both Donetsk and Luhansk, rising to 80% in Donetsk and 90% in Luhansk in the summer/fall 2016 (Figures 22 and 23). IDP SMEs in the summer/fall 2016 catered to the local markets at their new place of residence (40% in

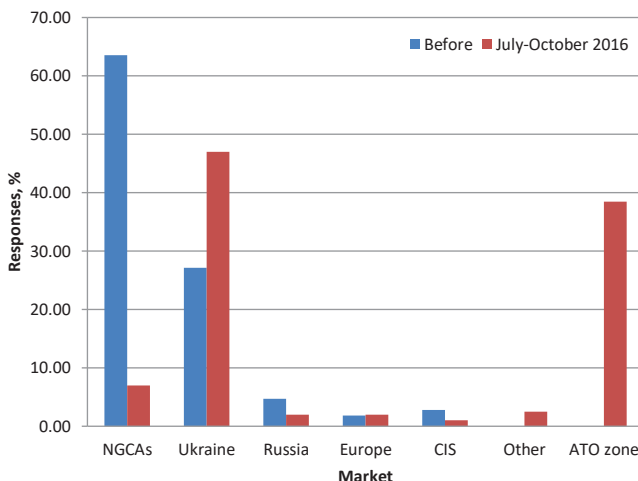
**Figure 22.** Markets for businesses (%) before the conflict and in July-October 2016, Donetsk SME sample



**Figure 23.** Markets for businesses (%) before the conflict and in July-October 2016, Luhansk SME sample



**Figure 24.** Markets for businesses (%) before the conflict and in July-October 2016, IDP SME sample



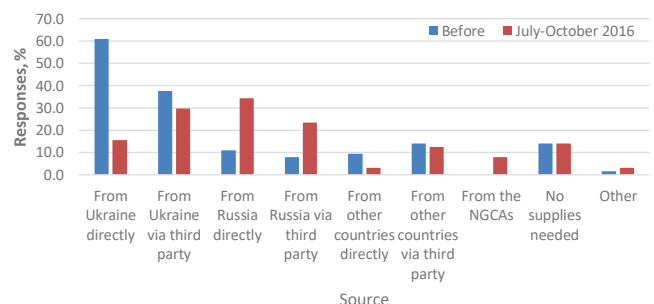
the so-called ATO zone, areas adjacent to the line of contact, and 45% in the local markets in the Kharkiv, Zaporizhzhia and Dnipro regions (Figure 24). Of businesses from Donetsk, some 40% were oriented towards the broader Ukrainian market, while only 25% of businesses in Luhansk used to operate also in the Ukrainian market outside their place of residence before the conflict. Since the eruption of armed conflict, Luhansk businesses have completely severed links with the Ukrainian market, while 20% of those who stayed in Donetsk continue to be present in the broader Ukrainian market.

Interestingly, the share of enterprises that have re-oriented themselves towards the Russian market is miniscule, although Russian companies from the adjacent regions have massively expanded their products and services into the NGCA markets. Many entrepreneurs pointed to the asymmetric nature of engaging with Russian businesses when they sell their products and services to clients in and from the NGCAs, citing numerous official and unofficial barriers for their businesses to gain access to Russian markets. IDP entrepreneurs work hard to enter local markets in the areas of their new residence, but also seem to be strongly motivated to reach out to further markets in Ukraine and beyond.

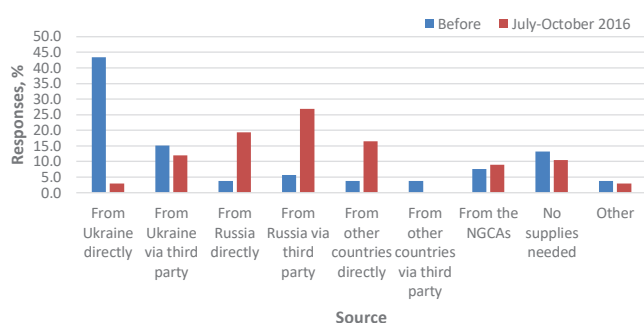
### 2.2 Changes in supply chains

It is important to stress that parts of Luhansk region was less well connected to the rest of Ukraine prior to the conflict due to inadequate infrastructure, while the Donetsk region previously had better road links with the rest of Ukraine. This partially explains why the economic ties between Donetsk-based SMEs and Ukraine were (and continue to remain) stronger than those of Luhansk-based SMEs. The pattern identified in the 2015 research remained in 2016: the share of Ukrainian supplies for businesses in Donetsk and Luhansk has dramatically reduced (Figures 25 and 26). The decline in

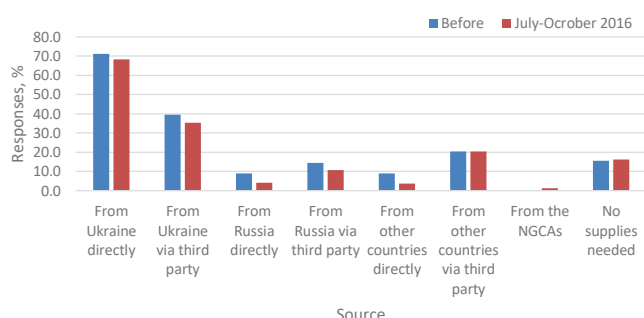
**Figure 25.** Supply chains (%) before the conflict and in July-October 2016, Donetsk SME sample<sup>18</sup>



**Figure 26.** Supply chains (%) before the conflict and in July-October 2016, Luhansk SME sample<sup>19</sup>



**Figure 27.** Supply chains (%) before the conflict and in the summer/fall 2016, IDP SME sample



Ukrainian supplies needed for business operation in Luhansk and the substitution of Ukrainian with Russian suppliers is particularly evident. Donetsk entrepreneurs retain some supply chains with Ukraine, but also actively increase their supply from Russia. IDP SMEs continue receiving supplies from Ukrainian sources (Figure 27).

Great difficulties and associated risks involved in retaining business ties with the familiar and economically expedient markets, partners and suppliers across the line of contact pushed SMEs in Donetsk and Luhansk to cut economic ties with Ukraine, which was reciprocated by Ukrainian suppliers and customers having disengaged from the NGCAs. It is important to stress that none of the surveyed entrepreneurs in the NGCAs or outside has complained about the quality of the previous business ties. In 2015 nearly all SMEs in Donetsk and Luhansk expressed their regret at having lost ties with reliable partners. In 2016 some Donetsk SMEs are still nostalgic about Ukrainian supplies, suppliers and customers; while in Luhansk individual experiences of positive work relations with Ukrainian counterparts have been replaced by a collective narrative of complete and irreversible separation from the Ukrainian state, which explains the rejection

of further work with Ukrainian counterparts by Luhansk SMEs. Identically worded responses appeared in nearly every interview, which may mean that this narrative had been largely shaped by the Russian and local mainstream media or self-censorship.

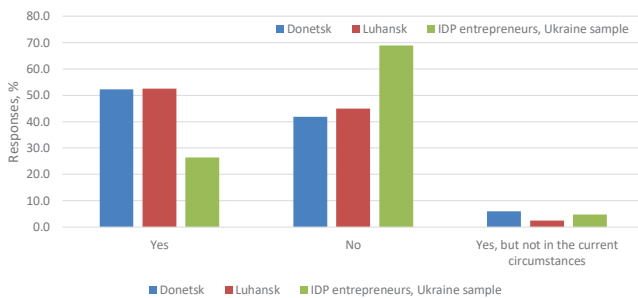
According to all Luhansk businesses surveyed and interviewed, Russian produce that was initially unfamiliar and of lower quality than Ukrainian products, has eventually nevertheless squeezed Ukrainian goods out of the local market. This is not least because the comparative advantage of the competitive price was lost due to elevated transport expenses and unofficial payments at crossing points. However, in Luhansk in particular, there is widespread boycotting of Ukrainian goods where these are accessible.

As a compensation for the heavily restricted movement across the line of contact in the Luhansk region, where only one crossing point is operational and limited to pedestrians,<sup>20</sup> there is intense movement of people and trucks across the Ukrainian border with the Rostov region of Russia. The distance is shorter, and the crossing can be made by vehicle and without risk. It is nearly exclusively vehicles with Ukrainian registration plates that cross the border.<sup>21</sup> As a result, businesses and consumers from Luhansk have helped to boost local trade and services in the adjacent Russian region. Luhansk businesses purchase goods in Russia and bring them back as either personal luggage or commercial cargo, in which case they pay duties to the customs established by the self-proclaimed republic. However the issue of VAT remains unresolved and VAT cannot be reclaimed, hence business-people prefer to avoid registering commercial exchanges between businesses in Russia and in the self-styled republics. When this is not feasible, it is a consumer in the Luhansk NGCAs who covers the extra cost. Russia's humanitarian aid aside, its role in assisting the private sector is largely inflated, while the local economy of adjacent Russian areas is the main beneficiary of the asymmetric supply chains.

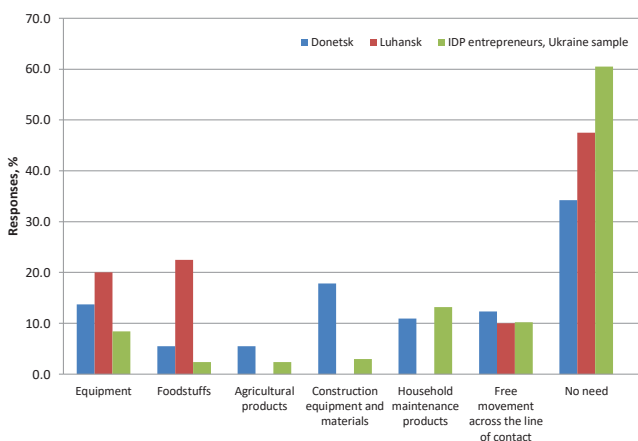
### 2.3 Need for supplies across the line of contact

SMEs in Donetsk and Luhansk have greater need of supplies from across the line of contact (just over 50%) compared to the IDP SMEs outside the NGCAs (24%) (Figure 28), which points to the shortage of supplies there even with the supplies from Russia having replaced supplies from Ukraine, while IDP SMEs have access to alternative suppliers elsewhere in Ukraine.

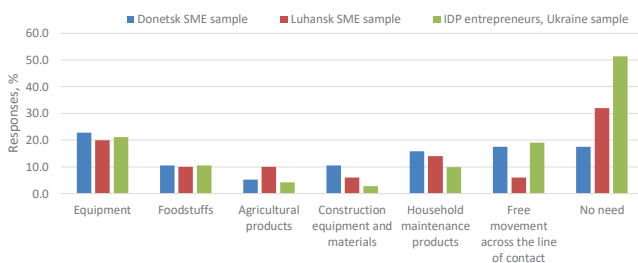
**Figure 28.** Need for supplies across the line of contact: Donetsk, Luhansk and IDP SME samples (%), 2016



**Figure 29.** Need for specific supplies across the line of contact: Donetsk, Luhansk and IDP SME samples, 2016



**Figure 30.** Need for supplies across the line of contact: Donetsk, Luhansk and IDP entrepreneurs,<sup>22</sup> Ukraine samples (%), 2015



The composition of the needed supplies has also changed among those who still require goods from across the line of contact (Figures 29 and 30). In 2015 every item was in demand on both sides. In 2016 substitutes to supplies from across the line of contact have been found, but unevenly across the categories of supplies. The percentage of the Luhansk SMEs needing foodstuffs increased from 15% to over 40%, while the demand for food products among Donetsk busi-

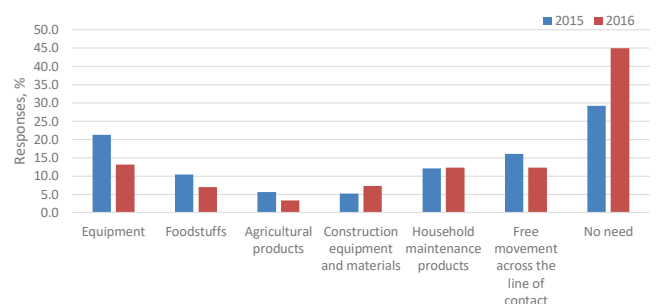
nesses and among IDP SMEs residing in the GCAs decreased from 15% to around 5%.

The upsurge of the demand for foodstuffs among Luhansk SMEs surveyed seems likely to be an anomaly of the small sample and is dissonant with the narrative of Luhansk entrepreneurs about their lack of will to preserve any ties with Ukraine. The surprising finding may be due to the change in the relative need for different supplies and needs to be analysed against the total composition of the needed supplies. Thus, Luhansk businesses did not need Ukrainian agricultural products, household maintenance products or construction materials any more, hence the relative increase in the need for foodstuffs. However there may be an actual demand for foodstuffs raised due to the increased number of people returning to Luhansk, while the supply falls short of meeting demand because of the decrease in local food industry. Apparently foodstuffs from Russia are still less favoured than Ukrainian products, of which there are only memories left, by the Luhansk consumers as evidenced from interviews and focus groups.

Luhansk SMEs tend voluntarily to boycott Ukrainian products. However the stark refusal to work with Ukrainian goods that only a year ago had been clearly favoured over Russian ones may be also because of the surveillance and persecution by the new leadership and self-appointed inspectors, often armed, for having goods with Ukrainian symbols or even with routine Ukrainian-language labels on display. Some cases of punishment for the 'propaganda' made others alert and selective in what they were bringing across the line of contact. A surprisingly high percentage of IDP entrepreneurs in need of equipment from the NGCAs comprises those who need to evacuate their own equipment from the NGCAs.

In one year, from 2015 to 2016, the percentage of businesses needing supplies from across the line of contact

**Figure 31.** Need for supplies across the line of contact: Donetsk, Luhansk and IDP SME samples combined (%), 2015 and 2016



decreased from 71% to 55% in the combined sample of the Donetsk and Luhansk businesses in and outside the NGCAs (Figure 31). This marks a clear tendency to substitute supplies from across the line of contact with supplies from elsewhere or to operate businesses in survival mode, with minimal supplies. Risks, difficult logistics and unofficial and official payments make supply chains from Ukrainian sources increasingly economically inexpedient and simply dangerous for businesses in the NGCAs.

## 2.4 Freedom of movement

Freedom of movement across the line of contact has been curtailed since the active phase of the military conflict, and restrictions were authorised after the first ceasefire agreement in Minsk. On 11 January 2015, the Security Service of Ukraine (SBU) introduced the Temporary Order on Control of the Movement of People, Transport Vehicles and Cargo along the Contact Line in Donetsk and Luhansk regions which regulated movement into and out of the ATO zone and came into effect on 21 January 2015. With this order in place, there is no possibility of passing through a checkpoint upon showing ID, as before. The new Temporary Order required all movement into and out of the ATO zone to be conducted through the seven designated government-controlled checkpoints through the seven corridors and with a special permit issued by the security service. The initial manner of implementation with paper permits and cumbersome and non-transparent approval procedures was heavily criticised by the international community and outraged the population in the NGCAs.<sup>23</sup> Since July 2015, electronic permits were introduced and a more organised system was established for passing through the checkpoint on the Ukraine-controlled side.

However, commercial goods were completely banned from crossing the line of contact. Rules for taking commercial cargo across the line of contact were set by the ATO headquarters on 12 June 2015.<sup>24</sup> The only goods that could cross were either those under 50kg and worth less than 1,000 UAH or those exempted from the ban by the National Security Council, ATO headquarters and specialised ministries or other agencies, depending on the nature of goods. Criteria for granting permissions were neither clear nor fair according to the interlocutors in this study, preference was given to the enterprises that had re-registered in the GCAs and those vital for Ukraine's national interest within the critically important industrial and energy chains. Rumours about the corrupt procedure for getting on the list are not rare. The 'entrance fee'

for some applicants from the big-business sector seemed to be quite high given their declining production and minimal profits. As a result businesses either re-registered in Russia, were shut down or found creative ways to circumvent the ban.

These barriers effectively cut off the majority of SMEs that had stayed in the NGCAs but were willing to continue business with their Ukrainian suppliers and clients. Commercial goods, according to the 2015 regulation, could not be transported across the line of contact by any transport besides the railway, which was not expedient for small commercial quantities traditionally transported by road. This was particularly prohibitive for perishable foodstuffs that had to be delivered quickly.

The need for free movement among SME samples is significantly less pressing in 2016 in comparison to 2015 (Figures 28 and 29) Donetsk and IDP SMEs have mixed feelings about their reduced motivation to cross the line of contact: some have made a conscious politically-motivated choice while others regret that this vital channel has been gradually made inaccessible. Interviews with Luhansk SMEs confirm that the inclination to cross to the Ukrainian side of the divide is weak if not absent. Mostly, blame for the restricted movement and criminalisation of business transactions between the two territories is attributed to the Ukrainian side. This stirs resentment not only because of the disruption of business and income generation for SMEs, but also because of the restrained ability to move freely, to receive social payments and pensions guaranteed by law. Individual residing in Luhansk blame the Ukrainian state for having infringed on their fundamental rights. A narrative of resistance is strong among the Luhansk SMEs. They feel proud of having survived and are determined to build their republic from scratch.

SMEs in Luhansk are particularly vocal about Ukraine having cut them off, but no one mentioned the ban on Ukrainian foodstuffs introduced by the LPR leadership as early as January 2015 and harassment and extortions at the checkpoints of the self-proclaimed republic. Instances of harassment and corruption by the Ukrainian military at the checkpoints are widely recounted and become incorporated into the narrative of Ukraine having pushed them away, trying to make them starve. None of the surveyed and interviewed entrepreneurs used the services of the humanitarian-logistical centres established at the Ukrainian checkpoints. They either never heard about these centres or heard that these are no better than the conventional informal payment system at the checkpoints.

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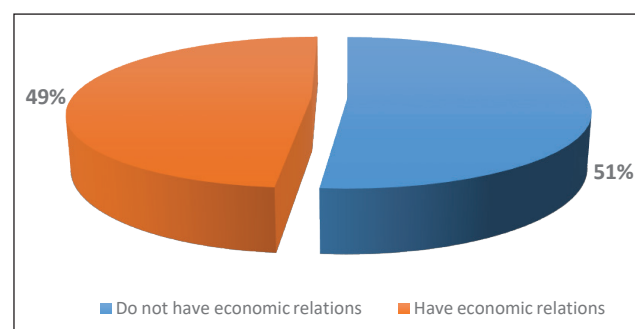
The resentment within Luhansk and Donetsk NGCAs with regard to the limited opportunities to cross to and from the Ukrainian GCAs seemingly contradicts the lack of support or outward rejection of the current Ukrainian leadership's course and blame for waging war against its own people, a popular line in the daily discourse there. However Donetsk SMEs are far less enthusiastic about the future prospects of the DPR, about quarter of them being convinced that only re-integration into Ukraine will bring peace and business development.

Free movement with Russia has not replaced the need to move freely in and out of Ukraine among the surveyed Donetsk SMEs and even some of the Luhansk SMEs: people still want to stay connected with particular people, companies and institutions there, albeit political conditionality comes first in the case of the Luhansk entrepreneurs. Besides, the markets and business opportunities are very different and not interchangeable. Overall, economic connectivity between the GCAs and NGCAs is getting weaker, and substitutes for suppliers across the line of contact are being found elsewhere. However, the objective need for economic connectivity is felt by half of the Donetsk and Luhansk entrepreneurs from the sample and by 30% of the IDP entrepreneurs. Apart from 'objective' economically backed preferences for continuing to receiving certain supplies from the other side, subjective factors are also important. These include relations with individual people, discomfort about changing a working system that may have required years to establish, and uncertainty about new supplies and suppliers.

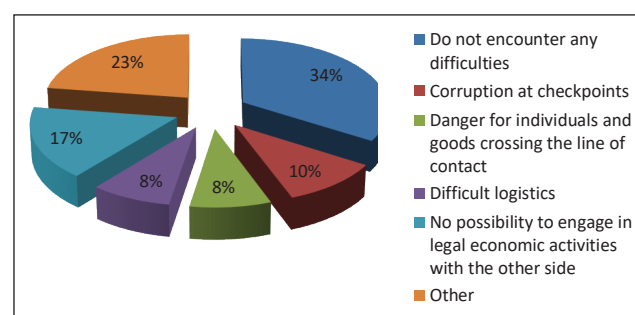
## 2.5 Difficulties in maintaining economic relations

Half of the IDP entrepreneurs, many of whom left their entire businesses, equipment, offices and staff in the NGCAs, maintain business ties with clients or partners across the line of contact (Figure 32). Of these, 34% do not experience any difficulties, while others mention corruption at checkpoints, difficult logistics and lack of legal possibility to engage in economic activities with the other side, among other problems (Figure 33). These results need to be assessed against the market orientation of the IDP entrepreneurs that have settled in a new location – hardly any are catering to markets in the NGCAs. Some keep manufacturing goods in the NGCAs and manage to take them across the line of contact to the government-controlled territories; others have put their business operations on hold, but consider their business alive

**Figure 32.** Engagement in economic relations with NGCAs: IDP entrepreneurs, Ukraine sample (%)



**Figure 33.** Difficulties in maintaining economic relations with NGCAs: IDP entrepreneurs, Ukraine sample (percentage of those who engage in economic relations with NGCAs)



and ready to be resumed in the NGCAs once the situation normalises. Yet others in the service sector provide services to their clients on both sides without being physically present there. Some family businesses have split, younger generation having moved to the government-controlled territories, while parents stayed to run their business or guard business assets.

Some of those who had fled the war-affected area later returned to their offices and workshops and resumed production there. Some such businesses were included in the Donetsk and Luhansk SME samples. The economic rationale for this decision was the depletion of savings and inaccessibility of bank loans due to the prohibitively high interest rates and reluctance of banks to give loans to IDPs, let alone entrepreneurs residing in the NGCAs, and lack of government support. Programmes of business assistance run by international agencies were very important in quickly providing so-called 'seed' money<sup>25</sup> and other support, such as re-training and social contracts, but could not accommodate all applicants' needs given the scale of migration. Smaller-



scale industrial enterprises could have moved their entire teams to a new place but were deterred by lack of government support with housing and basic services to enable people move out with their families. For these reasons, in addition to a variety of personal and political considerations, some collectives were split between the two territories and either continued to operate across the line of contact or closed business in the NGCAs.

Businesses in the NGCAs continue reassessing costs of bringing supplies across the line of contact or catering to markets in Ukraine outside the NGCAs. In the earlier stages of the conflict, the links were more robust due to well-established business patterns and because Ukrainian supplies were more competitive in terms of quality/price ratio. However, with time the restrictions have been tightened on both sides, bribes demanded at checkpoints have increased and the Ukrainian hryvna has been washed out of the economic space of the NGCAs. With the artificially inflated hryvna/rouble, retaining business links with partners across the line of contact has become increasingly costly and Russian supplies have started to replace Ukrainian ones.

New arrangements introduced in 2014 have effectively precluded enterprises in the NGCAs from obtaining certificates of origin, licences and other authorisation documentation, or carrying out money transfers to purchase or sell goods and services. These restrictions include the Resolution of the Cabinet of Ministers of Ukraine No. 595 as of 7 November 2014, On the Issues of Financing of State Institutions, Payment of Social Benefits to Citizens and Provision of Financial Support for Some Enterprises and Organisations of Donetsk and Luhansk Oblasts, and the Decree of the National Bank of Ukraine of 9 August 2014 No. 466 suspending any bank and other financial institutions' operations in the NGCAs as well as the suspension of postal services. Businesses outside the current NGCAs but within the adjacent areas and formerly connected with enterprises in Luhansk and Donetsk have also had to reduce or terminate contacts mostly because of the illegal nature of supplying from the NGCAs spare parts or other goods necessary for their business or making official contracts for services. They have had to find alternative suppliers, resulting in greater transport costs.

Service and manufacturing businesses that were in a chain of production with big industrial enterprises that remained in the NGCAs have suffered the most. However, business reputation, including outside Ukraine (in Europe and elsewhere) was a more important asset. Some businesses would

“ Economic connectivity is being steadily disrupted in Donbas, against the wishes of the majority of the business communities across the line of contact. Donetsk and IDP SMEs rarely regarded sustaining business relations as intrinsically tied to political loyalties.

not want to cooperate with the NGCAs or Russia because of ethical considerations. However, SMEs across the line of contact – a few among the Luhansk SMEs surveyed and many among the Donetsk and IDP SME samples – are ready to re-establish business links with their former clients or suppliers once the conflict is resolved.

Luhansk SMEs seem to have drifted further away from the Ukrainian market and suppliers compared to their Donetsk colleagues. This may be because more Donetsk SMEs had had customers outside local markets in the rest of Ukraine, had been further-integrated into production and service networks and had been exporting more compared to the Luhansk SMEs. IDP businesses are predominantly actively seeking new niches in other regions of Ukraine and are not intending to return home in the near future. Thus, the IDP business community is most closely linked to the Ukrainian political and economic space, followed by the Donetsk businesses, while the Luhansk business community has largely detached from the Ukrainian economic space and found itself building closer ties with Russian suppliers while catering predominantly to the limited local market.

## 2.6 Conclusions

Economic connectivity is being steadily disrupted in Donbas, against the wishes of the majority of the business communities across the line of contact. Donetsk and IDP SMEs rarely regarded sustaining business relations as intrinsically tied to political loyalties. Luhansk SMEs, on the contrary, tend to place political loyalty before economic imperative, and mostly boycott Ukrainian supplies and markets. Personal links with business partners appears to have been a counterbalance to the political rift, maintaining connections between businesses divided by conflict and maintaining the possibility of restoring connectivity in future.

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Imposed difficulties and risks have pushed entrepreneurs toward alternative markets, suppliers and clients:

- Luhansk SMEs have drifted away from the Ukrainian market by substituting nearly all Ukrainian supplies with Russian ones
- Donetsk SMEs remain partly linked with Ukrainian suppliers and customers
- nearly half of the IDP SMEs retain business links with the NGCAs.

Some large industrial enterprises from the NGCAs have re-registered in the GCAs and are on the list of exempt companies. They can then transport their products to the GCAs and on to export destinations, including Russia. Big businesses not exempt from the export ban either re-register in Russia or operate through intermediaries and smuggle their produce across the Ukrainian–Russian border currently not controlled by Ukraine. The lack of both freedom of move-

ment and legality of business transactions are regarded as key barriers to retaining or restoring business links and reinvigorating the economy on both sides of the conflict.

Russia as a business destination is not a substitute for Ukraine for private enterprises in Donbas. SMEs and big businesses from Donbas that are exporters or involved in services such as transport consider having an opportunity to cater to both markets as an economic advantage. However the dynamic since 2014 shows that catering to both markets in the current circumstances causes moral discomfort, comes at a reputational cost and is risky amid turbulent political relations between Russia and Ukraine.

Humanitarian-logistical centres established by the Ukrainian side with the aim of facilitating trade in basic products are not known to or not used by SMEs in Donetsk and Luhansk. No one surveyed had ever used these services because they obtain supplies from elsewhere and/or consider the centres a corrupt arrangement.

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### 3. Political connectivity

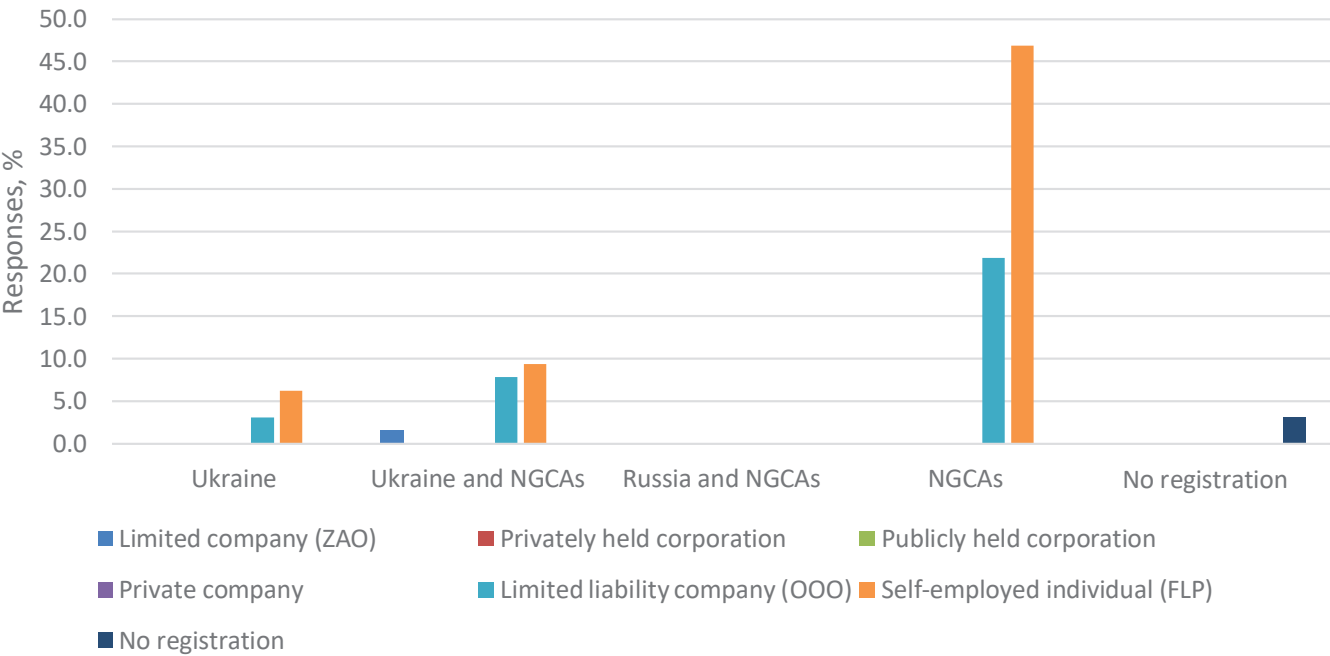
#### 3.1 Business nature and registration

The Donetsk and Luhansk SMEs surveyed differ significantly with respect to the proportions that retained their registration in Ukraine. Overall, 28% of companies from the sample that operate in Donetsk retain their Ukrainian registration as the sole registration (9.38%) or in combination with registration with the de facto authorities locally (18.75%) (Figure 34).

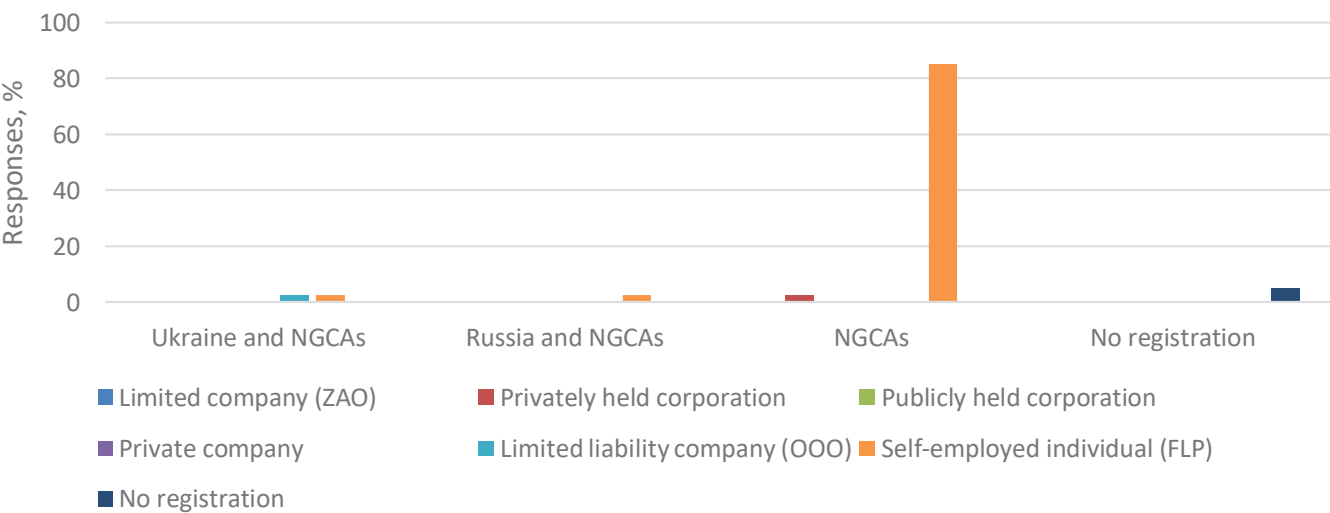
In the Luhansk SME sample there are virtually no enterprises that kept their registration in Ukraine (Figure 35). Nearly all SMEs in Luhansk have re-registered with the authorities of the self-proclaimed republic.

IDPs from the NGCAs have mostly re-registered in the GCAs and just a few of them retain registration in the NGCAs as well (Figure 36). However about 15% of IDP entrepreneurs do not have any registration. This rather high percentage could

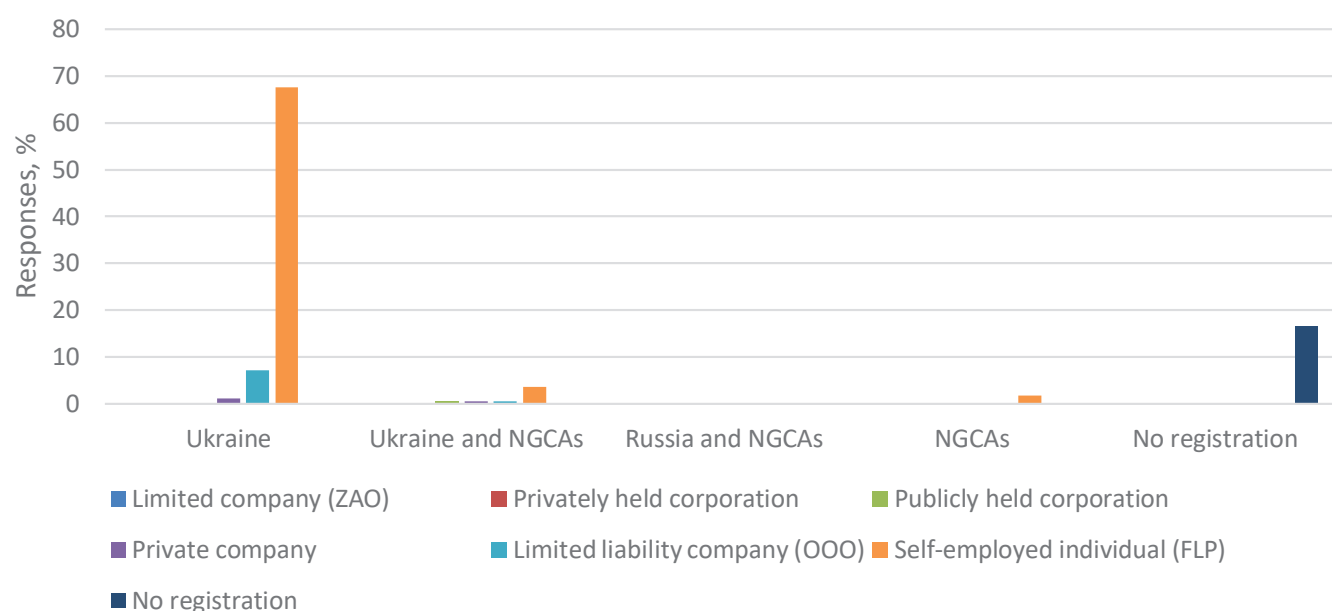
**Figure 34.** Place of registration and company type: Donetsk SME sample (% of all companies)



**Figure 35.** Place of registration and company type: Luhansk SME sample





**Figure 36.** Place of registration and company type: IDP SME sample

be explained by the lack of decisive reasons to completely abandon the idea of return to territories in NGCAs, instead starting a new business in a new location. Many entrepreneurs lack financial means to start legal operation for re-registering, and are deterred by the need to accumulate funds before starting to pay tax as required in Ukraine. They are also concerned to avoid being taxed for operations in the NGCAs as most probably taxes are already paid to the breakaway republics.

Interviews and focus groups indicate a variety of motives among SMEs that continue to operate in the NGCAs for keeping either or both registrations. Micro and small enterprises in the NGCAs, predominantly in retail trade or services and catering exclusively to the local market, had little choice but to register with the local authorities and follow the established rules, even if precarious and constantly changing. After the first year of lawlessness, banditry and racketeering as the dominant 'regulatory' framework, many are satisfied with the seemingly normalised system of the collection of tax, although all stated that the rules of the game change frequently. However, many of those who have obeyed the new rules are critical of the authorities for their incompetence and self-interest as apparent drivers of their decisions.

In Luhansk nearly all businesses surveyed are registered in the self-proclaimed republic only. They explain their decision by political convictions that make their individual acceptance

of the present authorities in Kiev impossible. Resentment towards Ukraine for the warfare and for having cut them off was invariably cited by the Luhansk entrepreneurs interviewed and surveyed as the rationale for their rejection of the common state framework. By contrast, they believe in the future of their republic and say they are trying to make it survive and develop it either as an independent entity or as part of Russia.

IDP SMEs that relocated to the GCAs and currently also operate in the NGCAs depend on informal arrangements such as relatives or friends running the business or guarding the assets without any registration. They may have two different companies registered in the NGCA and in the GCA, while in reality they are one and the same business. This mode allows for functioning in the NGCAs as a local enterprise, while retaining Ukrainian registration. This implies double accounting and double taxation, an option that few can afford.

SMEs that keep their Ukrainian registration and whose businesses operate in the NGCAs treat the current situation as abnormal and transitory and are convinced that the breakaway entities have no economic future outside Ukraine's legal and administrative framework. They are highly vulnerable and operate at risk of prosecution both under Ukraine's Criminal Code clause on financing terrorism<sup>26</sup> and by the NGCA local authorities.

Big companies, such as major mines and metallurgic factories with Ukrainian and foreign shareholders, like DTEK of Rinat Akhmetov or the Industrial Union of Donbas, have managed to continue operation in the NGCAs while retaining only Ukrainian registration. For such companies, special arrangements have been made and were formalised as early as June 2015.<sup>27</sup> They retain their registration and pay tax in Ukraine, while providing jobs and paying salaries to hundreds of thousands of people in the NGCAs. This compromise has been in place since the early days of the armed escalation, officially permitted by the Ukrainian government.<sup>28</sup> The authorities in the NGCAs have never been completely happy with the arrangement and have kept approaching the directors of the enterprises with demands to nationalise them, and to collect environmental or land-use taxes, among others.

Since all of the enterprises with special arrangements are exporting their produce, including to Russia and Europe, they have had to be vigilant with regard to not compromising the legal basis of their operations within the international system. The major argument in favour of keeping the arrangement was that hundreds of thousands Ukrainian citizens and their families, a sizeable part of the population currently residing in the NGCAs, remain within the Ukrainian legal space (an argument aimed at the Ukrainian constituency). This helps to guarantee social stability in the impoverished NGCA areas where authorities have extremely limited capacity to provide jobs outside the public sector fully subsidised by Russia (an argument for the audience on the other side of the line of contact).

The arrangement is nevertheless volatile and not sustainable, according to interlocutors from the industrial sector that operates in the NGCAs but is fully incorporated into the Ukrainian legal and economic system. Some respondents even suggested that, if not for the political will of the major shareholder, the system would not have lasted to date, given current unprofitability of the business due to high operational costs, severely restricted transport options and loss of the Russian market that used to constitute about 22% of Donetsk and 43% of Luhansk exports.<sup>29</sup> With high coal prices, the mines manage to balance their expenditures with profit, but this model of operation is unsustainable.

Half of the big industrial enterprises in Donetsk and Luhansk have eased operation altogether. Their owners have moved their activities to other regions of Ukraine or overseas.<sup>30</sup>

### 3.2 IDP entrepreneurs in Ukraine (before February 2017)

Restrictions on the movement of commercial cargo across the line of contact introduced by the Ukrainian government in May 2015 are commonly referred to as 'blockade'. However, the ban by the authorities of the self-proclaimed LPR on the entry of Ukraine-produced foodstuffs from December 2015<sup>31</sup> or customs procedures and duty collection at the line of contact introduced by the DPR are rarely or never included in the notion of the blockade by respondents in the NGCAs. Donetsk and Luhansk SMEs are unanimous in their negative assessment of the economic blockade by the Ukrainian side. IDP SMEs are divided on this matter (Figure 37).

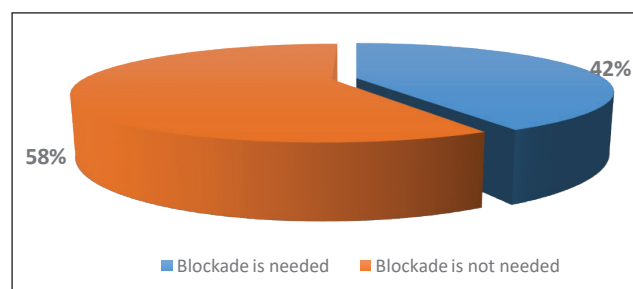
Interestingly, both supporters and opponents of the blockade agree that it is:

- not working and does not achieve its goal
- fosters corruption at checkpoints
- makes ordinary people suffer
- selective and favours oligarchic businesses
- not beneficial for Ukraine
- preventing any legal business engagement, for those who want it, with the other side
- making Ukraine economically absent from the NGCAs.

However, supporters and opponents of the blockade draw differing conclusions. Those in favour of the blockade argue that it:

- should be total
- provides military security for Ukraine.

**Figure 37.** Attitude to economic blockade: IDP SME sample



Those in favour of lifting the blockade argue that it

- serves private interests of the Ukrainian authorities, self-proclaimed authorities in the NGCAs and Russia
- prevents business development
- cuts off vital economic connections with the other side.

Supporters of the blockade place security first and regard the porous line of contact as breaching Ukraine's military security. This leads to their resolute conviction that complete sealing of the line of contact will strengthen security of the government-controlled territories. The population in the NGCAs is of secondary concern and needs to prove its loyalty to the Ukrainian state as a condition of return. Sealing out the NGCAs in their view will make local residents regret their choice or even rebel against the de facto authorities. An option of re-taking the territories militarily is a viable strategy to supporters of the blockade.

Opponents of the blockade draw their predominantly economic justification from the assumption that the end goal is to re-integrate the NGCAs peacefully. They put economic and humanitarian considerations forward and propose more effective use of the 'soft power' of Ukraine through economic presence in the NGCAs.

The restrictions have made an impact on political connectivity between business actors across the line of contact. The two-year period of restricted movement and criminalised economic exchange has dealt a serious blow for the business of the vast majority of SMEs and to their attitude towards the other side. Interestingly, Luhansk entrepreneurs are most vocal and unanimous about Ukraine having cut them off and cite their rejection of any possibility of re-integration as caused by hostile behaviour of Kiev. However, they downplay bans and restrictions introduced by the authorities of the self-styled republics. This discourse has been internalised by them and strengthened by local and Russian media messages.

As previously noted, the Luhansk region had always been less connected to the rest of Ukraine due to inadequate infrastructure. The Donetsk region is better connected, with individuals crossing the contact line more often. There is currently one crossing point between the areas under the control of the LNR and GCAs of Ukraine, while there are five crossing points between the areas under the control of the LNR and GCAs of Ukraine.

### 3.3 Preferred political–territorial status of NGCAs in Donbas

Welcomed or not, the two self-proclaimed republics of DPR and LPR are a reality for businesses situated in those territories. Respondents acknowledged that there had been progress towards the normalisation of business operation and the business environment after the first year of looting and ruthless extortion and expropriation by the self-proclaimed leaders of the republics. Donetsk and Luhansk SMEs diverge in their assessments of the sustainability of the current status quo, economic viability of the two entities and on the pros and cons of the political–territorial options ranging from re-integration into Ukraine to full secession.

Luhansk SMEs are nearly unanimously devoted to political project of an independent LNR as they invariably call the self-proclaimed entity and believe in its future outside Ukraine, and possibly integration into Russia. The current leadership of the self-proclaimed republic is often regarded by the business class as corrupt and incompetent and more of an obstacle than a help to the development of the republic. However this does not seem to challenge their commitment to the LNR and their determination to cut ties with Ukraine. The discourse of resistance to the oppressive and hostile Ukrainian state seems to serve as the main motivator in business: survive and thrive against all odds. SMEs from Luhansk, overall, demonstrate primacy of political considerations, to which business rationale is secondary.

The big Luhansk enterprises are manufacturers and exporters or engaged in the service sector that thrives on networking for business contacts and customers and access to large markets. They are more economically minded and more aware of the drawbacks of non-recognition than the SMEs. They acknowledge the benefits of staying within Ukraine's legal space without necessarily accepting Ukraine's current leadership. However, this does not seem to be a popular strategy among the – very few – big exporting enterprises still operating in Luhansk. According to the estimates of the interlocutors in this study, export volume from Luhansk fell by a factor of 30.

Members of the business community in Donetsk appear to be more business-minded overall, compared to their colleagues in Luhansk. They are able to assess political–territorial options from the perspective of their individual businesses, for which they unanimously endorse freedom of movement and legal and administrative clarity and transparency. They also stress

“Businesspeople, even those not in favour of the post-Maidan developments in the country, became quickly disillusioned about prospects of the enactment of self-rule in the breakaway territories.

a wider macro-economic perspective, factoring in competition, access to markets elsewhere and banking as stimulating economic development. For small retail companies in Donetsk, the balance is steadily shifting towards Russian supplies because of the increased costs and risks associated with bringing goods from across the line of contact. However, many still express their willingness to resume co-operation with Ukrainian suppliers and expand to Ukrainian markets. Bigger enterprises clearly opt for the return of the entire Donbas into the Ukrainian legal space, to regain access to bank loans and proper transport and other necessary infrastructure.

Many respondents from Donetsk rate managerial capacity of the de facto local authorities very as very poor and wait for the leaders of Ukraine, Russia and the self-proclaimed republics to resolve the conflict. Although they refer to the DPR as a real entity, few believe it is a viable one. Businesspeople, even those not in favour of the post-Maidan developments in the country, became quickly disillusioned about prospects of the enactment of self-rule in the breakaway territories, having seen and experienced banditry, murders and looting by the leadership and its incompetence in administration and economic affairs. Some businesses have moved out, while others stayed and eventually adjusted to the new order. However, many remain in a state of unclear identity, resentful of the restricted movement in one's own country and yet living and working outside the country's framework.

The Donetsk business community demonstrates a range of political preferences with respect to the future status of the NGCAs – a more diverse picture than in politically homogeneous Luhansk. The bottom line is the urgent need to operate in the internationally recognised legal field. Many are aware of the unlikelihood of independence of the breakaway republics and of the equally unlikely prospect of being absorbed by Russia. Immediate or gradual renewal of political, administrative and economic links with Ukraine – although not necessarily with the current leadership – are regarded as the

best option. Many prefer the prospect of large-scale national reform that would turn Donbas into a modern and prosperous industrial hub.

For enterprises with important business links with clients or suppliers in Ukraine or other countries, including Russia, registration in Ukraine allows them to continue serving markets and retaining business links with suppliers and partners outside the NGCAs. This allows them to obtain officially recognised certificates of origin and for supplies to be shipped to an address in Ukraine.

For those who have chosen loyalty to the self-proclaimed republics, but nevertheless require proper legal credentials in order to export to Russia and beyond, and to carry out bank transfers, local registration in an unrecognised entity is problematic. Registration of a new enterprise in Russia can become a solution. Intermediaries that are companies already under sanctions, Russian state and non-state agencies and other companies, including banks from South Ossetia, can ensure that big Russian companies integrated into the global market engaged in trading raw materials with enterprises in the NGCAs do not appear in the multi-actor deals.

The decision to switch jurisdiction from Ukraine to Russia has not usually been immediate or without hesitation. Some companies eventually re-orienting themselves towards the Russian market, including by means of registering in Russia, had initially tried to get on the list of companies allowed to take their goods across the line of contact. Only after assessing the pros and cons of the requirement to re-register in the GCAs did they decide that double registration, and hence double taxation, was too costly (especially given declining profits). In addition, it was reported that go-between services offered to ensure a company was on the list were too expensive. Registration in the self-proclaimed republics was either a matter of principle or the only way to keep a business in profit.

### 3.4 Conclusions

Nearly one third of SMEs operating in Donetsk retain their registration in Ukraine as their sole registration or in combination with registration with the de facto authorities. No Luhansk SMEs have retained sole Ukrainian registration, having all re-registered with the de facto authorities. IDP SMEs have overwhelmingly registered in the GCAs, while 15% still operate without any registration.

Decisions about the place of legal registration for SMEs were based on a combination of political, security and economic considerations. Those who have re-registered in the GCAs, but continue their operation in the NGCAs, are most vulnerable to sanctions from both Ukrainian and the de facto authorities of the NGCAs. Most often, this implies double taxation.

Big exporters are mostly registered in Ukraine only. The status quo of non-payment of taxes in the self-proclaimed republics was considered as fragile and unsustainable in the long run. Registration in the self-proclaimed republics is incompatible with export operations and manufacturing for markets outside the NGCAs.

For big enterprises that have left the Ukrainian legal framework, the decision was not necessarily obvious or politically motivated. The procedure for getting on the list of the companies exempt from the ban on commercial transactions was considered to be non-transparent and corrupt. Visibility in the NGCAs made companies vulnerable and few could withstand the pressure to register with the de facto authorities.

Luhansk-based SMEs are overwhelmingly in favour of the political future of the LPR as an entity independent from Ukraine, either seeking its own statehood or integrating into Russia. The future economic trajectory of the LPR is seen as away from Ukraine, which is regarded as hostile. Economic ties with Ukraine are not desired or considered economically expedient by the majority of Luhansk enterprises.

SMEs in Donetsk exhibit a range of preferences for political-territorial status. They view possibilities from the perspective of their individual businesses, for which they unanimously endorse freedom of movement and legal and administrative clarity and transparency. They also take a wider macro-economic perspective, factoring in competition, access to markets elsewhere and banking as stimulating economic development.

Economic restrictions on doing business with suppliers and customers across the line of contact have long been referred to by ordinary people as an economic 'blockade'. This has negatively impacted political connectivity between SMEs in the NGCAs and the Ukrainian state and people.

Supporters of the blockade prioritise security and consider that complete sealing of the line of contact will strengthen security of the government-controlled territories. They feel that those in the NGCAs are of secondary concern and must prove their loyalty to the Ukrainian state as a condition for return. Sealing out the NGCAs, according to this view, will make local residents regret their choice or even rebel against the de facto authorities. An option of re-taking the territories militarily is a viable strategy in the view of those who support the blockade.

Opponents of the blockade draw their predominantly economic justification from the assumption that the end goal is peaceful reintegration of the NGCAs. They stress economic and humanitarian considerations and propose more effective use of the 'soft power' of Ukraine through economic presence in the NGCAs.

## 4. Economic and political connectivity: future outlook

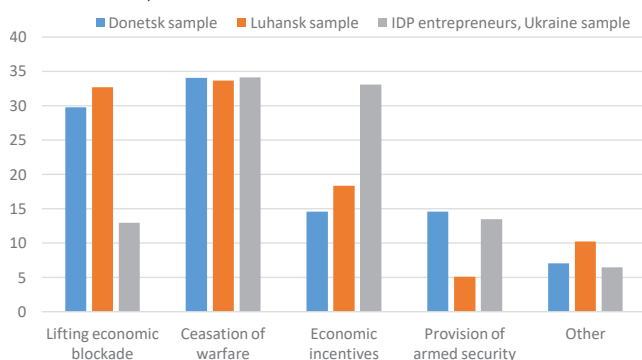
### 4.1 Conditions for improvement of the business environment

Lifting the economic blockade is twice as important for SMEs in Donetsk and Luhansk compared to IDP entrepreneurs in the GCAs (Figure 39). Compared to survey results in 2015, the number of those for whom the economic blockade was an impediment for business development has slightly decreased in all communities (Figure 39).

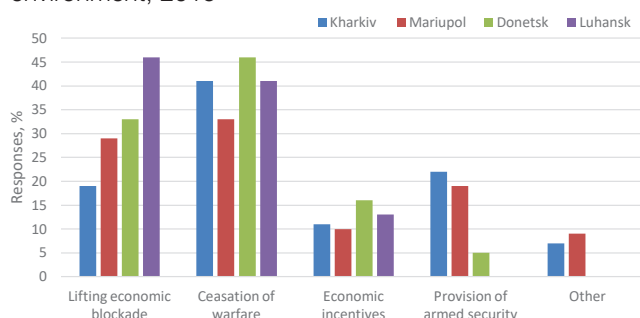
This is indicative of Donetsk and Luhansk business circles wanting to stay economically connected with Ukraine irrespective of the de facto current division, while IDPs have economically and politically disengaged from the NGCAs and invested their energy and resources into building a new life elsewhere or believing that the economic blockade will accelerate the fall of the de facto regimes.

Economic incentives are important for 33% of IDP entrepreneurs compared to 15% and 17% for Donetsk and Luhansk. This may mean that businesspeople in Donetsk and Luhansk prioritise basic security and freedom of movement and do not expect economic stimuli to be provided and possibly

**Figure 38.** Conditions for improvement of the business environment, 2016



**Figure 39.** Conditions for improvement of the business environment, 2015

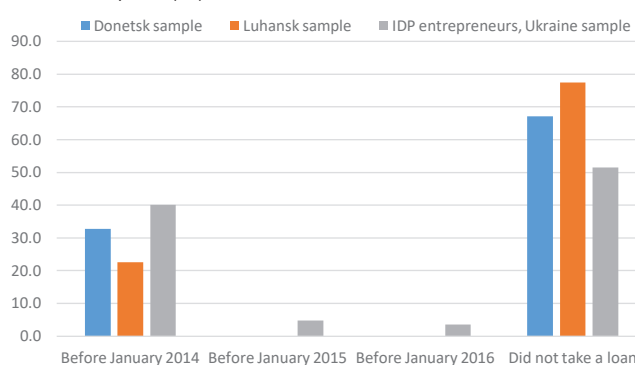


do not make long-term plans. Cessation of armed hostilities remains high on the agenda of business communities on both sides of the line of contact, which not only points to the fragility of ceasefire but also reflects the overwhelming importance of a lasting truce before any political or economic proposals can be negotiated.

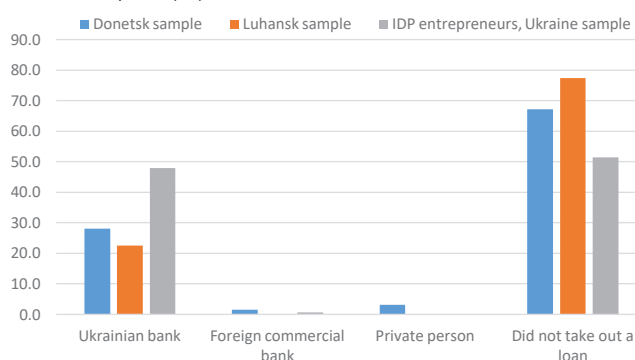
### 4.2 Investment patterns before and after the conflict

SMEs from the conflict-affected Donbas did not apply for loans after the outbreak of armed hostilities in the summer of 2014, although around a third of the sample did before January 2014 (Figure 40). Borrowing money from banks, in general, was not a popular trend among entrepreneurs in the sample, which is in line with the overall tendency in Ukraine where only 22% of businesses apply for bank loans.<sup>32</sup> However SMEs that left the NGCAs demonstrated a higher-than-average rate of taking out loans, which may indicate greater scale of business and/or greater profitability. Before

**Figure 40.** Borrowing history, Donetsk, Luhansk and IDP SME samples (%)

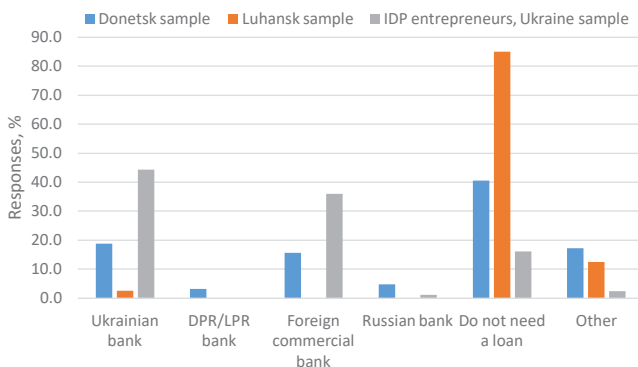


**Figure 41.** Source of loans, Donetsk, Luhansk and IDP SME samples (%)





**Figure 42.** Taking out a loan: an ideal bank: Donetsk, Luhansk and IDP entrepreneurs, Ukraine samples



the conflict, all enterprises that did take out loans had dealt exclusively with Ukrainian banks (Figure 41). The companies that left the NGCAs had been borrowing 1.5–2.0 times more than those that stayed. Entrepreneurs from the Donetsk sample were taking out loans more actively than those from Luhansk (28% and 22%, respectively).

Entrepreneurs that stayed in Donetsk nevertheless consider Ukrainian and foreign commercial banks as the preferred options for taking out a loan (Figure 42). Luhansk-based entrepreneurs appear to completely disregard hypothetical borrowing from the bank.

This is a striking difference between the two NGCAs, with Donetsk entrepreneurs considering the possibility of the resumption of business and legal relationships with Ukrainian and foreign banks. This is in line with the desire of Donetsk SMEs to return to the legal space compliant with international norms in order to grow, whereas Luhansk

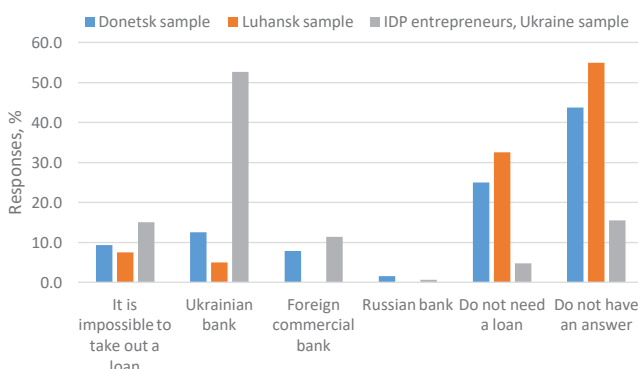
businesses seem to have limited their horizons to the local market and local resources exclusively. IDP entrepreneurs in Ukraine demonstrate a strong tendency for hoping to be able to borrow from both Ukrainian and foreign commercial banks.

Businesses from both regions are highly uncertain about the possibility and modalities of taking out a bank loan. Rates of those who did not have an answer to the question regarding realistic prospects of borrowing and did not believe this is a feasible option are 52% among the Donetsk sample and 62% in the Luhansk sample (Figure 43). About 20% of Donetsk entrepreneurs from the sample felt that the option of taking out a loan from a Ukrainian or foreign bank was realistic, as opposed to 5% in Luhansk.

Of IDP entrepreneurs, 15% thought it was impossible to get a bank loan but 50% felt certain about being able to take out a loan from a Ukrainian bank, with another 11% considering it feasible to borrow from a foreign commercial bank.

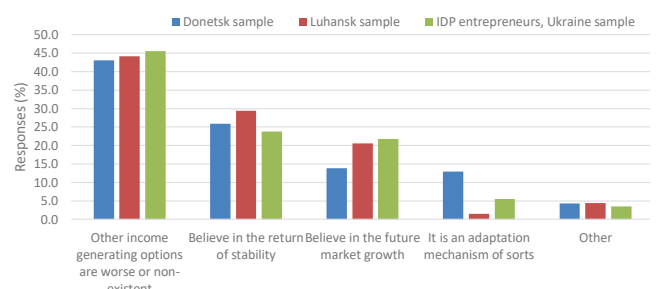
Overall, the elicited pattern of attitudes towards borrowing from a bank as an integral business-investment strategy clearly points to the distinct business development models adopted by the entrepreneurs residing in Donetsk and Luhansk and those who have left the NGCAs. The former do not consider borrowing from the bank a feasible or desirable option due to legal obstacles and decline in business turnover, which makes the already high interest rate even less attractive. IDP entrepreneurs, by contrast, appear to become more hopeful with the partial or complete revival of their business activities and are willing to take risks in order to grow.

**Figure 43.** Taking out a loan: a realistic bank: Donetsk, Luhansk and IDP SME samples<sup>33</sup>



### 4.3 Reasons to stay in business

**Figure 44.** Reasons to stay in business, Donetsk, Luhansk and IDP SME samples (%)



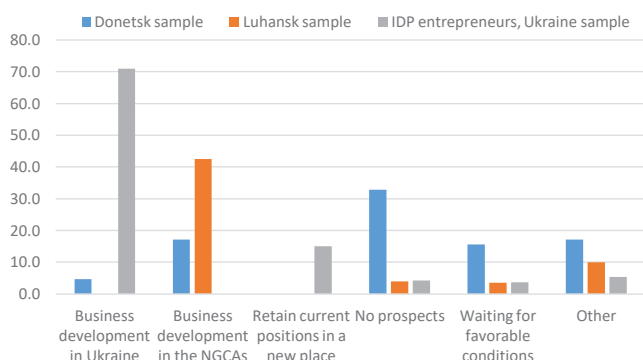
#### 4.4 Prospects for the next six and twelve months

Donetsk SMEs are least optimistic about immediate possibilities to continue their business operation. Only 15% of them are planning to develop their business in their current place of residence as opposed to 40% of the Luhansk-based entrepreneurs and 70% of the IDP SMEs (Fig. 45).

##### Prospects for the next twelve months

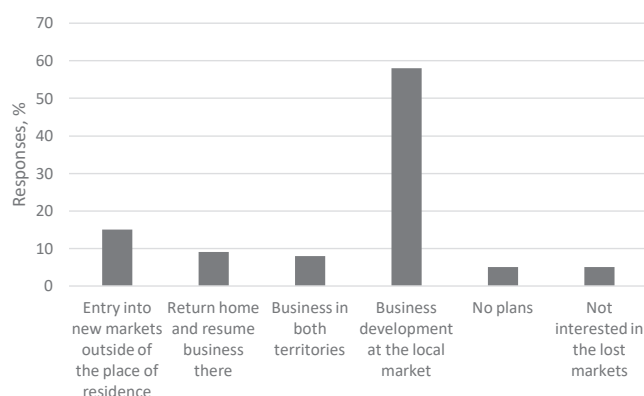
When the planning horizon expands to a year, the pattern of six-month planning remains, with the majority of businesses trying to establish themselves locally and become

**Figure 45.** Prospects for the next six months, Donetsk, Luhansk and IDP entrepreneurs, Ukraine samples (%)

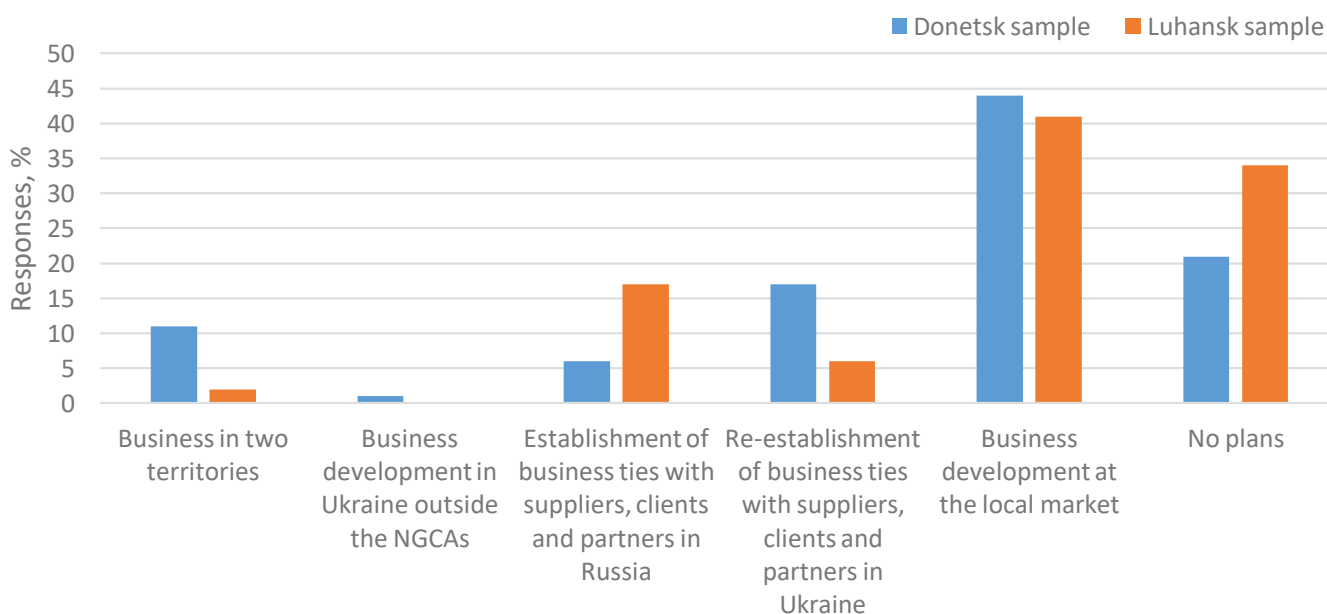


operational (Figures 46 and 47). However SMEs in Donetsk become more optimistic as the time horizon expands, while Luhansk SMEs become less clear about their plans beyond the very immediate future. Donetsk-based SMEs generally tend to be more economically minded, hoping for minimal legal and security conditions to improve soon in order to re-engage with markets and suppliers, irrespective of the final political solution of the conflict. Luhansk SMEs are equally unclear about the time horizon for the final settlement of the conflict, nevertheless they have subdued their business operation to the local market and supplies that are increasingly secluded and shrinking, and are unable to enter the Russian market and compete with Russian supplies.

**Figure 46.** Prospects for the next twelve months, IDP SMEs sample (%)



**Figure 47.** Plans for the next 12 months, Donetsk and Luhansk SME samples



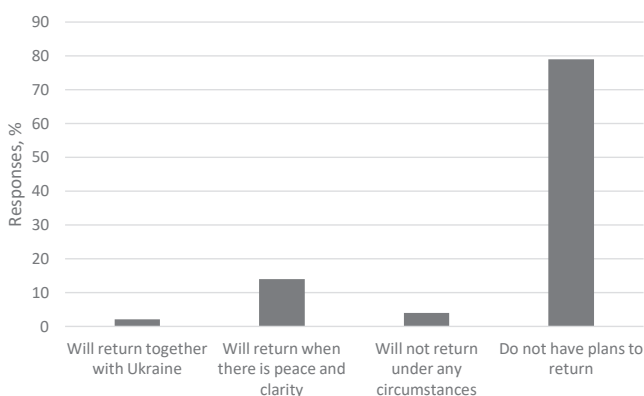


While the percentage of the outward-looking SMEs in both Donetsk and Luhansk is slightly above 15%, the diametrically opposite market orientations are evident for this sub-category. In their narratives, all emphasised lack of legal status and insecurity making any business plans ephemeral. Some in Donetsk clearly hope for the return of the territories to the Ukrainian legal field. Others in Donetsk and all surveyed in Luhansk see some sort of an agreement on the status of the disputed territories between the stakeholders – Ukraine, the self-proclaimed republics and Russia – as a minimum condition to reinvigorate their business through re-starting legal operations. This implies the expansion of markets, export opportunities and availability of bank loans.

Some IDP entrepreneurs have returned home and re-started their business in accord with local requirements because their prospects in the Ukraine-controlled areas were even gloomier.<sup>34</sup> The number of returnees is not small and their presence is felt, judging by the increase of clients and demand for services reported by local businesses in the NGCAs, which in turn conditioned their relative growth after recession. However compared to the results of our 2015 research,<sup>35</sup> hopes among IDP entrepreneurs to go home in the foreseeable future are fading and giving way to the determination to start a new life in a new place.

Entrepreneurs who had left the NGCAs and settled in the government-controlled territories have little inclination to go back, although very few excluded this option altogether (Figure 48). The proportion of IDPs who would be willing to return is declining as the conflict persists, regardless of obvious hardship and lack of governmental support for resettlement. At the same time, the share of those who would like to leave the NGCAs is not growing.

**Figure 48.** Plans to return, IDP SMEs sample (%)



“ Estimates of time needed to put all big industries that were not destroyed back into full operational mode range from three to five years.

### Reconstruction of Donbas: how soon?

Many admit that, once a mutually satisfactory solution is found, which most often implies re-integration of the NGCAs into Ukraine, and the sides re-establish relationships, the economy will re-start sooner than human relations will be repaired. Estimates of time needed to put all big industries that were not destroyed back into full operational mode range from three to five years. At the level of SMEs, respondents said that they would re-enter lost markets and re-engage with clients and suppliers within days or months. Full restructuring and modernisation of Donbas industry could take up to 20 years but the upside is that then it may become internationally competitive.

### Is Donbas an asset or a liability for Ukraine?

In the present study, entrepreneurs from Donbas were those offering assessments of the region. The most popular line of discourse was that Donbas is a region of enormous wealth, and that industry is Ukraine's strength rather than a weakness. Many from the region forecast Ukraine's agrarian future without Donbas, which is a way of saying that the expect Ukraine's status as a heavily industrialised and globally-exporting economy to seriously suffer.

Big business presents a global overview of Donbas as a part of certain global markets, notably coal and metals, therefore viewing the region as one of the main economic assets of Ukraine. Recent modernisation has made the Alchevsk metallurgic industry the leader in this sector in Europe, an investment that might become a waste of funds if an end to the conflict is not achieved soon. Donbas is a region with industries competitive in non-European markets, some of them quite promising at the moment, such as Iran. Developing diversified destinations for industrial outputs from Donbas is regarded as the most viable policy – including for sustaining peace and security.

Accounts on the significance of Donbas are diverse<sup>36</sup>. Political and social significance (software) need to be incorporated into economic analysis of the industrial outputs (hardware) and calculate economic value in terms of the totality of resources.

## 4.5 Conclusions

- Some Donetsk SMEs clearly hope for return of the territories to the Ukrainian legal field. Others in Donetsk and all surveyed in Luhansk see some sort of agreement on the status of the disputed territories as an essential condition for reinvigorating their businesses.
  - Donetsk SMEs are less optimistic when considering near-term prospects, compared to IDP and Luhansk SMEs. This is largely the case because Donetsk SMEs seem to be more concerned with economic expediency rather than the political outcome of the conflict. Luhansk SMEs are similarly uncertain about political outcomes, however they have already limited their economic activities to an increasingly shrinking local market as they are unable to expand or compete with Russian entities.
  - About 15% of Donetsk SMEs are ready to expand into the Ukrainian market, with 5% ready to establish links with the Russian market. Luhansk SMEs indicate similar proportions but in reverse, with the larger share looking to Russia. The majority among both SME communities are planning to operate in their local market.
  - Compared to the results of our 2015 research,<sup>37</sup> hopes among IDP entrepreneurs of returning home are fading. Most entrepreneurs who left the NGCAs and settled in the government-controlled territories have no plans to return, although very few excluded this option altogether.
  - Few of the Donetsk SMEs are considering leaving the territory, mostly because of lack of prospects elsewhere and because of attachment to their home communities although they do not exclude Ukraine as a potential destination. Luhansk SMEs are determined to stay and would under no circumstances move to Ukraine.
  - Minimal possibility to legally engage in business relations across the line of contact is generally acceptable and sufficient for SMEs in Donetsk and in other regions in Ukraine that used to do business with the current NGCAs in Donbas to re-establish economic activities with former suppliers, customers and partners. Luhansk SMEs put political resolution as a pre-condition for economic relations with the Ukrainian counterparts.
  - When a satisfactory, even if provisional solution, is found and the sides re-establish relationships, expectations are that the economy will re-start sooner within months or years. Respondents expect that human relations will take longer to repair, and that they will require a generational change.
  - Big businesses and SMEs alike consider Donbas industry and other resources to be an asset to Ukraine, and integral to certain global markets, such as coal and metals. Developing diversified destinations for industrial outputs from Donbas is regarded as the most viable policy – including for sustaining peace and security.
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# Endnotes

- 1 Mirimanova, N. (2015) 'Business opportunities lost. . . and found', Centre for Humanitarian Dialogue.
- 2 *Temporary Order on Control of the Movement of People, Transport Vehicles and Cargo Along the Contact Line in Donetsk and Luhansk Regions* was in force since 21 January 2015 as amended on 16 June 2015. Exemption of certain commodities and raw materials were approved by the government. See ТИМЧАСОВИЙ ПОРЯДОК контролю за переміщенням осіб, транспортних засобів та вантажів (товарів) через лінію зіткнення у межах Донецької та Луганської областей [Temporary rules of the control of the crossing of the line of contact within the limits of the Donetsk and Luhansk regions by persons, vehicles and cargo (goods)] and the Annexes 4 and 5, 12.06.2015, 24.06.2016.] available at <http://sfs.gov.ua/diyalnist/zakonodavstvo-pro-diyalnis/nakazi-pro-diyalnist/63768.html> <http://sfs.gov.ua/diyalnist/zakonodavstvo-pro-diyalnis/nakazi-pro-diyalnist/63768.html>; At the end of 2015 the self-styled Luhansk People's Republic (LPR) banned foodstuff produced in Ukraine by virtue of having put forward a requirement that Ukrainian produce enters LPR through the border with Russian Federation only, not even by transiting the adjacent self-proclaimed Donetsk People's Republic (DPR). Only small quantities for personal use were allowed. In contrast, the DPR has never banned Ukrainian goods, but introduced so-called customs duties. See СОВЕТ МИНИСТРОВ ЛУГАНСКОЙ НАРОДНОЙ РЕСПУБЛИКИ, ПОСТАНОВЛЕНИЕ от 29 декабря 2015 г. №02-04/414/15.
- 3 <http://www.rnbo.gov.ua/documents/441.html>
- 4 See, for example <https://ru.hromadske.ua/posts/deputat-hosdumy-rf-donbass-nado-zabyrat-k-seberain.ru>; <http://novosti.dn.ua/article/6698-kak-budut-rabotat-y-kuda-sbyvat-produkcyu-zavody-nepodkontrolnoy-territory>; <http://www.rbc.ru/politics/15/03/2017/58c7f8c69a7947312027714e>
- 5 See, for example <http://en.interfax.com.ua/news/economic/410421.html>
- 6 [https://bank.gov.ua/control/en/publish/article?art\\_id=45199781&cat\\_id=76291](https://bank.gov.ua/control/en/publish/article?art_id=45199781&cat_id=76291); Saha, D. and Kravchuk, V. (2017) 'Trade suspension and company seizures in non-controlled area: economic impact on government-controlled area', German Advisory Group, Institute for Economic Research and Policy Advising, Policy Briefing Series [PB/06/2017], May ([www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/06/PB\\_06\\_2017\\_en.pdf](http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2017/06/PB_06_2017_en.pdf)); wiiw Opinion Corner: Economic effects of Donbas trade blockade, 1.06.2017, <https://wiiw.ac.at/wiiw-opinion-corner-economic-effects-of-donbas-trade-blockade-n-224.html>
- 7 See, for example 'India-Sri Lanka Relations: Strengthening SAARC, 2013'; Pugh, M., Cooper, N. and Goodhand, J. (2004) *War economies in a regional context: challenges of transformation*, Lynne Reiner Publishers, London, Boulder; Mirimanova, N. (2012) 'Prospects for the regulation of trans-Ingur/i economic relations: stakeholder analysis', International Alert. [http://www.international-alert.org/sites/default/files/Caucasus\\_TransInguri\\_EconRelationsAnalysis\\_EN\\_2012.pdf](http://www.international-alert.org/sites/default/files/Caucasus_TransInguri_EconRelationsAnalysis_EN_2012.pdf)
- 8 Mirimanova, N. (2015) 'Business opportunities lost. . . and found', Centre for Humanitarian Dialogue.
- 9 Yesmukhanova, Y. and Ackles, D. 'Economic connectivity in Ukraine: a regional focus', CASE-Ukraine, [http://www.case-ukraine.com.ua/](http://www.case-ukraine.com.ua/wp-content/uploads/2016/08/Economic-Connectivity_eng_13-07-3-compressed.pdf)  
[wp-content/uploads/2016/08/Economic-Connectivity\\_eng\\_13-07-3-compressed.pdf](http://www.case-ukraine.com.ua/wp-content/uploads/2016/08/Economic-Connectivity_eng_13-07-3-compressed.pdf)
- 10 Mirimanova, N. (2015) 'Business opportunities lost. . . and found', Centre for Humanitarian Dialogue.
- 11 Enterprise size here is defined by number of employees: micro = 0–10, small = 10–50, medium = 51–250, big = over 250; see *Neighborhood SME Financing: Ukraine*, European Investment Bank, February 2016.
- 12 The smaller sample size in Luhansk was due to the increasing difficulties in reaching out to people and the high rate of declined invitations for participation in the study. However, the high uniformity of responses demonstrates a clear trend among Luhansk entrepreneurs.
- 13 Расследование РБК: на чьи деньги живет Донбасс, [RBC investigation: with whose money does Donbass live?] <http://www.rbc.ru/investigation/politics/15/06/2015/5579b4b99a7947b063440210>
- 14 The IDP SME sample was divided into two sub-samples of Donetsk and Luhansk residents. The sub-samples were then added to the current Donetsk and Luhansk samples to track the dynamic of business from January to August 2014.
- 15 The self-proclaimed Donetsk People's Republic established a 'customs regime' in July 2015 and introduced duties that are universal for any goods entering the de facto republic, including from Ukraine. No Ukrainian products were banned. See Постановление от 12.02.2016 N1-10 «О внесении изменений и дополнений во Временное положение о таможенном тарифе Донецкой Народной Республики, утвержденное Постановлением Совета Министров Донецкой Народной Республики N19-29 от 16.10.2015»
- 16 Zhukov, Y. (2015) 'Trading hard hats for combat helmets: the economics of rebellion in Eastern Ukraine', *Journal of Comparative Economics*, 1 November 2015; 'Украина привыкает жить, не торогуя с Россией', Ведомости, 23.11.2015, <https://www.vedomosti.ru/economics/articles/2015/11/23/617942-ukraina-ne-torguya-rossiei> (English version: 'Ukraine adapts trade links to soften Russian economic blow, Financial Times, 22.11.2017, <https://www.ft.com/content/f2795d64-8eb6-11e5-a549-b89a1dfde9b>
- 17 Rinat Akhmetov managed recently to relocate his large, modern medical centre from Donetsk to Mariupol, with all the equipment and personnel, but the majority of businesses could not afford this move.
- 18 The category 'Before the conflict' comprises IDP SMEs from Donetsk.
- 19 The category 'Before the conflict' comprises IDP SMEs from Luhansk.
- 20 <https://www.hrw.org/news/2017/02/17/ukraine-dangers-unnecessary-delays-crossing-points>, 17 February 2017.
- 21 SMM OSCE reports.
- 22 In the 2015 study, IDP SMEs were surveyed in Kharkiv and Mariupol.
- 23 See, for example <http://www.osce.org/ukraine-smm/156791?download=true>
- 24 Cabinet of Ministers of Ukraine, Resolution No. 1035 on restrictions on the supply of certain goods (works, services) from temporarily occupied territory to another territory of Ukraine and/or from another territory

- of Ukraine to the temporarily occupied territory, adopted 16 December 2015 (*Про обмеження поставок окремих товарів (робіт, послуг) з тимчасово окупованої території на іншу територію України та/або з іншої території України на тимчасово окуповану територію*), <http://zakon3.rada.gov.ua/laws/show/1035-2015-%D0%BF>
- 25 UNDP programmes, for example.
- 26 Кримінальний кодекс України, Стаття 258-5. Фінансування тероризму (Criminal Code of Ukraine, Article 258-5, Financing of terrorism), [http://kodeksy.com.ua/kriminal\\_nij\\_kodeks\\_ukraini/statja-258-5.htm](http://kodeksy.com.ua/kriminal_nij_kodeks_ukraini/statja-258-5.htm); there were cases of businesspeople based in the GCAs but having business links with the NGCAs being arrested for the ‘financing of terrorism’: <https://inforesist.org/sbu-arestovala-top-menedzhera-seti-supermarketov-za-finansirovanie-dnr/> СБУ арестувала топ-менеджера сети супермаркетів за фінансування «ДНР» (SBU arrested a top-manager of the supermarket chain for the financing of the “DPR”)
- 27 ТИМЧАСОВИЙ ПОРЯДОК контролю за переміщенням осіб, транспортних засобів та вантажів (товарів) через лінію зіткнення у межах Донецької та Луганської областей [Temporary rules of the control of the crossing of the line of contact within the limits of the Donetsk and Luhansk regions by persons, vehicles and cargo (goods)] and Annexes 4 and 5, 12.06.2015, 24.06.2016.] available at <http://sfs.gov.ua/diyalnist-/zakonodavstvo-pro-diyalnis/nakazi-pro-diyalnist/63768.html><http://sfs.gov.ua/diyalnist-/zakonodavstvo-pro-diyalnis/nakazi-pro-diyalnist/63768.html>
- 28 Ibid.
- 29 ‘The economy of the Donbas in figures’, German Advisory Group and Institute for Economic and Policy Consulting, June 2014, [http://www.ier.com.ua/files/publications/Policy\\_Briefing\\_Series/TN\\_04\\_2014\\_en.pdf](http://www.ier.com.ua/files/publications/Policy_Briefing_Series/TN_04_2014_en.pdf)
- 30 Расследование РБК: на чьи деньги живет Донбасс, [RBC investigation: with whose money does Donbass live?] <http://www.rbc.ru/investigation/politics/15/06/2015/5579b4b99a7947b063440210>
- 31 <http://sovminlnr.su/akt/06.01.2016/7.pdf>
- 32 Рейтинг інвестиційної привабливості регіонів України 2014, Підготовлено Київським міжнародним інститутом соціології у партнерстві з Інститутом економічних досліджень та політичних консультацій на замовлення Державного агентства з інвестицій та управління національними проектами України, Київ 2014 [Kiev International Sociology Institute and Institute for Economic Research and Political Consulting, Investment attractiveness rating of the regions of Ukraine, Kiev, 2014].
- 33 Russian banks were put in a separate category and were excluded from the foreign commercial banks category.
- 34 They were counted as part of the Donetsk or Luhansk samples according to their current location.
- 35 Mirimanova, N. (2015) ‘Business opportunities lost. . . and found’, Centre for Humanitarian Dialogue.
- 36 See, for example, ‘The significance of the Donbas’, <http://www.dw.com/en/the-significance-of-the-donbas/a-17567049>; ‘The economy of the Donbas in figures’, German Advisory Group and Institute for Economic and Policy Consulting, June 2014, [http://www.ier.com.ua/files/publications/Policy\\_Briefing\\_Series/TN\\_04\\_2014\\_en.pdf](http://www.ier.com.ua/files/publications/Policy_Briefing_Series/TN_04_2014_en.pdf)
- 37 Mirimanova, N. (2015) ‘Business opportunities lost. . . and found’, Centre for Humanitarian Dialogue.









