Trade and conflict: Ukraine's trade with Russia in and after 2014

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Introduction

Ukraine's trade relations with Russia have been uneasy for quite a long time. Although the countries have had a formal free trade agreement since the early 1990s, trade flows have been disrupted frequently by exemptions and non-tariff restrictions.

Obvious differences in the countries' long-term regional integration objectives have also contributed to tensions. Ukraine's key interest has always been to achieve stable cooperation using free trade agreements as a tool, rather than proceed with the reintegration efforts advocated by Russia.[1]

Ukraine's decision to conclude an Association Agreement with the European Union, which clears the path for closer economic integration with European markets through the establishment of a Deep and Comprehensive Free Trade Area (DCFTA), fueled tensions. Although the DCFTA with the EU precludes neither the implementation of other FTAs already signed nor concluding agreements on new FTAs, Russia has taken an antagonistic position, highlighting the potential negative impacts of the DCFTA on Russia[2] and even on Ukraine.[3] In the case of the latter, many assumed that the introduction of the DCFTA would automatically disrupt free trade with Russia and other members of the Customs Union.

In 2014, Russia's annexation of Crimea and military aggression in the Donbas dramatically changed Ukraine's political and economic landscape. The economy has undergone severe structural shock as it de facto lost a part of its territory and the associated production capacities. Ukraine moved away from its "multi-vector" foreign policy, and announced an ambitious reform program aimed at strengthening its institutions, promoting business growth, and leading the country down a path of stable economic development.

The unilateral opening of the EU market to a majority of Ukrainian products, as well as Ukraine's ratification of the Association Agreement with the EU, paved the way for accelerated economic cooperation between Ukraine and the EU. In 2014, exports of goods and services to the EU constituted 32 percent of Ukraine's trade as compared to 27 percent the previous year.[4]

At the same time, relations with Russia have (predictably) worsened. According to official statistics, trade with Russia dropped by more than a third in 2014, and further halved in the first six months of 2015. In 2013, trade with Russia in goods and services amounted to 49.6 billion USD, or about 27

[1] Rilka Dragneva-Lewers and Katarina Wolczuk, "Trade and geopolitics: should the EU engage with the Eurasian Economic Union?" EPC Policy Brief, (April 2, 2015).

[2] Vladimir Putin's speech at Russia-EU Summit on January 28, 2014: http://kremlin.ru/events/president/news/20113; Vladimir Putin's speech at the meeting of the heads of states of the Customs Union with the President of Ukraine and representatives of the European Union, August 26, 2014: http://kremlin.ru/events/president/transcripts/46494; Dmitry Medvedev, "Russia and Ukraine: Living by new rules." http://government.ru/en/news/16118/

[3] E. Vinokurov, ed. Ukraine and the Customs Union: Comprehensive assessment of the macroeconomic effects of various forms of deep economic integration of Ukraine and the member states of the Customs Union and the Common Economic Space. Eurasian Development Bank, Centre for Integration Studies. St.Petersburg, 2012. http://www.eabr.org/general/upload/reports/Ukraina_doklad_eng.pdf

[4] Ricardo Giucci. Mykola Ryzhenkov, and Veronika Movchan, "Cancelation of FTA between Ukraine and Russia? Estimation of impact on Ukrainian exports." GAG/IER Policy Briefing Series PB/11/2015.

percent of Ukraine's total trade; in January-June 2015, it amounted to 7.8 billion USD, or 17 percent of total trade.

Mulilateral consultations between the EU, Ukraine, and Russia regarding the Association Agreement's implementation and its potential impact on the Russian economy have resulted in the postponement of the DCFTA's implementation for more than a year; the DCFTA is now set to launch on January 1, 2016. The EU and Ukraine have not succeeded in persuading Russia that the DCFTA will not cause major damage to its economy, and Russian Prime Minister Dmitri Medvedev recently announced that Russia will withdraw partially from its duty-free trade regime with Ukraine immediately after the official start of the DCFTA.[5]

The obvious negative trend in Ukrainian-Russian trade relations raises concerns that disruptions in trade with Russia will result in huge economic losses for Ukraine, while trade reorientation will prove both difficult and costly.[6]

This paper aims to review existing Ukrainian-Russian trade relations and explore the feasibility of Ukraine's trade reorientation away from the Russian market, given growing trade tensions.

Trade regime

Trade relations between Ukraine and Russia have been based on formal free trade agreements – initially, a bilateral agreement signed in 1993,[7] and, later on, on a multilateral CIS FTA signed in 2011.[8] Both these FTAs envisage duty-free trade for goods, but with exemptions.

Still, trade wars have always been quite common, and since 2013 the use of non-tariff barriers has intensified. For instance, in August 2013, Russia adopted enhanced border controls for Ukrainian imports, as all Ukrainian products were classified as "high risk." This measure resulted in the virtual stop of shipments to Russia for several weeks until these controls eased somewhat.

Moreover, bans on imported goods from Ukraine have become increasingly common. Table 1 lists TBT and SPS measures that Russia has introduced since mid-2013. Estimated trade losses related to these measures total about 3 billion USD.

Table 1: List of TBT/SPS related Russian bans of Ukraine's products since mid-2013

Product	Date	HS07 code*	Trade value**
Railcar equipment (4 companies)	Sep-Oct 2013	8603-8607	USD 1261.2 m (2013)
Confectionery (Roshen)	July 2013	1806	USD 413.0 m (2012)
Raw milk and dairy products	July 2014	0401-0406	USD 374.2 m (2013)
Confectionery	Sep 2014	1806	USD 306.6 m (2013)
Cheeses	Apr 2014	0406	USD 301.4 m (2013)
Alcohol products (three companies)	Aug 2014	22	USD 230.7 m (2013)
Vegetable and fish cans	July 2014	20;1604	USD 209.4 (2013)
Soya beans, sunflower seeds, maize groats, soya residuals	July 2014	1201; 1206; 1103; 2304	USD 98.4 m (2013)

[5] "Medvedev anonsiroval vvedenie ekonomicheskikh sanktsii v otnoshenii Ukrainy." *Ekonomicheskaya Pravda* (October 30, 2015). http://www.epravda.com.ua/news/2015/10/30/565338/
[6] Amat Adarov et al., "How to Stabilize the Economy of Ukraine." The Vienna Institute for International Economic Studies, 2015. http://wiiw.ac.at/how-to-stabilise-the-economy-of-ukraine-dlp-3562.pdf
[7] Agreement between the Government of Ukraine and the Government of the Russian Federation on Free Trade dated June 24, 1993. http://zakon5.rada.gov.ua/laws/show/643_009
[8] Agreement on Free Trade Zone, CIS, dated October 18, 2011. http://zakon5.rada.gov.ua/laws/show/997_n25

Product	Date	HS07 code*	Trade value**
Sanitary pads	May 2015	4818	USD 81.2 m (2014)
Poultry (largest company)	Feb 2014	0207	USD 71.6 m (2013)
Detergents	Apr-Jun 2015	3402	USD 49.6 m (2014)
Cheese-like products	Nov 2014	1516-1517	USD 28.5 m (2013)
Wood chipboard	Oct 214	4411	USD 24.5 m (2013)
Potatoes	Jun 2014	0701	USD 1.3 m (2014)

Source: Giucci, Ryzhenkov, Movchan (2015)

*Notes: *HS code is tentative based on available product description.*

*** Trade value is provided for tentative HS codes and doesn't take into account that in some cases products of only selected companies are banned. Thus, trade impact is likely to be overestimated and should be considered an upper bound estimate*

Ukraine has challenged the introduction of the non-tariff measures in the World Trade Organization. The country has raised a number of specific trade concerns in the WTO TBS and SPS Committees, and in October 2015, it filed a dispute against Russia over imports of railway equipment.[9]

In September 2014, the Russian government passed Decree № 959,[10] which provides for the introduction of MFN duties for a number of Ukrainian products as soon as Ukraine implements the DCFTA with the EU. In August 2015, Russia passed Decree № 842,[11] which imposes sanctions on Ukrainian agricultural and food products to be launched simultaneously with Decree № 959.

According to a 2015 study by Giucci, Ryzhenkov, and Movchan, the implementation of Decrees № 959 and № 842 will result in a 0.6 billion USD loss in trade even beyond the loss caused by bans already introduced. It should be noted that the impact of Russia's unilateral withdrawal of its duty-free trade regime with Ukraine will be less painful for the economy in 2016 than it might have been several years ago. The negative shock of rapid trade disintegration that occurred in 2014-2015 will ease the impact.[12]

Russia has already taken similar measures abusing existing trade links and trade agreements against Moldova and, earlier, Georgia. According to a 2014 study, these measures may be considered punishment for these countries' "crime" of not joining Russian-led regional integration initiatives.[13]

Trade with Russia carries a high risk due to possible punitive measures and abuses of existing economic dependencies; however, there are certain challenges to the feasibility of further reducing trade dependency on Russia and thus reorienting trade away from its market.

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[9] World Trade Organization, "Ukraine files dispute against Russia over imports of railway equipment" (October 21, 2015). https://www.wto.org/english/news_e/news15_e/ds499rfc_21oct15_e.htm
[10] Text of the decree is available online at: http://www.consultant.ru/document/cons_doc_LAW_168881/92d969e26a4326c5d02fa79b8f9cf4994ee5633b/
[11] http://ivo.garant.ru/#/document/71162292/paragraph/1:1
[12] Ricardo Giucci. Mykola Ryzhenkov, and Veronika Movchan, "Cancelation of FTA between Ukraine and Russia? Estimation of impact on Ukrainian exports." GAG/IER Policy Briefing Series PB/11/2015. http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2014/06/PB_11_2015_en.pdf; Ricardo Giucci, Mykola Ryzhenkov, and Veronika Movchan, "Ukraine's Exports Dynamics in 2014." PB/02/2015. http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2015/03/PB_02_2015_en.pdf
[13] Denis Cenusa, Michael Emerson, Tamara Kovziridse, and Veronika Movchan, "Russian punitive trade policy measures towards Ukraine, Moldova and Georgia." CEPS WD 400, September 2014. http://www.ceps.eu/system/files/WD%20300%20Punitive%20Trade%20Measures%20by%20Russia_0.pdf

The feasibility of trade reorientation: a review of selected sectors

Export reorientation presents two options: goods can be sent to domestic markets or exported to third countries. In both cases, it is faster to supply more to incumbent markets instead of searching for new markets. In the latter case, trade reorientation would require that Ukrainian companies adapt to new standards, change their packaging and labeling, etc., or even change the composition of goods produced. “Macro” reorientation will likely entail changes in the composition of export companies.

For imports, reorientation of trade could comprise part of a solution. Yet another approach would be to increase efficiency and decrease consumption of those products which cultivate a high level of dependency.

Below we will consider the feasibility of trade reorientation for the agriculture and machine building industries, in the case of exports, and energy, in the case of imports.

Agriculture and food

The agriculture and food industry in Ukraine has suffered the most as the result of Russian import bans. Exports of these products to Russia dropped by 52 percent in 2014, and continued to reduce rapidly in 2015. At the same time, exports of these products to the EU increased by 7 percent in 2014. The value of agricultural trade with the EU allowed Ukraine to compensate many of the losses incurred on the Russian market in terms of export receipts, but not in terms of merchandise structure.

The forthcoming DCFTA and current autonomous trade preferences unilaterally provided to Ukraine by the EU significantly reduce tariff barriers for exporters, but do not compromise on safety regulations. In most cases, the Russian market’s closure to Ukrainian animal-based products could be compensated by reorientation to the EU over the medium-term, after Ukraine completes regulatory approximation and institutional building related to SPS measures. Still, there are exceptions. For instance, Ukraine successfully exported honey to the EU before the introduction of autonomous trade preferences, and its export volume continues to expand. Ukraine has also effectively exported plant-related agricultural and food products to the EU, where market access is somewhat easier.

Moreover, as Movchan et al. have demonstrated, the agriculture and food industry’s exposure to the Russian market historically has been low, hovering at 1-3 percent of output.[14] The products are either sold on the domestic market or exported to other destinations. In 2014, Ukraine exported 29 percent of its agricultural and food products to the EU, and the other half to third countries.

In sum, the Russian market has never been an important destination for Ukraine’s agricultural and food exports, and thus Russia’s bans on imports have had an impact more political than economic.

Machine building

Machine building has probably served as the most important export linkage with Russia, as Russia has traditionally been the largest consumer of Ukrainian machines and equipment outside the country.

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[14] Movchan V., Guicci R., Ryzhenkov M. (2014) Ukrainian exports to Russia: sector and regional exposure. Technical paper TN/03/2014
http://www.ier.com.ua/files//publications/Policy_Briefing_Series/TN_03_2014_en.pdf

According to a 2014 study, in 2012, about one third of Ukraine's machine building sector output[15] was supplied to Russia and another 30 percent of output was sold to countries other than Russia, including 12 percent to the EU market.[16]

Dependence on Russia varies for different machine building subsectors and products. A 2014 study by Saha et al. distinguishes three categories of subsectors. The auto industry represents the "low exposure" category, as this subsector is primarily oriented towards the domestic market and exports to the EU come in second in importance. The production of electronic and optical equipment and production of aircrafts, spacecraft, and ships belong to the "moderate to high exposure but high diversification" category. Electronic and optical equipment manufacturing depends the least on the Russian market, as these producers export over two thirds of their output to the EU and the rest of the world. Finally, three subsectors – the railway industry, electrical equipment industry and machinery and equipment all belong to the "moderate to high exposure but low diversification" category. These three sectors are the most sensitive to fluctuations in the Russian market.

Among these sectors, the railway industry is uniquely situated, as railway equipment is one of very few categories of Ukrainian products that, if exported, are exported predominantly to Russia. Moreover, if Russia imports this equipment, it does so from Ukraine. This situation of mutual dependence, however, has not precluded trade wars. In September-October 2013, Russia refused to recognize several Ukrainian railcar producers' certificates of conformity, de facto banning trade. In March 2015, Ukraine even raised specific trade concerns at the WTO TBT Committee meeting regarding technical regulations on railway transport safety implemented by Russia,[17] and, in October 2015, filed a dispute regarding the issue.[18]

Russia's military aggression has negatively affected machine building, since in 2014 Ukraine unilaterally banned trade in military and dual-use products with Russia. In August, President Poroshenko issued a decree prohibiting the export of military and dual-use products to Russia.[19]

Due to these factors and others, exports of machinery and equipment (other than transport equipment) to Russia dropped by 40 percent in 2014. Exports to the EU increased by 5 percent. However, as products supplied to the EU and Russian markets are not identical, quick short-term reorientation remains unlikely. However, there are positive prospects over the medium-term, especially after Ukraine and the EU sign the ACAA agreement establishing a common market for selected industrial products.

The Ukrainian machinery industry has several other options. First, it can increase domestic sales, especially of military and dual-use equipment, as demand within the country has changed dramatically. Railway equipment also has strong potential for domestic supply growth as soon as the macroeconomic situation in the country stabilizes. The state railway monopolist Ukrzaliznytsya

[15] Here output is measured in basic prices and thus does not take into account VAT and other indirect taxes. The share is about 20 percent if output in consumer prices is used.

[16] David Saha, Ricardo Giucci, and Dmytro Naumenko, "Ukrainian Machine Building: Strategic options and short term measures in view of trade disruptions with Russia." GAG/IER PP/02/2014 (Berlin/Kyiv, August 2014). http://www.beratergruppe-ukraine.de/wordpress/wp-content/uploads/2014/06/PP_02_2014_en.pdf

[17] World Trade Organization, "New Specific Trade Concerns" (March 17, 2015). https://www.wto.org/english/news_e/news15_e/tbt_17mar15_e.pdf

[18] World Trade Organization, "Ukraine files dispute against Russia over imports of railway equipment" (October 21, 2015). https://www.wto.org/english/news_e/news15_e/ds499rfc_21oct15_e.htm

[19] Available online at: http://www.president.gov.ua/documents/18028.html

recently announced that it plans to buy new trains from domestic producers.[20] Second, the country could intensify supply to third-country markets.

In sum, the machinery-building sector is among the most vulnerable to changes in access to the Russian market, especially with the major shockwaves now coursing through it. But this sector has strong potential both to increase its domestic sales and to reorient towards other markets; as such, reviving trade with Russia should not be considered a viable solution.

Energy

Ukraine's energy sector is considered the most dependent on Russia. Estimates based on the International Energy Agency (IEA)'s balance for Ukraine showed that in 2012, Russia supplied about 44 percent of Ukraine's energy.[21] Particularly high dependence was registered for gas. In 2012, 62 percent of Ukraine's total gas supply came from imports, and it bought all of its imported gas from Russia.

This dependency has allowed Russia to use energy bargaining as a policy tool, and has been recognized widely as a national security threat. President Poroshenko's "Strategy 2020" program postulated energy independence as one of the most urgent reform steps.[22]

By 2014, some important steps had been taken. Ukraine's gas consumption dropped by 16 percent, (although the country's economic activity had dropped overall), and the composition of domestic supply chains changed. First, the share of domestic production increased from 43 percent in 2013 to 51 percent in 2014.

Second, Russia's dominance as a gas supplier has ebbed. In 2014, Russia supplied only 36 percent of Ukraine's total gas needs, or 73 percent of imported gas, largely due to the establishment of reserve gas routes from the EU that managed to supply almost 13 percent of Ukraine's total gas needs, or 27 percent of imported gas. In 2015, according to Naftogaz plans, the structure of gas imports will change further, with 60 percent of imported gas coming from Europe and only the remaining 40 percent directly from Russia.[23]

Ukraine is currently implementing multiple measures with the goal of reducing its gas dependency on Russia. Ukraine aims to increase its energy efficiency and reduce its energy consumption by creating market incentives for consumers (gas tariffs) and promoting modern energy-saving technologies in both manufacturing and construction. A number of assistance programs designed to decrease heat losses and increase buildings' energy efficiency have cropped up in the country.[24]

Several institutional reforms are taking place in this sector, in particular, related to improving Naftogaz's transparency and efficiency. In May, President Poroshenko signed a law designed to break up Naftogaz's monopoly on the gas market in line with the requirements of the Third Energy Package of the EU. The agenda also includes diversification of gas import sources, envisioning a growing role

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[20] "'Ukrzaliznitsa' napravit' dopolnitel'no 1 mlrd grn na remont." *RBK-Ukraina* (October 23, 2015). http://www.rbc.ua/ukr/news/ukrzaliznytsya-napravit-dopolnitelno-mlrd-1445597768.html

[21] International Energy Agency, "Ukraine: Balances for 2012." http://www.iea.org/statistics/statisticssearch/report/?year=2012&country=Ukraine&product=Balances

[22] Available online at: http://www.president.gov.ua/documents/18688.html

[23] "Ukraine Reform Monitor: August 2015." Carnegie Endowment for International Peace (August 19, 2015). http://carnegieendowment.org/2015/08/19/ukraine-reform-monitor-august-2015/iewe

[24] For instance, the Ukraine Energy Efficiency Programme. http://www.ukeep.org/en/

for the EU as gas supplier, and diversification of sources of energy (i.e., exploring alternative energy sources, including nuclear power).

Ukraine's energy dependence on Russia extends to nuclear power as well. Ukraine imported 81 percent of its nuclear power from Russia in 2012, and 100 percent in 2014. In 2014, after Ukraine restored its contracts with Westinghouse Electric (Sweden), the share of imports of nuclear power from Russia fell slightly (to 94 percent), but remained very high. Diversification of nuclear fuel supply, especially given projections of high reliance on nuclear power as energy source, presents a challenge.

The gas pipeline between Ukraine and Russia comprises yet another energy link: Ukraine provides Russia with services of gas transit to the EU. The smooth functioning of this pipeline constitutes one of the EU's short-term security priorities, especially for some Central and Eastern European countries. However, over the long term, the pipeline's importance will most likely diminish. On the one hand, the EU is expected to facilitate the diversification of energy supply and reduce dependence on Russia, thereby reducing the demand for gas transited through Ukraine. On the other hand, Russia announced its intention to stop using the Ukrainian pipelines and build a new gas pipeline to Turkey, as an alternative route.

In sum, Ukraine has accelerated efforts aimed at energy independence, which, in the medium- to long term, is expected to significantly reduce Russian energy leverage over Ukraine. The EU plays a multifaceted role in this process: it provides a regulatory foundation for sector reforms through the Association Agreement and the European Energy Community. Moreover, the EU offers alternative routes of energy supply and provides technical and financial assistance for projects aimed at improving energy efficiency.

Conclusions

Ukraine's trade relations with Russia have historically been uneasy, and they deteriorated further in 2014-2015, against the backdrop of Russia's occupation of Ukrainian territories and Russia's ongoing threat to decrease access to the Russian market if Ukraine proceeded with the implementation of the DCFTA. Trade in goods and services dropped by approximately two thirds as compared to 2013, and will likely deteriorate further. In this situation, policy-makers must consider whether it is possible to reorient to other markets and what should be done to facilitate this reorientation.

The study of the reorientation potentials of selected sectors and products demonstrates that the situation is quite uneven. For instance, agriculture and food exports facing bans on the Russian market do not actually depend on this market for the majority of products; they successfully supply domestically and also export to the EU and – primarily – to third countries.

In machine building, Ukraine's dependence on the Russian market is higher; thus, prospects for quick reorientation of exports to the EU or third countries are lower. Here, growing supply to domestic market could be used as a short-term solution while producers explore new export opportunities.

The energy sector has made great strides in diversifying supply sources in the case of natural gas. At the same time, the diversification of nuclear fuel supplies poses a greater challenge and thus the prospects of realizing this project are more distant. An increase in energy efficiency and the development of domestic energy supply, with a focus on renewable energy, will continue to play a very important role in Ukraine's strategy for reducing its trade dependency in this case.