

The effect of company seizures and trade suspension in Donbas

In March, a further escalation of the economic component of the conflict in Donbas occurred. Ukrainian-owned businesses in the non-controlled area (NCA) were seized by the de-facto authorities. In reaction, the Ukrainian government suspended all trade-related goods transports across the contact line. In this report, we assess the economic impact of these two events on the government-controlled area (GCA), but not on NCA.

The effect of the company seizures is estimated to take 0.7% off Ukraine's GDP in 2017, as the seized companies no longer are a part of Ukraine's GDP. The trade suspension is likely to result in a negative effect of 0.6% on GDP in 2017, as several value chains are disrupted. However, reorganisation of production processes and substitution of inputs through imports and of sales through exports are possible. The magnitude of the effect in 2017 hence depends much on the speed of adjustment and is likely to be temporary. Grave disruptions such as electricity shortages due to a lack of anthracite coal or strong decreases of steel production do not appear realistic. However, Ukraine's trade deficit in 2017 will probably increase by USD 1.8 bn, corresponding to 1.9% of GDP.

To sum up, the negative impact on GCA is significant, but much smaller than the economic disturbances in previous years related to the Donbas conflict.

Remaining economic links in the Donbas

Although the conflict in the Donbas had already led to the severance of most economic links between the non-controlled area (NCA) and government-controlled area (GCA), some links had persisted until 2017. Some companies had re-registered their NCA activities in the GCA and continued to pay taxes. These companies could transport goods across the contact line by rail and received Ukrainian certificates of origin, enabling them to export their products. These economic links first came under stress when in late January the rail transports were blockaded by activists.

March: Seizures and trade suspension

The situation escalated in March of this year, when the de-facto authorities in the NCA seized most remaining Ukrainian-registered companies in the NCA. These included mines producing anthracite coal, a high-grade coal used to fire power plants in Ukraine, as well as many large assets in the metallurgy industry. In response to this illegal expropriation of assets, the Ukrainian government then formally suspended all

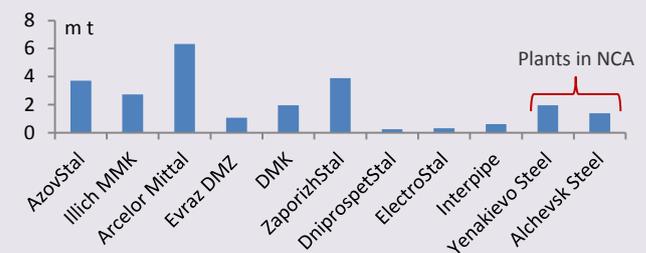
cargo traffic across the border. Hence, since March, companies in the NCA are unable to legally export goods, lacking recognised certificates of origin and supply chain links between NCA and GCA are interrupted.

Effect of company seizures on GCA

The National Bank of Ukraine (NBU) estimates that the company seizures will lead to a negative GDP effect of 0.7% in 2017 on GCA. The seized companies have essentially been removed from the Ukrainian economy. Although this is still a sizeable effect, its relatively small magnitude indicates that most of the economic substance of the NCA has already been lost in previous years due to destruction, companies no longer being registered in Ukraine or no longer operating. For comparison, the economic share of the NCA in the Ukrainian economy in 2013, before the conflict, was 8.4%.

Most of the loss of economic substance affects the Ukrainian steel industry, which has been deprived of large assets such as Yenakievo Iron and Steel Works, belonging to the Metinvest group as well as Alchevsk Steel. Steel production in the NCA in 2016 was around 14% of Ukraine's total steel production. However, free capacities in GCA plants may make up for a large part of that loss.

Steel production in Ukraine, 2016



Source: Ukrstat

Furthermore, the company seizures also imply the loss of NCA exports (mainly steel) for the Ukrainian economy. As the NCA were a net exporter in previous years, the seizures cause a negative net effect on Ukraine's 2017 trade balance of USD 0.4 bn or 0.4% of GDP.

Effect of trade suspension on Ukraine

The NBU estimates the negative effect of the trade suspension for 2017 at 0.6% of GDP. The economic disruption caused by the trade suspension results from the difficulties of reorganising supply chains: Products received from the NCA must be substituted by other, domestically available, products or imports;

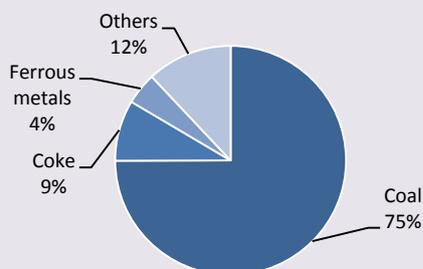
products previously sold to the NCA must be sold elsewhere.

Other than the permanent effect of company seizures, where a part of GDP simply has been lost, the effect of the trade suspension can be temporary. If companies are able to successfully reorganise their supply chains, production levels can recover.

Metal and energy sectors can replace NCA supplies

The sectors most affected by the trade suspension are the metal and energy sectors. Intra-Ukrainian goods transports from the NCA were mainly made up by coal, coke and other intermediate products in the metallurgy sector, whereas the NCA mainly received iron ore (57%) and coal (32%) from the GCA. At 15.7 m tonnes, the NCA sold more to the GCA than it bought from it (9.7 m tonnes).

Goods transport from NCA to GCA*, 2016



Source: Ukrzaliznytsia *International trade excluded
Note: Total goods transport amounted to 15.7 m tonnes

Our analysis shows that in both sectors, the lost inputs from the NCA can be substituted. Anthracite coal can be imported from countries such as South Africa or, although politically sensitive, Russia. Also, power plants can be converted to use more easily accessible coal types. Nuclear power plants in Ukraine also appear to have run well below their maximum effective capacities in previous years and have substantially contributed to substituting coal power since March. Hence, an energy shortage appears unlikely.

In the metal sector, the main dependency is coke from the NCA. Coking coal will most likely not be a bottleneck, as the NCA was a net importer of coking coal in previous years. Hence, coking coal imports can be redirected to the GCA, requiring only coking capacity. This capacity exists in the GCA. However, some risks exist with regard to Avdiivka coking plant, as it will play a pivotal role in this regard, but is situated near the contact line and has been affected by the conflict in previous years.

Sales to the NCA previously were focused on iron ore, which can be either used domestically or exported on the world market, although increased transport costs will negatively impact competitiveness and profits.

Aggregate effect of both events

In sum, the negative effect on GDP will total -1.3% in 2017 according to the realistic estimate of the NBU. The trade deficit will increase by USD 1.8 bn, 1.9% of GDP. This is caused by the combination of the loss of NCA trade for Ukraine, the need to import goods to substitute deliveries from the NCA and – probably temporary – drops in production while supply chains are being reorganised.

In total, the economic effects of seizures and trade suspension on Ukraine are still significant and will noticeably depress GDP growth for 2017. However, in comparison with the effects experienced in previous years, the magnitude will be limited. Rumours about possible energy shortages or a critical hit to the metal sector appear unfounded according to our analysis.

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A more comprehensive analysis is provided by the Policy Briefing PB/06/2017 [“Trade suspension and company seizures in non-controlled area: Economic impact on government-controlled area”](#).

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The group advises the Government of Ukraine on economic policy issues since 1994. It is funded by the German Federal Ministry for Economic Affairs and Energy and implemented by the consulting firm Berlin Economics.



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