

ECONOMIC REASONS OF THE RETURN

Analytical Report
July 2023



This publication has been made within the frameworks of the MATRA Programme supported by the Embassy of the Kingdom of the Netherlands in Ukraine. The opinions expressed are those of the authors only and should not be considered as representative of the Embassy's official position.

ECONOMIC REASONS OF THE RETURN

Vasyl YURCHYSHYN,
Director of the Economic and Social Programmes, the Razumkov Centre

As has been repeatedly emphasised, human capital is the most important factor in ensuring the country's socio-economic development, improving competitiveness of the national economy, and providing for decent well-being of households.¹ A necessary prerequisite for the country's development is, of course, the formation of a strong economic potential and its translation into real growth, which, among other things, should be based on minimising unemployment and directing society towards full employment.

Note that employment expansion does not automatically mean growth of the national economy. Equally important are the presence and activity of factors that, on the one hand, contribute to economic agents' readiness to work productively in their own country and, on the other hand, generate an expanded supply of employment based on sustainable economic dynamics. In this mixture of mutual influences between economic growth and effective employment, a special role is played by an active working-age population and its ability to sustain itself (a positive factor), and by a declining population, including that associated with its withdrawal from the labour force, both natural and emigration-related (a negative factor). This is where the significant risks and challenges for Ukraine are. The UN estimates that almost 13 million people left Ukraine during the first year of the large-scale war, of whom just over 8 million had already returned by the end of 2022, and 4.8 million had been granted temporary protection in the EU.²

Ukraine faces a difficult task of post-war recovery and strengthening of its human capital. The war destroyed thousands of production facilities and millions of jobs, some of which will never be restored. Moreover, competitiveness will require not just rebuilding old production facilities, standards and technologies, but also training of new quality workers who will be able to work effectively in new information and technological environments. This will require a significant supply of sufficient skilled labour resources in the domestic economic environment.

Macroeconomic dynamics. It is clear that the essential components of the socio-economic environment – economic growth, welfare, decent and well-paid work, and balanced regional development – are inter-related, requiring systemic and comprehensive measures to maintain an adequate level of welfare and full employment, reduce internal migration, and minimise the outflow of labour and human capital.

Classical macroeconomic postulates point to a rather clear interrelation between the gross domestic product dynamics and employment/

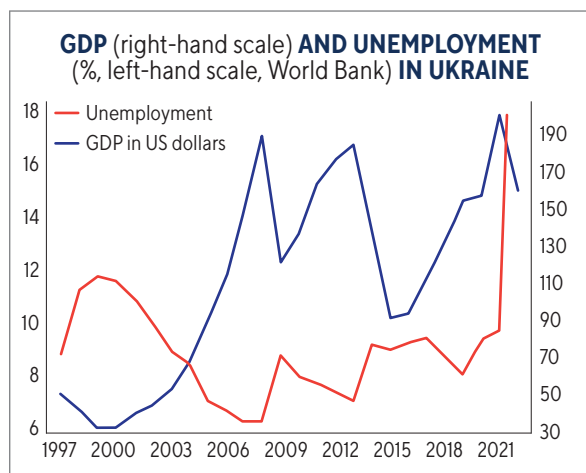
unemployment. It is universally recognised that higher employment (or lower unemployment) means higher involvement of labour force in production processes and is a positive factor in monetary and fiscal stabilisation, thus contributing to economic development, which is manifested through the growth of domestically produced product – GDP.³ Usually, this interrelation between GDP and employment dynamics is a long-term one, although in transition economies, including Ukraine, such interactions are manifested even in the short term (Figure «GDP and unemployment in Ukraine»⁴).

¹ Socio-economic and humanitarian consequences of Russian aggression for Ukrainian society (in Ukrainian) / Kyiv, Razumkov Centre, 2022, https://razumkov.org.ua/uploads/article/2022_Gum.pdf.

² Y.Vinokurov. Millions of Ukrainians lost their jobs because of the war. Where do they get money to live on? – «Ekonomichna Pravda», <https://www.epravda.com.ua/publications/2022/12/8/694732/>.

³ Accordingly, an increase in unemployment is a negative factor in economic growth and GDP production.

⁴ To minimise the impact of significant inflation and devaluation, the US dollar equivalent of GDP is used as the volume of GDP produced. This is psychologically acceptable for Ukrainians, as the dollar equivalent of goods, services, wages, financial assets, etc. is often used as a measure of value in Ukraine.



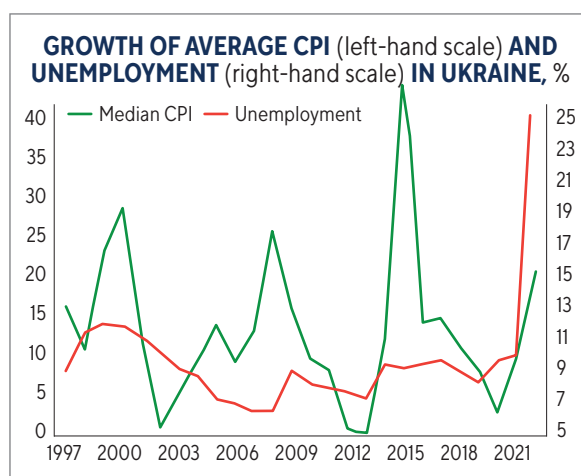
It is understandable that demand for labour was growing against the country's upward economic dynamics in the first half of the 2000s, with significant reduction of unemployment rate. However, a deterioration in economic conditions, including accelerating inflation or devaluation, meant that workers were laid off, which immediately affected the rate of domestic product. Moreover, external shocks, such as the Global Financial Crisis of 2008–2009, the first Russian aggression in 2014–2018 and subsequent full-scale invasion in 2022, caused a sharp decline in both the number of people employed in the economy and economic performance.

Another macroeconomic postulate – the inverse interrelation between employment/unemployment and inflation – is not clearly manifested in Ukraine (Figure «Growth of Average CPI and Unemployment in Ukraine»). Rather, it is more about the inflation's indifference to employment. This is due to the fact that, given the low living standards, households spend the lion's share of their income on the most basic necessities (food, housing and utilities). A decrease in income, including as a result of job losses or salary cuts, means either a transition to another price niche, e.g., buying consumer goods of lower quality, or an increase in arrears, e.g., for housing and utility bills.

Price parameters are also affected by shadow activity, which increases during periods of turmoil in the formal economy, weakening the interrelation between official GDP and official inflation.

Meanwhile, it is worth noting that inflationary spikes occurred in the early

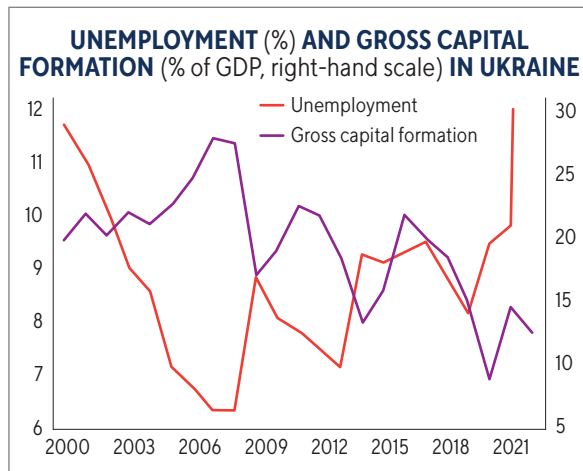
2000s, during the Global Financial Crisis of 2008–2009, the first Russian attack of 2014–2018, and the coronavirus shock of 2020, and were mainly linked to various governmental administrations in consumer markets, such as severe restrictions on food supplies during the coronavirus crisis, and the «management» of housing and utility tariffs, even if the authorities decided to freeze them, which caused an even greater price shock. Of course, such administrative interventions in the markets resulted in supply gaps, shortages in supply and demand for a wide range of goods, and a decrease in orders, which led to a decline in production and thus to an increase in unemployment.



Investment. When it comes to economic growth and development, an important prerequisite is the existence of a certain stock of capital (investment), and usually capital accumulation should mean readiness for investment expansion, which creates additional demand for labour. Often these two processes can be stretched in time, but the time lag for an emerging domestic economy is significantly reduced, so capital accumulation is often accompanied by employment growth (or unemployment reduction).

But here, the peculiarities of domestic socio-political processes come to the fore. This particularly concerns the period of the first Russian invasion in 2014–2018, when the capture of the Donbas, the destruction of production facilities and the refusal to invest in the region, which has always been capital-intensive, the forced departure of workers to other Ukrainian regions, where employment was neither quick nor easy, led to the fact that capital accumulation in the form of stockpiling was accompanied by an increase in

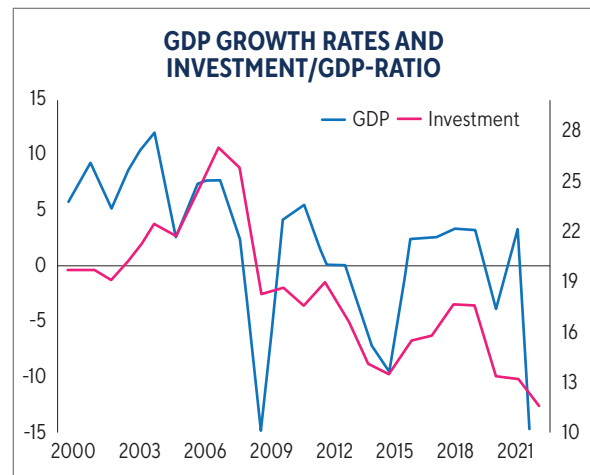
unemployment (Figure «Unemployment and gross capital formation»).



This «abnormal» interrelation will partially answer the question of employment as a result of labour inflows/outflows in 2022-2023 caused by Russian aggression and massive migration of Ukrainians abroad.

The situation with investment and employment is further aggravated by the fact that any increase in state participation in investment projects is very unlikely in the coming years. The state budget expenditures for 5 months actually indicate the expenditure structure relevant for the entire 2023. Thus, out of the total budget expenditures of UAH 1,408 billion, defence expenditures amounted to UAH 745 billion (53% of total expenditures), public order and security – UAH 174 billion (12%), social protection – UAH 196 billion (14%), and all other expenditures, including healthcare, general government functions, and education, will account for about 20% of total expenditures, which generally corresponds to the structure of 2022. This means that there are simply no resources for capital public investment.

The experience of emerging economies shows that for economic acceleration, the share of investment in the GDP structure should be at least 22-24%, while in many Asian countries, this share exceeds 30-35%. The same was true for Ukraine, when high economic growth rates (over 7% per annum) were maintained in 2000-2007, and the share of investment reached 20-25% of GDP (Figure «GDP growth rates and investment/GDP-ratio»).



In the coming years, Ukraine's GDP is unlikely to exceed \$200 billion. Therefore, in order to accelerate its economy, Ukraine needs to invest about \$40-50 billion every year to reach the desired level of 20-25% of GDP. Of course, domestic resources are out of the question – this figure can only be achieved through financial assistance from developed partner countries and the corresponding attraction of (foreign) labour.

Foreign trade. Another postulate alleges that the growth of imports has a negative impact on both national production and GDP, and is a factor in increasing unemployment, thus justifying the need for import substitution. However, the spread of globalisation, the flow of investment and the rapid retraining of the workforce appear to be providing additional opportunities for workers to access new jobs. Although there is some displacement of labour due to trade expansion, it is trade that pushes for the formation of a renewed labour system, the creation of new jobs, and increased productivity.

In fact, numerous studies of international trade point to different kinds of patterns, in particular:⁵

- ✓ in foreign trade accounts, exports and imports are often interrelated. Competitive exports usually use a significant share of imported components and inputs. Therefore, imports do not displace employment, as fewer exports are produced;
- ✓ opening up international trade and domestic markets is often a prerequisite for

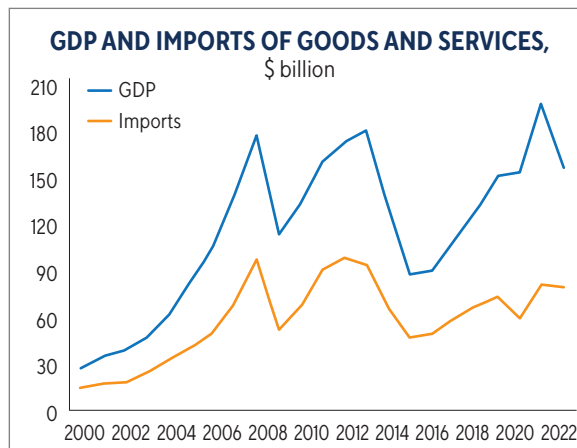
⁵ Making trade work for all. – OECD, <https://www.oecd.org/trade/>

a country to recover from a crisis and start revival and growth on a new competitive basis. Therefore, the domestic markets' openness is an important factor in creating competitive jobs in the country and thus reducing the incentives for emigration;

- ✓ exports and imports are determined by different components. For exports, external demand is important, while for imports, it is purchasing power in the country. Therefore, the impact on employment (unemployment) can vary significantly. However, given the interrelation of exports and imports, both components contribute almost equally to the creation of better jobs;
- ✓ expanding trade relations improves employment (often on a higher-skilled basis) and contributes to higher wages;
- ✓ increased employment in the country means higher purchasing power of the population, and therefore accompanies the growth of imports;
- ✓ sustained improvement in the employment situation (reduction of unemployment) stimulates domestic demand and thus imports, which improves the households' wellbeing and expands the resource base of the national economy, rather than displacing the national labour force from economic activity.

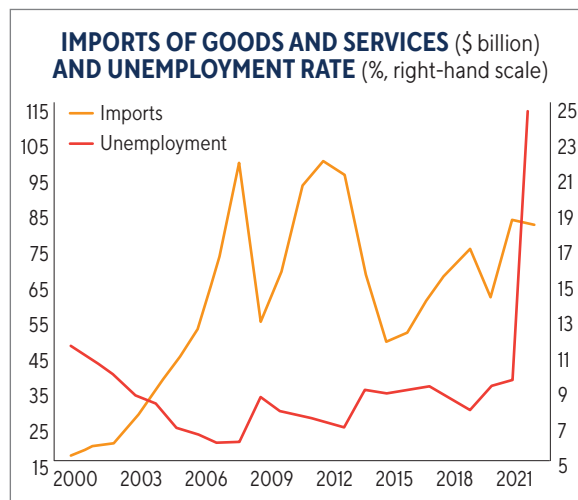
In a small open economy, such as Ukraine's, both domestic absorption (consumption and investment) and export supply are largely determined by the availability of and access to competitive imports. Therefore, in the case of Ukraine, there is a significant positive correlation between the dynamics of GDP and imports (Figure «GDP and imports of goods and services»),⁶ where imports can be rightly interpreted as a component of the national economy's competitiveness.

This is indeed the case for Ukraine, as evidenced by the inverse interrelation between imports and unemployment (Figure «Imports of goods and services and unemployment rate»). The generalisation is that any restrictions on foreign trade not only cause economic losses to countries, but also affect migration



flows, which in turn can trigger additional macroeconomic imbalances.

These interrelations determine important policy directions. For example, economic recovery without job creation is only a temporary solution to short-term problems, because economic sustainability is determined by the quantity and quality of labour, that is, the growth in demand for it and, consequently, its higher price. This can ultimately contribute to long-term sustainability or growth, albeit with a possible acceleration of inflation.

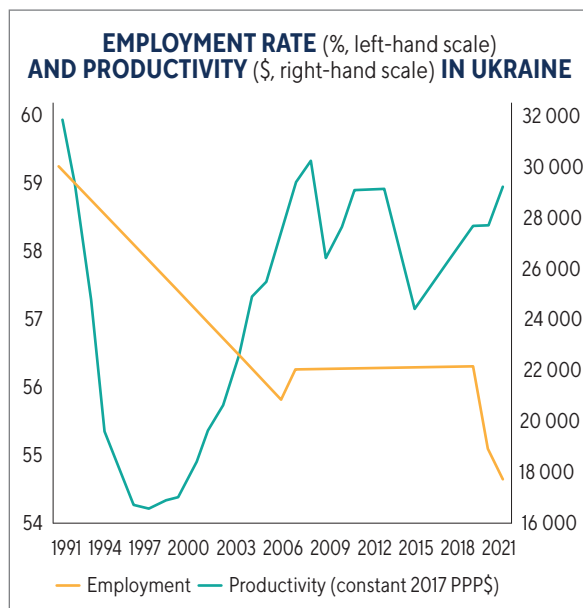


It turns out that the labour market in Ukraine is quite flexible, and even global shocks are not devastating enough to trigger mass unemployment and poverty in the country. For example, the banking crises of 2008-2009 and 2014-2016 provoked a significant surplus of bank employees who, rather than registering as unemployed, quickly found work in other sectors, namely services.

⁶ The coronavirus crisis has triggered imbalances and shocks in many markets as a result of global and local bans on the movement of not only goods but also people, which has had a significant impact on macroeconomic links. In 2021, these links began to recover or form on a new basis.

Productivity. Another indication of the «unconventional» impact of economic components on employment is the productivity estimates provided by the World Bank with internationally adjusted FX and inflation dynamics. For Ukraine, the task of increasing labour productivity and restructuring the economic environment to maintain competitiveness remains particularly relevant, as it will ensure a steady increase in wages and reduce emigration incentives. A prerequisite is to attract and support investment, including foreign investment, and create a «pro-European» investment climate, which Ukraine has begun to shape through a series of EU-approved «visa-free regimes» that allow Ukraine to fit in the CEE space.

It turns out that employment after the Global Financial Crisis and until the coronavirus pandemic was stable and did not depend on external shocks. At the same time, productivity was significantly affected by the 2008-2009 crisis and the first wave of Russian aggression in 2014-2018 (Figure «Employment Rate and productivity in Ukraine»).



It is important to note that while productivity growth in the private sector will indeed depend heavily on investment, productivity in the public sector should be based on a combination of institutional reforms and job rationalisation (there is no doubt that wage growth in the public sector in most cases

is not accompanied by improvements in the quantity and quality of goods and services provided by the public sector, in particular in public administration, education, healthcare, etc.)⁷ Maintaining high employment in the public sector means that the tax burden on the private sector will need to increase, thus worsening the prospects for its recovery. Therefore, it may be better to promote job creation in the private sector, along with retraining and upgrading the skills of those who will be forced out of the low-productivity public sector.

It also points to an alternative search for ways to strengthen the country's economy, which, however, largely depends on investment and innovation that are rather scarce in a weak economy. Most often, when it comes to post-war recovery, the focus is on policies and measures aimed at bringing back those who left the country (an extensive approach). **However, an intensive approach may be more productive, where an increase in the productivity of workers is recognised as the most important factor in the recovery.**

Benefits of labour competitiveness. The fact that the country's economy has survived despite significant human and material losses suggests that the country has potential and productive niches, focusing on which (primarily in terms of investment and innovation) will help the country to demonstrate a new level of competitiveness, and thus a new economic performance, which will be «caught up» by other sectors of the domestic economy.⁸

This approach has yet another component. There is no doubt that Ukraine will become the EU member in the foreseeable future and enter the free European market, including the labour market. Therefore, the country will have to address the issue of competitiveness both at the level of the entire economy and individual employees. In modern world, the competitiveness of a national economy is determined by the productivity of economic agents (individual employees, companies, industries) working in it. Therefore, along with the task of bringing Ukrainians back home, even greater effort should be made to ensure that they return to renewed sectors of the economy.

⁷ Djankov S., Blinov O. Ukraine's wages and job loss trends during the war – <https://cepr.org/voxeu/columns/ukraines-wages-and-job-loss-trends-during-war>

⁸ Migration. Overview. – <https://www.worldbank.org/en/topic/migration/overview>

In its own recovery programmes or projects, Ukraine should assume that competitiveness, rather than access to «cheap» raw materials or government and external interventions, will increasingly determine living standards, even if the initial conditions are very unfavourable. This is true both for the country as a whole and for individual workers, while the greatest benefits will accrue to skilled workers, as demand for them will grow at an outstripping pace.

It should be noted, however, that creating better prospects for more skilled and employed people does not completely remove incentives for migration. Many studies show that more skilled workers are the ones who tend to emigrate when faced with a lack of personal prospects or uncertainty about the future of their societies. Therefore, the benefits that may be offered to certain categories of workers will not actually have the desired effect of bringing Ukrainians back from abroad.

As for the benefits of labour migration, there are grounds to classify them as follows:

- ✓ the highest benefits go directly to migrants who get jobs they could never get in their home country or are paid significantly more than in their home country;
- ✓ significant benefits can also go to countries that act as a «source» of emigration through the system of transfers and remittances from workers to their families that remain in their home country, which primarily contribute to poverty reduction;
- ✓ benefits also go to the countries of «destination», although immigration inflows can create certain complications linked to the redistribution of income, namely displacement of unskilled local workers or reduction of social transfers to the local poor in favour of «newcomers» who agree to work for lower remuneration and in worse working conditions.⁹

In any case, citizens and the country – labour exporters – are the main beneficiaries of the

country's openness and its active involvement in global economic relations. At the same time, there can be a paradox when an increase in human capital in a country (also as a result of an improved education) means a greater outflow of human capital with a simultaneous increase in resources entering the country as a result of the emigration of skilled workers. Such additional resources can be viewed as a «bonus» for the country and encourage it to further build its human capital. The «brain drain vs brain gain» is a controversial dilemma in economic migration, with no solution in sight yet.¹⁰

Once again, even leaving the country, educated and skilled young people bring certain benefits to Ukraine's external image and its social and psychological perception by residents of other countries, as any country's civilised nature is largely manifested through its citizens and their activities abroad. The perception of Ukrainians as an educated, civilised, hardworking nation will probably soon become a factor in the country's business and investment attractiveness. Therefore, despite the risks of the outflow of educated youth abroad, the «fight» for proper education in Ukraine should only intensify.

Another outcome of globalisation and deeper integration for the labour force is a new distribution of income among workers, where the so-called skill premium, measured by the ratio of wages of skilled workers to the corresponding ratio of unskilled workers, is of major importance. According to international estimates, the share of skilled workers in developed countries is 32% of the total workforce, while in developing countries this share is much lower.¹¹

The problem that could undermine the potential benefits of the officially recognised literacy and professionalism of Ukrainians also deserves particular attention. The fact is that a high formal level of education and qualification among Ukrainians may not actually be the one. A significant share of graduates of Ukrainian universities have only a formal relationship to such institutions and the level of education offered there. It is no secret that

⁹ Див.: Миграция и денежные поступления от работающих за границей граждан. – http://siteresources.worldbank.org/INTECA/Resources/257896-1167856389505/Migration_RUSSIAN_Overview.pdf

¹⁰ Lam D. The Impact of Migration on Employment Outcomes. – Oxford Academic, <https://academic.oup.com/book/38942/chapter/338131914>

¹¹ Trade, Technology, and the Skill Premium. – University of Chicago Press Journals, <https://www.journals.uchicago.edu/doi/10.1086/693373>

senior students' studies are often «replaced» by the need to ensure at least an average standard of living for young people, which adversely affects their level of knowledge almost immediately.

Such a contradiction quickly becomes apparent during job interviews and may have painful consequences for job seekers, as in many Western companies, the mismatch between documents on education and practical skills is a significant regulatory violation.¹² If this is the case, the displaced person can hardly expect offers of decent and well-paid jobs in the new country.

Although the systems of professional development are aimed at ensuring the timely renewal of the workforce, the skill premium continues to grow, reflecting the outstripping growth in demand for skilled and highly qualified labour compared to its supply. Moreover, higher capitalisation leads to a higher skill premium, and therefore it will grow particularly rapidly in countries that ensure significant investment inflows, which, in turn, are the source of highly competitive goods and services on global markets.

Lessons and warnings for Ukraine. An important lesson for Ukraine is that if the country wants to preserve its labour resources and human capital, appropriate measures, «symmetrical» to those implemented in the EU, should be developed and actively implemented starting today. In addition to the availability of at least simple housing, it is primarily about the system of employment support and promotion in regions most popular among IDPs and those returning to Ukraine, as well as the provision of educational and vocational training services.

Also, **establishing a system of professional retraining** (which has been in decline in recent years) will be crucial for the creation of new environments, as it will facilitate redistribution of workers to sectors that are likely to be most active in the post-war period (construction, engineering, healthcare, IT) and therefore well-funded. A proper retraining system can

transform migration risks and challenges into benefits and gains.

Although numerous surveys indicate that a significant share of Ukrainians are ready to return, the final decision will depend on a set of macro- and micro-level factors. In particular, decisions will be based on:¹³

- ✓ the duration of hostilities, both in Ukraine as a whole and in the regions from which citizens have fled, as well as the level of destruction (the incentives to return weaken with an extended duration and significant destruction);
- ✓ economic dynamics in the government-controlled territories, including in terms of construction of housing and social infrastructure (slow recovery with no attention to living standards significantly reduces the attractiveness of such regions);
- ✓ the status of Ukrainians in European countries, rules and regulations for the employment of migrants (a long stay in a «new» country along with employment opportunities significantly increase incentives to stay, provided that there are appropriate legal conditions);
- ✓ the state and prospects of socio-economic dynamics in the host country (sustainable balanced growth, stable employment, satisfactory purchasing power with low inflation are additional factors that influence the decision to return to the home country).

One more aspect of cooperation with EU countries is particularly important in the context of the return of Ukrainians. Paradoxically, return can be rightly considered as a form of EU assistance to Ukraine.¹⁴ The more people return, the faster the Ukrainian economy will grow, contributing to security in Europe and reducing the costs of migration policy. Thus, part of the support resources could be directed to the retraining of Ukrainians and their return to their homeland.

¹² If such violations are reflected in computerised databases, it makes it virtually impossible to find a job in most companies across Europe.

¹³ See also Duvell F. The war in Ukraine: Post-war scenarios and migration repercussions. – <https://www.pragueprocess.eu/en/news-events/news/625-the-war-in-ukraine-post-war-scenarios-and-migration-repercussions>

¹⁴ D.Mykhailyshyna. What will stimulate Ukrainian refugees to return home – «Ekonomichna Pravda», <https://www.epravda.com.ua/publications/2023/03/20/698183/>