German Advisory Group Ukraine

NEWSLETTER

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Impact of Russian trade and transit restrictions on Ukraine

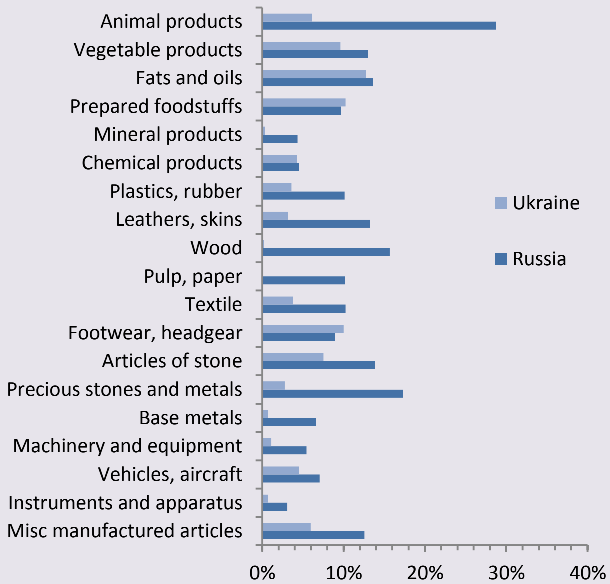
In January 2016, Russia implemented new trade restrictions on Ukrainian imports: The free trade agreement was cancelled and several agri-food products were banned; Ukraine reacted with mirror actions vis-à-vis Russia. According to our estimations, the new restrictions will lead to a decline of Ukrainian exports to Russia by USD 624 m and to a fall in imports from Russia by USD 505 m per year. Thus, Ukraine's annual trade deficit will increase by USD 119 m or 0.1% of GDP.

On parallel, Russia also introduced transit restrictions for Ukrainian goods destined to Kazakhstan. Direct transit through Russia is not permitted anymore, but indirect transit through Belarus is allowed. If the "Belarus route" works smoothly in practice, the impact on Ukrainian exports to Kazakhstan will be only minor. If this route turns out to be unfeasible, therefore forcing exporters to use the alternative route through the Caucasus, exports to Kazakhstan could decline by up to USD 405 m per year due to capacity limitations. Based on our research, additional ferries would be required at both the Black and the Caspian Sea to overcome physical transport constraints.

New trade restrictions

In January 2016, the Russian Federation introduced most-favoured-nation (MFN) tariffs for Ukrainian imports, thus ending more than twenty years of free trade with its Southern neighbour. Ukraine reacted with mirror actions.

MFN tariffs: Ukraine vs. Russia



Source: Own estimations

The introduction of MFN tariffs implies a strong increase of Russian tariffs for Ukrainian imports: the new trade-weighted average tariff amounts to 7.6%, compared to 0% under the free trade agreement. The corresponding increase of Ukrainian tariffs for Russian imports is – much lower – at 1.7%.

This significant difference can be explained by two factors. MFN tariffs are – in general – much higher in Russia than in Ukraine, and energy – traditionally a duty-free import item – accounts for more than 50% of Russian exports to Ukraine.

Besides these tariff measures, Russia introduced a temporary import ban on selected Ukrainian agri-food products. Ukraine reacted with a temporary ban on agri-food products, chemicals, locomotives and railway equipment from Russia.

Impact on trade between Ukraine and Russia

Whenever import tariffs increase, foreign goods become more expensive, making international trade less attractive. As a result, exports and imports decrease. In this particular case, the estimation of the reduction in trade has to be combined with the impact of the respective import bans. The combined effect is depicted in the table below.

Combined effect of MFN tariffs and import ban

	Change, USD m	Change, %
Exports to Russia	-624	-12.9
Imports from Russia	-505	-6.8
Trade balance	-119	--

Source: Own estimations

The impact of the new trade restrictions is quite high. In particular, exports to Russia will decline by USD 624 m or 12.9%, a significant amount. However, due to the mirror measures by Ukraine, the macroeconomic impact will be much less. Imports from Russia will decline by USD 505 m, and the trade deficit will increase by USD 119 m, equivalent to only 0.1% of GDP.

Sectoral impact on Ukraine

The Russian trade restrictions will impact many sectors of the Ukrainian economy. However, three sectors will be most severely affected: animal products, metals, and machinery. These three sectors account for 53% of the total expected decline in exports to Russia which amounts to 12.9%.

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Transit restrictions
Also in January 2016, the Russian Federation introduced restrictions on the transit of Ukrainian goods through its territory. Since then, the direct transit of goods from Ukraine to Kazakhstan is prohibited. Instead, Russia offered the usage of an indirect route through Belarus.

The alternative to this "Belarus route" is the transit through the Caucasus ("New Silk Road"). In this case, Ukrainian goods need to cross the Black Sea on a ferry, transit through Georgia and Azerbaijan and then cross the Caspian Sea.

The transit issue is important; in 2015, Ukraine exported goods worth USD 700 m to Kazakhstan. The main categories are machinery (19%), preparations of cereals (12%) und metals (8%). Furthermore, Ukraine also exports to other countries in Central Asia.

Impact of transit restrictions on exports
The use of the Belarus route as well as of the New Silk Road – when compared to the now forbidden direct transit route through Russia – feature some negative factors: Costs are higher, it is more time-consuming, and in some scenarios physical transit limitations prevail. We estimated the impact of these factors on Ukrainian exports to Kazakhstan; the results are presented in the table below.

Impact of transit restrictions on exports to Kazakhstan

Route	Assumptions	Effect, USD m	Effect, % GDP
"Belarus route"	Route operates smoothly	-13	-0.02
"New Silk Road" (Caucasus)	Current ferry capacity at Black and Caspian Sea	-405	-0.46
	Capacity at Black Sea +3 ferries and Caspian Sea +2 ferries	-43	-0.05

Source: Own estimations

The use of the Belarus route – assuming it operates smoothly – does not physically limit the transit and the additional costs in terms of time and money are not very high. Hence, exports to Kazakhstan would only decline by USD 13 m if transit is fully re-routed in this way.

The "New Silk Road" – as of today – features considerable physical limitations at both the Black and the Caspian Sea. As a result, only a fraction of Ukrainian exports to Kazakhstan could use this route. This would lead to a massive decrease in exports by USD 405 m.

This decline can be largely avoided by investing in new ferries. If three additional ferries are installed at the Black Sea and two at the Caspian Sea, exports would only decline by USD 43 m, which is quite comparable to the Belarus route.

Conclusions
Regarding the transit issue, it is crucial for Ukraine to secure a smooth operation of the Belarus route in the immediate future. While significant impediments were present during January and February of this year, contributing to a decrease in exports to Kazakhstan by 52%, the situation seemed to have normalised in March. Simultaneously, policy action and support from international partners are needed to overcome physical limitations in the Black and the Caspian Sea.

The new trade restrictions represent one further step in a constant process of deterioration of trade relations between these countries. The result of this deterioration is quite visible: Ukrainian exports to Russia amounted to USD 19.8 bn in 2011; the corresponding figure in 2015 is USD 4.8 bn, only 24% of the level in 2011 is left. A similar picture applies to imports from Russia. Thus, the process of economic disintegration between the two neighbouring countries has been continuously proceeding at high speed.

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Note: A more comprehensive analysis of the topic is provided by the Policy Briefing PB/05/2016 "The impact of new trade restrictions on Ukraine's trade with Russia" and PB/04/2016 "Ukraine's exports to Kazakhstan. Impact of transit restrictions through Russia"

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German Advisory Group
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