

## The importance of Russia to the Ukrainian economy

Russia is considered to be a very important economic partner to Ukraine. When we look closely at specific items of the balance of payments, however, a highly uneven picture emerges.

On the export side, the Russian market remains important to Ukraine, accounting for a share of 11% in the first quarter of 2015. But this proportion used to be much higher, amounting to 29% in 2011. In the first quarter of this year, Russia was no longer the main gas supplier; instead, most gas imports came from the EU in the form of 'reverse flows'. The EU is also responsible for most of the foreign direct investment (FDI) in the Ukrainian economy, with Russia accounting for a moderate 6% – equivalent to just half of the German contribution. By contrast, Russia's financial institutes currently play an important role in the Ukrainian banking sector.

Russia is still an important economic partner to Ukraine. However, a clear and accelerating trend of economic disintegration between the countries can be clearly observed, especially regarding trade.

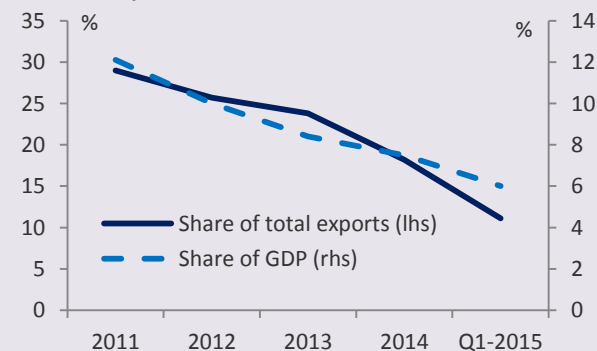
### Background

Conventional wisdom contends that Russia is a very important economic partner to Ukraine. To test this hypothesis, we will examine the development of economic links over recent times – and the balance of payments provides an appropriate framework for analysis. In the discussion that follows, we will pinpoint and assess a range of factors in the light of their significance to Ukraine.

### Exports

For many years, Russia constituted the main export market for Ukrainian goods; in 2011 Russia accounted for a proportion of 29%, making it more important than the EU.

#### Ukrainian exports to Russia



Source: Ukrstat

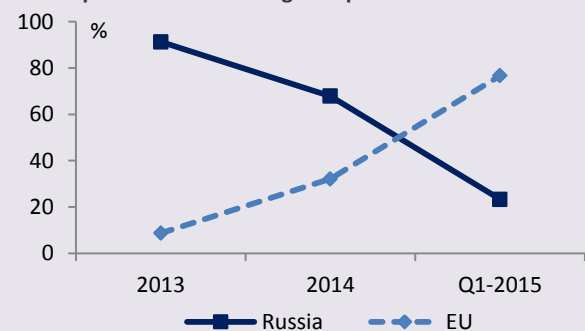
The proportion has declined steadily since then, the downturn accelerating throughout 2014 and into the first quarter of 2015, when the share of exports to Russia amounted to just 11%. The decline is also reflected in relation to GDP; exports amounted to 12% of GDP in 2011, with this figure falling to just 6% in the first quarter of this year.

The most important goods being exported to Russia are products for the mechanical engineering and metals sectors, which taken together make up nearly 50% of all exports; these are followed by the chemical industry with 11%. Exports to Russia are characterised by a high proportion of final products.

### Energy imports

Ukraine sourced 91% of its entire gas imports from Russia in 2013, equivalent to approximately USD 10.8 bn. In 2014, imports of gas fell by 30% in quantity terms in response to a drop in demand and lower levels of storage. With imports from the EU also on the rise ('reverse flows'), the decline has come about at the expense of Russia. This pattern accelerated during the first quarter of 2015, with just 23% of gas now being imported from Russia and the EU supplying the remaining 77%.

#### Development of Ukrainian gas imports



Source: Ukrstat

To a lesser extent, the diminishing importance of Russia as an energy supplier to Ukraine is also apparent in the falling imports of oil and oil products; the Russian share was just 16% in the first two months of 2015, compared to 31% in 2013.

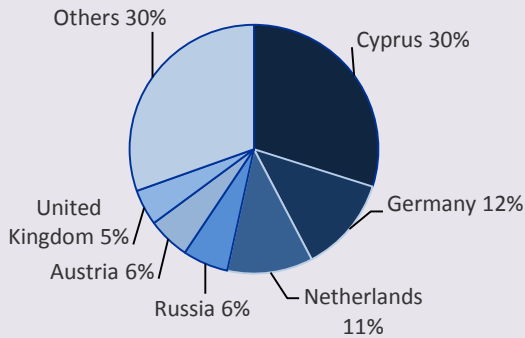
### Remittances

Aside from imports and exports, remittances from Russia constitute a key factor in the current account of Ukraine. Despite a sharp fall to around USD 2 bn in 2014, Russia remains by far the most important country for Ukrainian remittances with 36%.

**Foreign direct investment (FDI)**

At first glance it would appear that Russia, which for many years has accounted for an unvarying share of 6% of foreign direct investment in Ukraine, does not play a leading role; this value is comparable with the proportion provided by Austria and is just half of Germany’s contribution.

**Stock of FDI by country, 2014**



Source: Ukrstat

However, the official statistics leave a number of questions unanswered – not least of which is the role played by Cyprus. Although Cyprus is the most important country of origin for FDI in Ukraine with a 30% share, it is likely that these funds come from other sources (including Russia) and are merely diverted through Cyprus in a process known as ‘round-tripping’.

An examination of sectors shows that most Russian investment (71%) flows into the financial sector. The mechanical engineering and metallurgy sectors supply a negligible 2% each.

**The banking sector**

At the start of the second quarter of 2015, Russian banks contributed 16% to the total assets of the Ukrainian banking sector; this represents a marked increase on 2008, when the proportion was just 7%. At the same time, the share for Western banks has declined. Eleven Russian banks currently maintain a presence in Ukraine, four of which (Prominvestbank/VEB, Sberbank, Alfa and VTB) rank among the 10 most important banks in the country. Although we can see that Russian financial institutes have gained in importance in overall terms, the magnitude of their future commitment will largely depend on their willingness to supply additional capital in the face of the forthcoming recapitalisation of the sector.

**The Russian perspective**

The Russian viewpoint as regards bilateral economic relations is also interesting. Ukraine is of very minor economic significance to Russia, simply because of the difference in size of the respective economies (Russian economic power was 11.5 times that of Ukraine in 2013). Just 2.5% of exports went to Ukraine (on a par with Belgium and South Korea), while only 1.2% of

Russian FDI was located in Ukraine in 2014 (a level comparable with Turkey and Spain). In view of these figures, the economic importance of Ukraine to Russia as expressed in the public discourse of recent times seems highly exaggerated.

**Conclusion**

In summary, trade between Russia and Ukraine shows a strong and recently accelerating trend for disintegration, although remittances from Russia will remain important to Ukraine in the future. Russia does not play a large part as regards to FDI in the Ukrainian economy. Although Russian financial institutes are important in the banking sector, they will need to supply capital to maintain that position. To that extent Russia remains a significant economic partner, but its dominant importance to Ukraine would appear to be a relic of the past.

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**Note:**

For a detailed analysis of the subject, please refer to Policy Briefing PB/07/2015 “Economic links between Russia and Ukraine. A fact-based analysis”.

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**German Advisory Group**

The German Advisory Group advises since 1994 the Government of Ukraine on a wide range of economic policy issues. The group is financed by the German Federal Ministry of Economics and Energy under the TRANSFORM programme and its successor.

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