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Why is Ukraine losing in the Russian market?

The signing the Economical section of the Association Agreement with the EU may imply a resurgence in trade wars with Russia. On 18 June, 2014, Putin stated that in this case it would be impossible to continue with zero-rate import customs duties for Ukrainian products.[1]

However, regardless of whether the trade wars with Russia continue or not, Ukraine will be losing this market gradually due to the import substitution policies effective in Russia since 1998. So businesses have to promptly start producing products according to international / European standards (if they were not doing so before) and refocus their markets.

In 2008, the government of Russia endorsed a concept for the long-term socio-economic development of the Russian Federation until 2020 which asserts the realisation of import substitution programmes in many sectors of the Russian economy, both high-tech (aviation, shipbuilding, rocket-and-space industry, automotive industry etc) and mid-tech (consumer goods, food, woodwork, chemical industries, manufacturing of construction supplies, non-ferrous metallurgy)[2]. To support an import substitution production, enterprises of the respective industries receive a number of preferences including subsidy assistance relating to their contracted loan rates, investment tax credits, anti-dumping protection and the removal of excessive administrative barriers prohibiting development.

In March, 2014, Prime Minister Medvedev noted that import substitution was one of Russia's top priorities.[3] And in May, 2014, Denis Manturov, Head of the Industry and Trade Ministry of the Russian Federation stated that the speeding up of import substitution would become one of the counter-measures because of sanctions introduced by Western counties. Russia will seek alternative suppliers in the EurAsEC countries.[4]

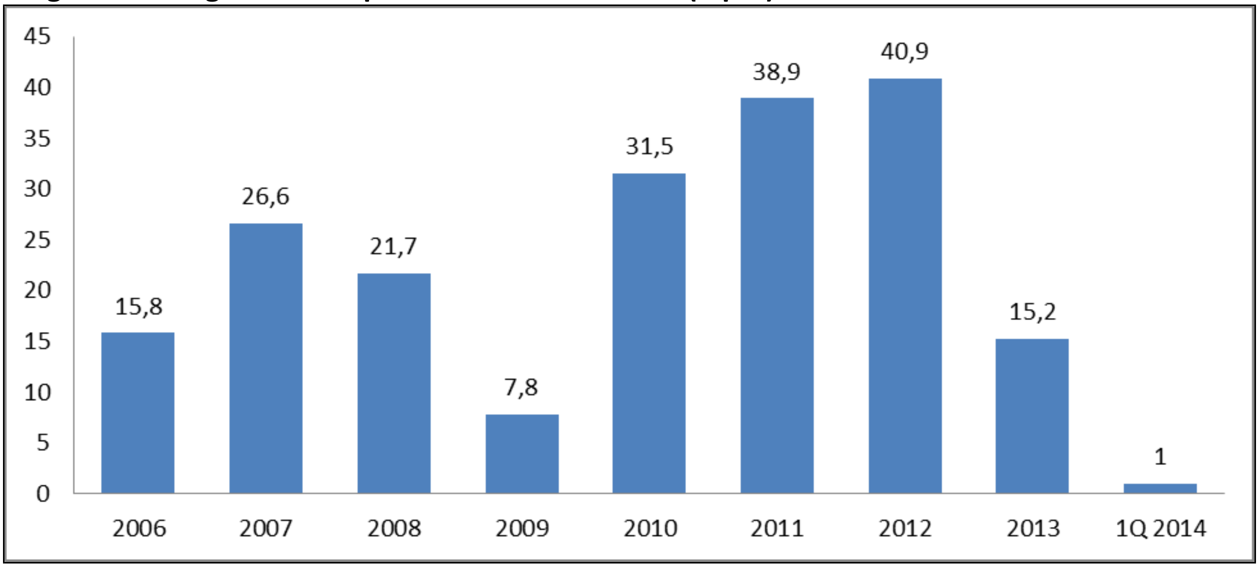
According to the data provided by the State Statistic Service of Ukraine, in the 1st quarter of 2014, export turnover with Russia has decreased by 24.4% compared with the same period of last year and amounted to $2721.89m. In parallel, imports of goods from Russia decreased by 26% compared with the 1st quarter of 2013 and amounted to $4016.37m. The decrease in exports to Russia by $966.8m compared with the 1st quarter of 2013 was largely due to declines in ferrous materials supply by

[1] http://www.pravda-tv.ru/2014/06/19/65317
[2] See «Concept for the long-term socio-economic development of the Russian Federation until 2020», pages 102-124
[3] http://ria.ru/economy/20140325/1001014233.html
[4] http://www.vedomosti.ru/politics/news/26126661/kiev-zaderzhivaet-postavki-oborudovaniya-dlya-oboronnoj

$201137K (by 37.9 %), ferrous material goods by $35388.7K (by 31.6 %) and railway locomotives by $296732.62K (by 58.7%).[5]

Let us consider the Russian Federation import substitution policies and their effect on Ukrainian manufacturers taking railway coach manufacturing as a model. Looking at freight stock export supplies from Ukraine to Russia we see that, after a crisis in 2009, supplies were growing, but they shrank by more than 2.5 times in 2013. In the 1st quarter of 2014, export of these goods from Ukraine to Russia amounted to 1058 pcs, which is almost 5 times less than in the 1st quarter of 2013 (export turnover in January-March, 2013 amounted to 5046 pcs).

Diagram 1: Freight stock export from Ukraine to RF (K pcs)



Source: the State Statistic Service of Ukraine

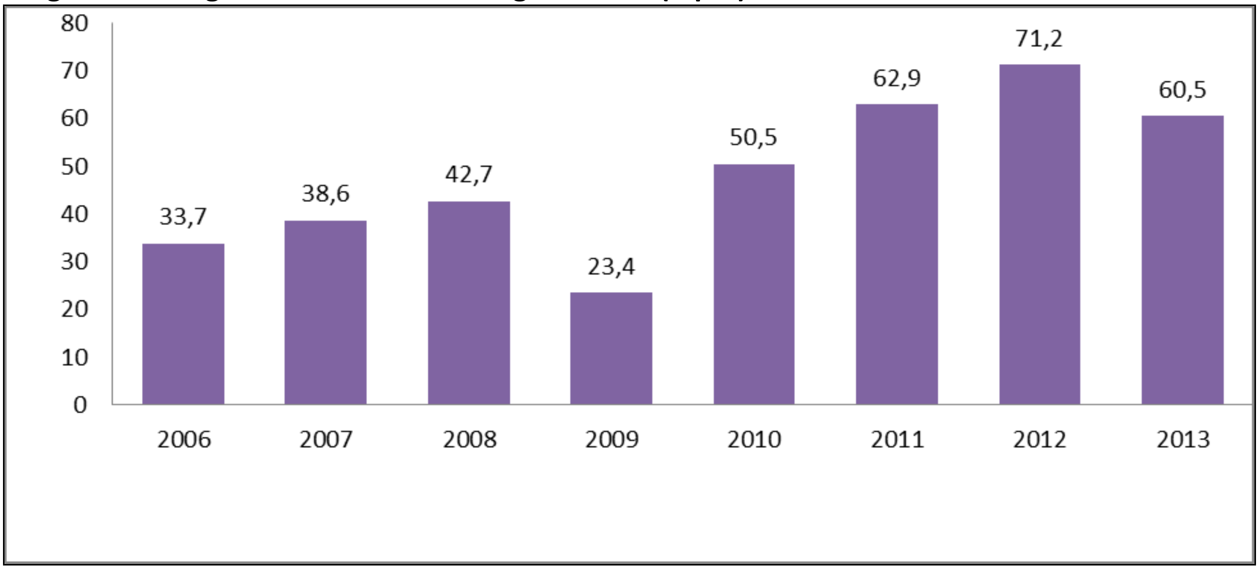
Retaliation to reduce freight stock imports from Ukraine, including the possibility of introducing a disposal fee for railway coach manufacturing products (similar to the one for cars) or changing certification requirements for railway coach manufacturing products, was actively discussed in Russia, starting in mid-2012.

It is to be noted that the freight stock industry in Russia has declined in 2013 as well (Diagram 2). One of the reasons for the decline in manufacturing was the Russian railway coach market overstocking. According to the information given by the Russian Railway, excessive stock of the railway coach amounted to 300K pcs, at the end of 2013.

The decline in railway freight services in 2013, also had a negative impact on the railway coach market (according to the Rosstat's information, decreasing by 2.8% in 2013 compared with 2012).

[5] In the 1st quarter of 2014, goods export and import turnover amounted to $14190.2n and $14240.7m, respectively. Compared with the same period of 2013, exports decreased by 6.9% and imports by 20.5%. Trade deficit compared with the 1st quarter of 2013 decreased and amounted to $50.5m (in the 1st quarter of 2013 the trade deficit was $2682.1m). Data provided by the State Statistic Service of Ukraine

Diagram 2: Freight stock manufacturing in Russia (K pcs)



Source: the Rosstat

According to the Programme for Industrial Development for 2012-2020, freight stock manufacturing should increase to 65K pcs in 2020, which equates to 82% of the domestic market. In 2013, 60.5K pcs of freight stock were manufactured which came out at less than 70% of the domestic market. So, the plans to increase manufacturing in natural units are not over ambitious. Still the increasing of its domestic market share is planned (Table 1). This implies a further decline in the freight stock import from Ukraine or a complete cessation of supply.

Table 1: Freight stock manufacture in Russia planned to 2020

	Units	2012	2013	2014	2015	2016	2017	2018	2019	2020
Freight stock	K pcs	70	62,8	63,2	59,6	65	62,4	64	65	65
Domestic market share	%	60	70	70	70	75	75	80	82	82

Source: the Concept for the long-term socio-economic development of the Russian Federation until 2020

It must be pointed out that the 2012-2020 Plan is a follow-up to the previous plans on growth in railway coach production in the RF. These plans have been known to the Ukrainian railway coach manufacturers during the period of growth in production in Ukraine, since 1998. The Russian Federation plans on import substitution concern almost every industry sector[6]. Some examples follow:

Automotive Industry [7]

[6] http://programs.gov.ru
[7] Programme for the industrial development and enhancing its competitiveness, Subprogramme 1

It is considered that the Russian market should be protected from new and old car imports. One of the purposes of the Automotive Industry Sub-programme is to reduce the import share in financial terms from 43.5% in 2012 to 32% in 2015.

It is also planned to increase the production in the automotive industry and growth in the domestic market share of the Russian manufactured goods in natural units until 2020:

Passenger car production should be increased to 3150K pcs per year, which will equate to 80% of the domestic market (in 2011 domestic share for Russian products was 68.3%)

Light commercial vehicle production should be increased to 280K pcs per year; 90% of domestic market share (81.2% in 2011)

Lorry production should be increased to 280K pcs per year; 85% of domestic market (65.5% in 2011)

Motor-bus production should be increased to 35K pcs per year; 99% of domestic market share (69.2% in 2011).

Besides that, growth of the Russian automotive industry export share is forecasted at an average of 12.5% (7.7% in 2011).

Consumer Goods Industry [8]

By implementation the consumer goods investment projects on modernisation and setting-up of new capacities, particularly by raising the efficiency and further development of the flax industry, import substitution at a 20% rate is expected in this sector. By 2020, it is expected that the share of the Russian products (clothing, knitwear and footwear) in the domestic market will be 50%.

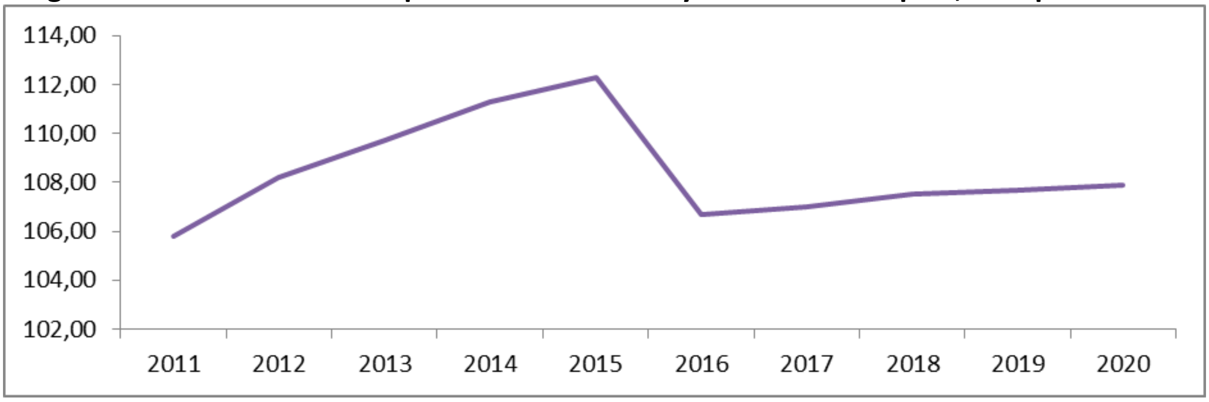
The Military-Industrial Complex [9]

According to the Military-Industrial Complex Sub-programme assortment of the military-industrial goods and the volume of imported service parts supply should be decreased due to the import substitution and improvement in cooperation so that by 2020, compared with 2010 there will be:

- Growth in industrial production volumes of the Military-Industrial Complex by 2.88 times;
- Increase of labour efficiency in the Military-Industrial Complex by 2.91 times;
- Increase in the salaries of the Military-Industrial Complex organisations employees by 2.87 times.

[8] Programme for the industrial development and enhancing its competitiveness, Sub-programme 4
[9] Programme for the industrial development and enhancing its competitiveness, Sub-programme 5, open data

Diagram 3. Index of industrial production in Military-Industrial Complex, compared to last year (%)



Source: http://programs.gov.ru

Vehicle Engineering[10]

One of the purposes of the Vehicle Engineering Sub-programme is full supply of domestic demand for railway engineering and a several-fold increase in the export of these products.

Table 2: production forecast in Vehicle Engineering to 2020

	Units	2012	2013	2014	2015	2016	2017	2018	2019	2020
Vehicle Engineering	m RUB*	223 996	226 870	229 785	232 860	253 970	274 920	302 070	332 370	360 090

*in prices of the year 2012

Source: the Concept for the long-term socio-economic development of the Russian Federation until 2020

Metallurgy [11]

Among the other purposes of the Metallurgy Sub-programme, an increase in export and growth in the Russian metal products domestic market share is planned. It is planned to reduce the import share in domestic ferrous materials finished steel consumption by 1.5 times before 2020.

Therefore, it may be concluded that the Ukrainian businessmen didn't see or didn't want to see the prospective loss of the Russian market despite the Russian Federation's open plans regarding import substitution, nor did they take measures to diversify their markets.

For today, there's only one way out: Ukraine has to exploit to the maximum, the opportunities provided by the Association Agreement with the EU, increase the Ukrainian product supply to the other countries of the world and decrease its dependence on the Russian market. This shock therapy (losing the Russian market channels) may be beneficial for the Ukrainian economy. In the short-term, some industries may find it difficult to reorientate, but in the long-term, when the painful transformation process is over, everything will be much easier, because our manufacturers will not be dependent on just one very emotionally volatile demander.

[10] Programme for the industrial development and enhancing its competitiveness, Subprogramme 6
[11] Programme for the industrial development and enhancing its competitiveness, Subprogramme 7