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The strategy of economic development based on the latest geopolitical changes

Today, the start of a long period of political confrontation between Ukraine and Russia is amidst. The annexation of the Crimea must lead either to the total global isolation of Russia with effective sanctions, and then will we witness a sharp about-turn and the Crimea will be transferred back to Ukraine, when it restores its sovereignty. Otherwise, for a long time, the territory of Crimea will become a grey zone in terms of world politics, and atopic of constant disputes between Russia and Ukraine.

On the other hand, there is the threat of instability in the long term due to separatist movements in eastern Ukraine. The constant threat of trade wars with Russia is rapidly heading towards a complete closure of its markets to Ukrainian goods. In this regard, there has been a drop in the volume of sales, and, consequently, a drop in the volume of production and jobs. The index of basic industries fell in the period of January-March by 2.4% compared with the corresponding period the previous year. However, this is due not only to the loss of Russian markets, but also other factors, among which an important place is occupied by weather conditions in March, which resulted in a decrease in the production of electricity.

In the face of deteriorating economic relations with the Russian Federation,some of the enterprises are reducingtheir number of employees and do not try to revert toprevious levels of production, whileother companies are actively shifting to other markets, including the European Union. For example, some steel mills, which mainly exported products to Russia, were compelled to suspend production. According to Gosvneshinform (state-owned information and analytical centre), exports of iron and steel products to Russia,in the first quarter of 2014 fell by 31.1% - down to 565 thousand tonnes.[1]At the same time, the devaluation of the hryvnia, which contributed to the growth in profitability, will have a positive effect on export-oriented industries in the imminent future.

Problems with certification in Russia of rail cars manufactured by Ukraine caused a five-fold reduction in their production in January-March 2014; compared with January-March 2013, the production of rail cars dropped to 500 pieces.

Low external demand by major trading partners due to the reduction of their economic activity led to a further decrease in the production in the mechanical industry.

Hence, the production of buses in the first quarter of 2014 fell more than three-fold compared with the corresponding period of the previous year,while the volume of the production of trucks - by approx. 7%. However, expectations regarding the rise in the price of cars caused an increased demand for cars meaning production has increased by a factor of 2.1 compared with the corresponding period the previous year. At the same time, the volume of mechanical production decreased by 17.9%, compared with the first quarter of 2013.

The food industry is a good example of neutralising the negative impact of the trade restrictions by Russia due to the opening of new markets in the European Union. Growth in sales of some food enterprises on foreign markets exceeded their performance on the domestic market.

[1]Export of iron and steel to Russia amounts to 12 % of the overall volume of export of the products from Ukraine

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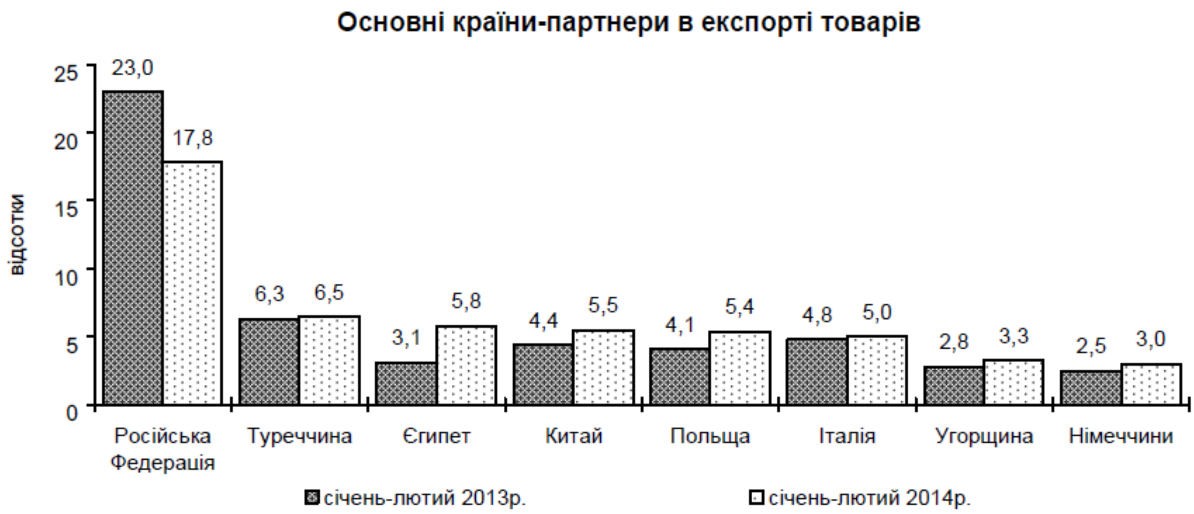
Further decline in the scope of production of food industry (-2.6% in March, in annual terms, compared with -1.3% in February 2014) was mainly caused by a significant decrease in the scope of production of alcoholic beverages due to the higher excise duty introduced on 1 March, 2014.

Analysis of foreign trade indices shows the trend of deteriorating relations with the Russian Federation and the reorientation of Ukrainian companies on other markets. According to the State Statistics Service of Ukraine, in January-February 2014, the deficit decreased by 20.6% compared with January-February 2013, and amounted to 267.4 million dollars. This is due to the fact that, compared with January-February 2013, imports decreased more than exports, by 17.9% and 10% respectively.
Exports of goods to the European Union states reached 35.5% of total exports, while to other countries - 64.5%.

Figure 1

Main partner countries in exports of goods



Percentage

The Russian Federation, Turkey, Egypt, China, Poland, Italy, Hungary, and Germany

January-February 2013 January-February 2014

Source: The State Statistics Service of Ukraine

As shown in Figure 1, the share of exports to the Russian Federation fell by 5.2% compared with January-February 2013, while the share of exports to other major partner countries has increased. Among the largest partner countries, exports of goods has increased: in Egypt - by 68%, Poland – by 18.1%, China – by 13.3%, Germany – by 8.1% and Hungary – by 3.6%. At the same time, the export of goods to Russia declined by 30.4%, to Turkey – by 7.1%, to Italy – by 6.4%.

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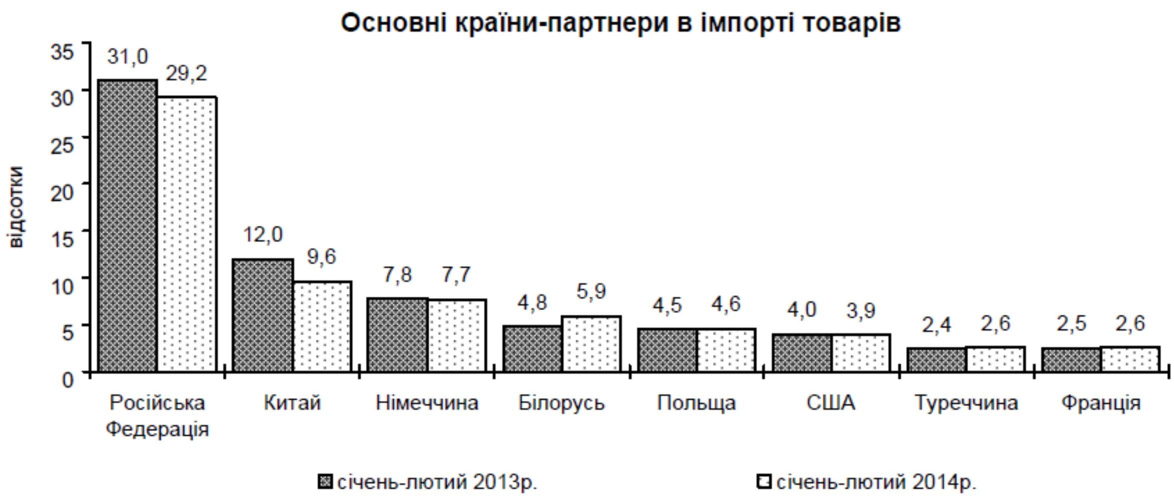
The decline in exports, compared with January-February 2013, was significantly affected by a limited supply of rail cars - 83.3%, mineral, chemical and nitrogen fertilisers - by 59.3%, sunflower oil - by 23.2%, rolled ferrous metal products – by 10.2%, cast iron pipes and ferrous pipes - by 40.5%. At the same time, exports of oil and oil products has increased by 2.6 times, wheat – by 69.3% , ferroalloys - by 38.3%, coal, briquettes - by 26.4%, iron ores and iron ore concentrates – by 24.6%, corn – by 15%.
The volume of imports from the EU amounted to 34.3% of total imports, while from other countries - 65.7%.

Figure 2

Main partner countries in imports of goods



Percentage

The Russian Federation, China, Germany, Belarus, Poland, USA, Turkey and France.

January-February 2013 January-February 2014

Source: The State Statistics Service of Ukraine

Distribution of the market among the biggest partner countries in imports of goods did not alter significantly compared with the corresponding period of the previous year, as can be seen in Figure 2. Supplies from China decreased by 34.5%, from Russia – by 22.6 %, USA – 19.8%, Germany - 18.9%, France and Poland - 15.6%, Turkey - by 10.7% and Italy - 9.8%. The main reason for this decline was the devaluation of the hryvnia, and the deterioration of consumer sentiment among the population.

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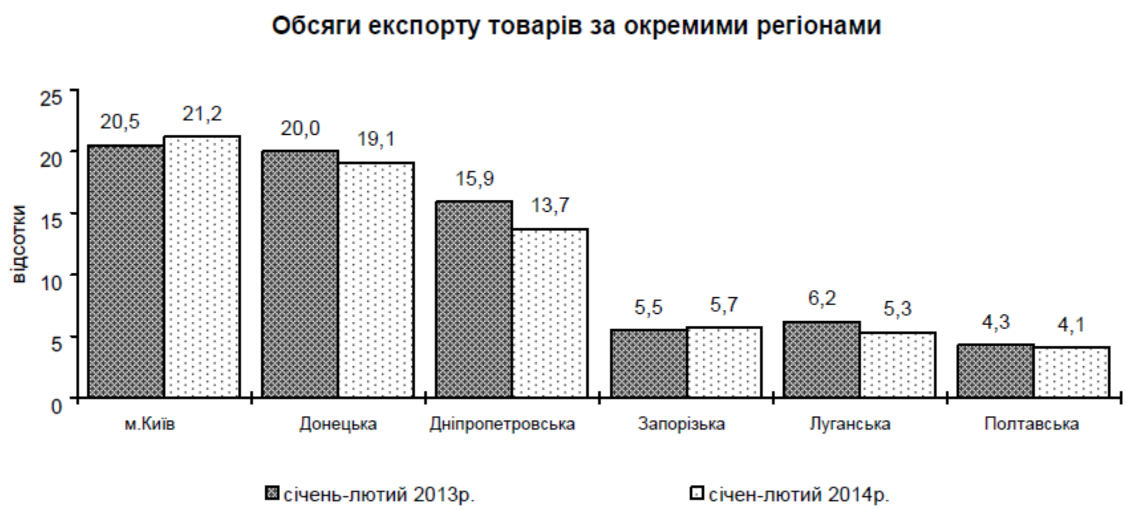
Imports, when compared with January-February 2013, decreased in connection with the drop in the supply of natural gas declined by 44.1 %, coal – by 42.3%, passenger cars - by 23.6%, pharmaceuticals (medicines) – 15.1%, trucks - by 55.3%, finished rolled steel products - by 27.5%.

Simultaneously, supplies of mineral, chemical and nitrogen fertilisers increased by 2.2 times, oil and crude oil - by 71.5% , iron ores and iron ore concentrates - by 48.9%, motor gasoline - by 40.7%, corn – 40.5%, oil and oil products - by 11.4%, diesel fuel (gas oil) – by 7.1%.

Companies of the city of Kiev, as well as Donetsk, Dnepropetrovsk, Kiev, Odessa, Zaporozhye and Lugansk Provinces were actively engaging in export and import operations.

Figure 3

Volumes of exports of goods by particular regions



Percentage

The city of Kiev, Donetsk Province, Dnepropetrovsk Province, Zaporozhye Province, Lugansk Province and Poltava Province.

January-February 2013 January-February 2014

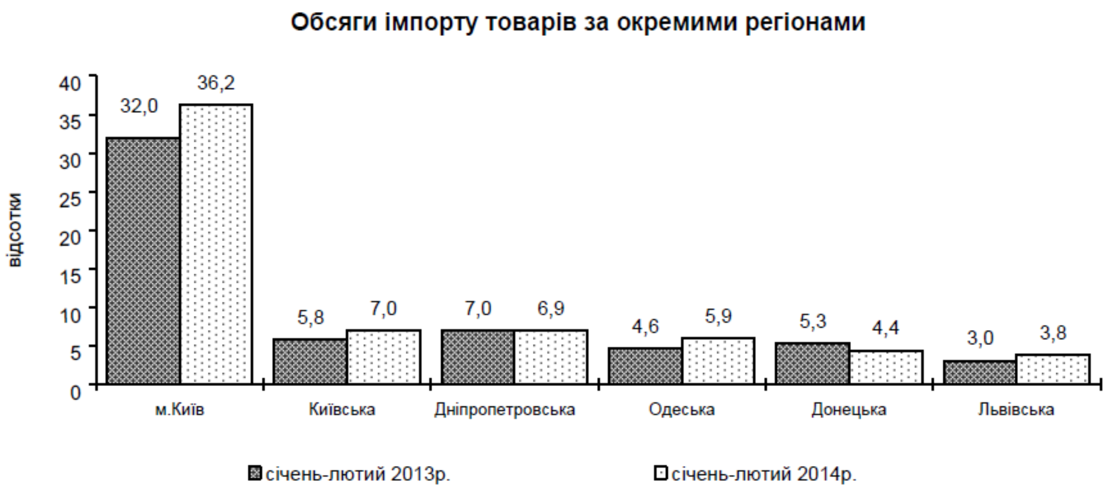
Source: The State Statistics Service of Ukraine

Trade restrictions introduced by the Russian Federation had the greatest impact on the eastern regions of Ukraine, as the regions are home to the largest portion of production plants, manufacturing products which are supplied to the Russian market. The largest factories working in the field of steel are located in KrivoyRog, Zaporozhye, Dnepropetrovsk (the Dnieper region), Makeyevka, Yenakievo, Alchevsk (Donbass) and Mariupol (the Azov Sea region). Nonferrous metallurgy is concentrated in the Donetsk and Dnieper regions.

The major railcar factories are located in Poltava and Lugansk Provinces. Production of buses and trucks is carried out in Cherkasy and Volyn Provinces (index of industrial production in the first quarter of 2014 in Cherkassy Province amounted to 93%, and in Volyn Province - 101.4%, compared with January-March 2013) .

Figure 4

Volumes of imports of goods by particular regions



Percentage

The city of Kiev, Kiev Province, Dnepropetrovsk Province, Odessa Province, Donetsk Province and Lvov Province

January-February 2013 January-February 2014

Source: The State Statistics Service of Ukraine

It is expected that Russia will continue the policy of import substitution, not only due to the conflict with Ukraine, but also because it has been one of the priorities of the state policy since 1998. Import substitution operates in many sectors of the Russian economy: the food industry, metallurgy, mechanical industry, chemical industry etc. For example, in the early 2000s, Russian companies did not manufacture large diameter pipes, and since 2008, they have had a completed production cycle of these products. Since 2011, the import of engines by the 'Motor Sich' has been actively reduced, and it is planned that in the near future the Russian market will be fully supplied with engines produced by domestic companies (it should be noted that products manufactured by 'Motor Sich' have a double purpose of use - both civil and military, and their high-tech level is most advanced). In the railcar industry, a policy of import substitution is also clearly visible. Today, Russia already refuses to import numerous types of cars and manufactures its own, and the phenomenon is not related to trade wars.

Ukrainian enterprises must speed up the process of diversification of markets maximally, in order not to address the problem of production suspension. Some steps have already been taken in this direction. And so, in late March, the Stakhanov Railcar Production Plant supplied the German operator, VTG Aktiengesellschaft with a pilot batch of 100 cars for cement transportation. The previous year, the Krukovka Carriages Production Plant began to increase its exports to Turkmenistan. In addition, exports of rail cars to Moldova have increased (in the previous year, the value of exports amounted to approx. 2 milliondollars, while since the beginning of the year – approx. 5 million dollars). However, these volumes are not sufficient to level the negative impact of reducing supplies of rail cars to Russia, especially in the short-term period of 2014-2015. In addition, the state policy in Ukraine is not conducive to maximising the opportunities of the domestic market. In particular, the demand for 5000 rail cars of the state-owned 'Ukrzaliznitsya', which was reported by railcar production plants, has not been fulfilled; hence, the placement of an adequate state order could stimulate the entire industry and help it to reduce production costs.

The geographical structure of exports of ferrous metals has also undergone changes. In the first quarter of 2014, supplies to CIS countries decreased by 37.6%, while to the EU countries, thesupplies increased by 12.9 %, and to the Middle East countries – by 10%. In this area, it is difficult to reorient exports as there is fierce competition and the search for new commodity markets is an extremely tough task. However, due to deterioration of Ukrainian production capacities, there is great potential for growth in the consumption of iron and steel products. In the event of increased government orders, the domestic consumption could increase by 1 million tonnes per year.

In the automotive industry, in the first quarter of 2014, the situation was saved by the increase in domestic demand due to expectations for an increase in prices for passenger cars. However, in the long term, if the Russian market is lost, Ukrainian enterprises should focus their efforts on the organisation of clusters for the production of components, as their chance of building a full-cycle production of cars through the collection of low localisation and a transition to a high level of localisation has already been missed.

The signing of the economic part of the Association Agreement after the presidential election in Ukraine in 2014 should contribute to the reorientation of Ukrainian target markets through the creation of favourable conditions for trade between Ukraine and the EU. According to our estimates, the exports of agricultural products and foodstuffs to the European Union countries could increase by approximately 7%, light industry - 9%, chemical industry - by 0.3%, mechanical industry - 2%, iron and steel industry - by 1%.

As can be seen from the calculations, industries which are strategically important in the eastern regions of Ukraine, will suffer more substantial losses due to the closure of the Russian market than the extent to which they may benefit from liberalisation of trade with the EU. Ukrainian produce of the engineering industry may draw interest from a European consumer only after costly renovations have been carried out and new standards for production have been implemented, and it is impracticable without the close cooperation of Ukrainian manufacturers with their new strategic partners. In the metallurgical industry, deliveries to the EU are currently determined in the majority by demand, as there are no significant barriers to trade; therefore, a significant increase in exports to the European Union market is unlikely. Reorientation of markets in this area should be directed towards the Middle Eastern markets and the domestic market.

Industries such as agriculture, the IT- sector and transportation should be the leverage of the Ukrainian economy in the period of transformation. It is assumed that agriculture will experience the greatest benefit from the opening up of the EU market. Crop production will increase immediately, and livestock production and the food industry will follow, after they receive appropriate quality certificates. The development of agriculture, in turn, provides growth in cargo transportation volumes. In January - March 2014, the volume of export traffic by 'Ukrzaliznitsya' increased by 7.3%. An increase has also been noted in goods in transit - by 0.6%. Internal cargo transportation compared with the corresponding figures of the previous year, amount to 97.7%, while import cargo - 97.5%.

As for the IT-sector, the previous year, the industry grew by 30%, but, in fact, the potential of growth is considerably greater. This sector is poised to grow by 40-50% per annum, provided that a favourable business environment is ensured. An unstable situation in the country may adversely affect the investment in the development of the IT-sector in the east of Ukraine, but this does not affect the development of Lviv's IT Cluster, as it has very positive prospects. Initiatives in the sector, supported by the government and aimed at decreasing the grey economy, as well as the transition from a pure outsourcing model of IT industry, to a product model, could also become a significant impetus for growth could also become a sector initiative.

Therefore, we can say that the loss of the Russian market will have a very significant impact on the eastern regions, however, due to instability, the negative impact will also spread in both central and western regions. In the East, it is expected that jobs in the depressed areas will be reduced by 20%. It is assumed that separatist movements will grow strongerunderthe conditions ofsignificant deterioration in the local economic situation. Also, the expected labour migration to the west of Ukraine and the central regions, as well as to Western Europe from the eastern regions has already begun. The EU's role in maintaining stability with regard to the situation may lie in the allocation of financial and technical assistance aimed at the re-equipment of industry and in carrying out a series of information campaigns in order to deliver to the business environment and the public, the idea that the future is in the modernisation of the economy and diversification of the commodity markets in the direction of the European Union countries, but not limited thusly. A joint work on the development of African and Middle Eastern markets may also be effective. The realisation that Russia is striving to achieve maximum economic and political isolation should convince the EU to adopt a decision on the provision of financial assistance to Ukraine, as the existing finances which lead to the achievement of macroeconomic stabilisation, are timely and important, but insufficient.

It is necessary to use the crisis period, associated with the closure of traditional markets, for such a reorientation of Ukrainian companies which will remain after the crisis, and will contribute to further development of the geopolitical situation in Ukraine in the track of Western policy and prevent recurrence of a so-called multi-vector policy of Ukraine, which led to the failure of signing the Association Agreement with the European Union and further destabilisation of the situation in Ukraine and throughout the entire macro-region.

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