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Economic Logic Pushed Ukraine to Russia

By Anatoly Medetsky

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Virginia Mayo / AP

For Ukraine's Prime Minister Mykola Azarov, it was not pressure from Russia that provoked Ukraine's flip-flop on the association deal with the European Union.

Azarov has said he bowed to the strong sentiment within the country for making up with Moscow, as exports to that key market declined.

"I had several meetings with our major industrialists, entrepreneurs and unions," he said in an interview. "They demanded that the government set the situation straight."

Most importantly, he said in the interview with Russia's Channel One that aired Sunday, the year was drawing to an end, and Ukrainian companies were looking for some clarity for their cooperation with their Russian counterparts going forward.

Ukrainian exports to both the EU and Russia fell last year, and the country's $176 billion economy has been shrinking, losing 1.3 percent in the first nine months of year. In 2014, GDP is forecast to fall a further 1.5 percent. Both partners said they were key to Ukraine's economic recovery, but Kiev chose Moscow at the last minute.

Azarov announced last week that Ukraine would indefinitely suspend its preparations to sign an association agreement with the EU, a step that the parties were to make on Friday. The turnaround followed months of threats from Russia, ranging from trade restrictions to demands for an immediate repayment of back bills for natural gas. Europe, meanwhile, exerted huge pressure on Ukrainian politicians to bring their laws better into line with Europe's, most notably in the case of jailed former prime minister Yulia Tymoshenko, whose release was made a condition of the deal.

President Vladimir Putin has denied his country was intimidatory. Russia has instead accused the EU of arm-twisting.

Azarov said in the interview that the last drop that tilted the balance in favor of Moscow was the tough set of terms from the International Monetary Fund in exchange for a much needed rescue loan being sought by Ukraine.

"We could not go with these terms," he said.

While Ukraine's about-face on the EU agreement provoked massive street rallies in Kiev, the country's corporate citizens were not overflowing with emotion.

The ones that were caught up in the bilateral trade squabbles did not appear willing to comment on Ukraine's new-found amicability with its eastern neighbor.

"We do not comment on these issues," said Vladimir Ravinsky, a spokesman for Metinvest, which Ukrainian media named as one of the companies whose shipments to Russia was forced to undergo additional scrutiny in August, when Russia stepped up inspections of trucks at the Ukrainian border.

Another such company, cheese maker Milkiland, did not respond to a request for comment. Neither did confectionery firm Roshen, whose sweets Russia banned in July, ostensibly over health concerns. The candymaker's owner, Petro Poroshenko, is a strong advocate of Ukraine's integration with the EU.

Anatoly Baronin, managing partner of investment company Da Vinci in Kiev, blamed Ukraine's economic distress on the recent "trade wars" with Russia. Even if Russia drops its bellicosity, Ukraine would be able only to reinstate its economic output to its previous level, rather than growth beyond it, he said.

Russia's restrictions on imports of Ukrainian goods, such as cheese and candies, would cost the Ukrainian economy at least $5 billion in lost sales revenues, Baronin added.

He suggested that it was Ukrainian exporters to Russia, who would not be competitive on global markets, that stymied Kiev's efforts to tie itself closer to the EU.

"Integration with Europe would have been a forced incentive to restructure the economy and produce more competitive goods," he said. This would require massive investment and create turmoil in the short term as producers scrambled to find their feet.

Here are some of the economic risks that Ukraine would have taken by falling out with Russia.

Shrinking Trade

Russia is Ukraine's second-biggest export market, taking $17.6 billion worth of goods, or a quarter of Ukraine's total exports.

Supplies of train cars and components brought in the most revenue in exports to Russia. The outbound goods also include steel sheets and pipes, aircraft engines, chocolate candies, newsprint, electric engineering products, building materials, and cheese.

In recent months, Russia has slapped several restrictions on imports from Ukraine, such as in the case of candymaker Roshen. One other measure was the cancellation in July of a trade quota for Ukrainian pipes that allowed a certain amount of shipments to dodge a prohibitive import duty.

On Tuesday, the Cabinet approved an agreement that assured purchases of Ukrainian components for Russian-made products.

Moscow has also argued that an association agreement with the EU will mean the end of the free-trade arrangement it currently has with Ukraine, raising the specter of a sudden tariff wall dropping on trade routes, and tightening border checks.

Partnership with Europe would also shut the door for Ukraine to join the smaller, Russia-led Customs Union, further complicating trade flows with Moscow. The Customs Union has been upgrading its quality standards, and it is unclear whether these are compatible with those of the EU.

The Federation of Employers of Ukraine warned in April that Ukraine would lose $15 billion a year — almost all of its current exports to Russia — if Kiev were to ignore the changing regulations in the Customs Union.

Demonstrating that for Ukraine there are no free lunches, the country would need to cough up investment to comply with standards in the Russian trade bloc — just like in the EU integration scenario — to support sales on the market.

These two markets are Ukraine's most important. While Russia may import huge quantities of goods from its former Soviet neighbor, exports to the EU overtook those to Russia last year, amounting to 14.6 billion euros, or $19.9 billion.

Eligibility for Loans

Ukraine has run up a debt of $129 billion, or 74 percent of its gross domestic product, as of the end of last year. At a time when it needs more cash to bridge gaping holes in its public finances, Russia could prove a lender of choice. The IMF turned away the country's policy makers with the terms it offered for its $15 billion loan, such as raising utility bills by 40 percent, according to Ukrainian Prime Minister Mykola Azarov.

Even as Russia faces a worsening outlook for the domestic economy, it could still extend a loan, although it might come with politically tinged conditions in train, according to Anatoly Baronin.

Steep Bills for Gas

Ukraine is reliant on Russian gas imports and is a major transit route to Europe. Gazprom in November demanded immediate payment of $1.3 billion in natural gas debts. It then soft-pedaled the issue and offered an extension to pay the bills.

On friendlier terms with Russia, Ukraine, which currently pays high tariffs for gas, may be able to expect softer payment terms and discounted rates.

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