

Integration Possibilities for Ukraine: Perspectives and Consequences

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FOREWORD

The report focuses on the highly topical issue of the economic dimension of Ukraine's participation in integration associations. The current organization of the world economic system breaks down the boundaries of national economies and reformates them into global regional associations, where the complicated, interrelated production chains are lined up. The place that the economy of Ukraine will take in the chain of value added and the conditions under which it will operate as a member of such associations influences on the success of the modernization and further development ways. International experience shows the higher share of high-tech products exchange in countries-participants of global regional associations, so the ultimate goal of Ukraine should be the inclusion of certain activities in the industrial process chains of EU countries, many of which rapidly implement new industrial strategies.

It should be noted that the steps of the EU towards Ukraine is unprecedented and certainly important, particularly, early operationalization of the EU obligations on the Association Agreement between Ukraine and the EU, which will operate temporarily from June to November 2014, cancels import duties on 94.7% of industrial production and decreases the rest of duties (including some chemical products). On agricultural and food products preferences are related to more than 80.0% of exports of goods, and products that are not included to the list of duty-free, will be exported under tariff quotas on the duty-free basis. We receive preferences before the commencement of the Agreement, and further, in order to protect the domestic market, gradually, for five years we will reduce import duties on export of goods from the EU, which will allow us to attain macroeconomic effects from the improving of trade regimes with the EU and the growing of goods and services output, i.e., a positive reaction for the real sector.

The failure to sign the Agreement on November 28th, 2013 has postponed the liberalization of trade regimes for Ukrainian exporters, which made impossible cost savings due to the abolition of import duties on January 1st, 2014, and today we can talk about the loss of the potential opportunities for Ukrainian producers at the EU markets in 2014. Lost economic opportunities are macroeconomic in their nature and should not be regarded only as a loss of exporters, because they are expressed in the reduction of the expected increase in production at constant 2010 prices by 7.0 billion UAH (0.36 pp), GDP – 3.7 billion UAH (0.33 pp), exports of goods and services – by 4.0 billion UAH (0.8 pp), imports – by 2.7 billion UAH (0.4 pp). The loss of the real sector and the service sector are: agriculture – 1.0 billion UAH, the food industry – 1.0 billion UAH, light industry – 0.4 billion UAH, the mining industry – 0.3 billion UAH, the wood industry – 0.3 billion UAH, metallurgy – 0.7 billion UAH, engineering – 0.3 billion UAH, hotels and restaurants – 0.5 billion UAH, the information sector – 0.6 billion UAH, financing activities – 0.3 billion UAH, law activities, accounting, engineering, services for entrepreneurs – 0.3 billion UAH.

Implementation of the Agreement regarding improving the trade regime, from January 1st, 2014 could create the basis for these macroeconomic effects for the year (at constant 2010 prices): an increase of production by 20.6 billion UAH (1.1 pp), GDP – by 11.1 billion UAH (1.0 pp), exports – by 11.9 billion UAH (2.4 pp), imports – by 8.2 billion UAH (1.2 pp), so that private consumption could further increase by 3.7 billion UAH (0.7 percentage points) and investments – by 0.8 billion UAH (0.5 pp).

For certain sectors of the economy of Ukraine consequences of signing the agreement in 2013 in regards to change the output would have the dimension: **in the real sector:** the greatest growth of output in agriculture (3.1 billion UAH), food (3 billion UAH), light (1.2 billion UAH), mining (1.1 billion UAH), wood (0.7 billion UAH) industries, metallurgy (2.2 billion UAH), engineering (1.0 billion UAH); **reduction** in production in the chemical industry (0.9 billion UAH in 2014 already and to 4.0 billion UAH in 2018), because, due to the increased share of imports from the EU, compared with exports to the EU, imports will increase faster; **in the service sector:** the greatest growth is in the activities of hotels and restaurants (1.5 billion UAH) in the information sector (1.9 billion UAH), financial activities (0.9 billion UAH) and law activities, accounting, engineering, services for entrepreneurs (0.8 billion UAH).

The necessary condition for effective implementation of the Agreement is to modernize the production and to include domestic enterprises in technological chains of European companies through the involvement of Ukrainian businesses in joint research, communication and information projects (as provided by section IV «Trade and issues related to the trade» and V «Economic and sectoral cooperation» of the agreement project). It would also compensate the consequences of cooperative relations breaking with the enterprises of Russia and diversify exports, mainly focused on the Russian market.

The current state of political relations between Ukraine and Russia will inevitably lead to a significant restriction of exports and Ukraine should be prepared to provide measures that would help minimize losses. However, despite the significant threats to individual domestic producers, trade conflicts in previous years yet forced them to seek the replacement of the Russian market, and Ukrainian business today is much better prepared to withstand a trade war, and to some extent it, has lost illusions about the market of the Customs Union and Russia, because the current export supplies to the EU and Turkey are about 41.0%, and to the countries of the Customs Union – about 23.0%.

The authors considered three scenarios of trade conflicts with Russia – depending on the use or non-use by Ukraine the counteract mechanisms and on the list of products that can be quickly replaced at the Russian market.

The usage of restrictions mainly could relate to products that in the short term may be replaced by Russia on its own products and the production of other countries, including some products of the agro-food sector, food and chemical industries, vehicles, machines and equipment.

Introduction by the Russian Federation of tariff and non-tariff restrictive measures in 2014 could lead to a decrease in merchandise exports of Ukraine (excluding energy materials) worth about 4.6 billion USD, which is around 5% of total exports of goods and services of the country.

Scenarios in the case of the introduction by Russia import restrictions for Ukrainian products are defined by actions to be taken by the Government of Ukraine on the formation of compensatory mechanisms to avoid possible negative effects on the reduction of Ukrainian exports of final goods and investment products.

By the condition of absence of measures taken by Ukraine in response, the adaptation to changes will occur at the enterprise level: in contrast to a reduction in exports (4.6 billion USD) can occur reducing imports at 2.05 billion USD, creating conditions for increasing the trade deficit by 2.6 billion USD and declining in GDP relatively to the expected at 12.3 billion UAH (0.8%).

By the condition of Ukraine using measures to increase domestic demand through government ordering the investment products, and in contrast to the decline in exports (4.6 billion USD) which can occur reducing imports at 1.9 billion USD, the trade deficit will increase by 2.7 billion USD and GDP will decline at 8.0 billion UAH (0.5%), because of the peculiarity of linkages in the production of energy- and material-intensive engineering products (railcars), due to rising costs of energy resources in related sectors and a high share of imported intermediate consumption production inputs.

According to the best scenario for Ukraine – the implementation of compensatory measures – in response to the decline in exports at 4.6 billion USD we may have to reduce the volume of imports, analogues of which are produced in Ukraine, at more than 2.0 billion USD. This will allow Ukraine to improve the trade balance and to support domestic producers because of the possibility of the

reorientation of production to the domestic market, which will result in some reduction in prices for consumers and is effective in conditions of today's exchange rate policy of the NBU.

Also it is necessary to increase volumes of the state order to the defense–industrial complex, which will intensify the activity of high–tech sector enterprises and will result in the creation of new jobs.

An important aspect of foreign relations between Ukraine and Russia is a possibility of industrial cooperation in the aircraft construction and aerospace sector, shipbuilding, railway engineering, but expectations in regards to the possibilities of its implementation are exaggerated.

In particular, in the aircraft construction and aerospace sector as areas of closest cooperation, the increase of production output in Russia by 1000 USD stimulates exports from Ukraine for 28 USD, 21 USD of which are engineering products. Thus the full output in Ukraine will increase by 55.4 and GDP – by 21.4 USD.

The lowest depth of cooperation is in shipbuilding. The growth of the output in this sector in Russia by 1000 USD stimulates an increase in exports of Ukrainian goods by 13 USD, full output – by 24.8 USD and Ukraine's GDP – by 9.6 USD.

In railway engineering, where cooperation is formed mainly in the framework of joint holdings, the output growth of this industry in Russia at 1000 USD stimulates export of goods from Ukraine by 19 USD, full output – by 37.4, and GDP – by 14.5 USD.

For a more realistic assessment of the impact of cooperation with Russia on the economy of Ukraine it was estimated the growth of Ukrainian exports and GDP under the different conditions for aircraft construction, shipbuilding and railway engineering. Even by the innovative scenario of Russian industry development, the volume of Ukrainian exports growth by the mutual cooperation is negligible. For the aircraft construction sector of Russia (the sector with deepest cooperation), we can increase the volume of Ukrainian exports from 500 to 700 million USD through 2018, which is the highest index of all scenario calculations, but it is extremely low for significant positive macroeconomic effects.

The cooperation between Ukraine and Russia in high-tech industries has a small impact on macroeconomic dynamics in both countries, including: the low share of high-tech exports of Ukraine to Russia (from 0.001 to 0.078% for the different product groups); very small percentage of Ukrainian high-tech imports in total imports of Russian Federation (0.03% of the computational techniques to 10.41% of the instruments and devices for automatic control and management). Exceptions are turbo–jet, turbo-prop engines of Ukrainian origin, whose share in total imports from Russia for this group of products is 49%, which confirms the importance of cooperative relationships for some of the enterprises in this sector, despite the fact that its share in the total exports of Ukraine is 1 %.

In the medium term, the decline in exports of engineering sectors, involved in the production cooperation, can occur as a consequence of the Russian Federation government programs of import substitution, strategic development of certain sectors (engines, turbines, propulsions, pumps, generators, etc.) and creating their own closed loops in the defense industry production and transport engineering¹. Limitations of such Russian products only in the medium term, driven by the complexity of the rapid reorientation of Russian producers to other suppliers and the loss of the Russian side will be substantial. In some sectors, particularly in engineering, replacement of suppliers may involve changing of production technologies that takes a lot of time and money spent. Ukraine for now has opportunities and should continue the diversification of exports, oriented to the Russian market, as initiated before.

¹ Development of Science and Technology (approved by the order dated December 20, 2012 № 2433-r); Development of the Aviation Industry for 2013-2025 (approved by the order dated December 24, 2012 № 2509-r); Development of Industry and the Increase of its Competitiveness (approved by the order dated January 30, 2013 № 91-r); Development of Electronic and Radio electronic Industry for 2013-2025 (approved by the order dated December 15, 2012 № 2396-r); Development of Shipbuilding Industry for 2013-2030 (approved by order dated December 24, 2012 № 2514-r); Development of the Pharmaceutical and Medical industry for 2013-2020 (approved by the order dated November 3, 2012 № 2057-r); Development of the Transport System (approved by the order dated December 2, 2012 № 2600-r); The Space Activity of Russia for 2013-2020 (approved by the order dated December 28, 2012 № 2594-r); Agricultural Development and the Regulation of Markets for Agricultural Products, Raw Materials and Food for 2013-2020 (approved by the order dated July 14, 2012 № 717); Economic development and innovative economy (approved by the order dated March 29, 2013 № 467-p); Energy Efficiency and Energy Development for 2013-2020 (approved by the order of April 3, 2013, № 512-p); Electricity Network Complex development strategy of Russia (approved by the order dated April 3, 2013 № 511-p).

The results of forecast calculations show limited economic opportunities for increasing of the cooperation between Ukraine and Russia in these areas because of the implementation by Russia of the import substitution policy, so at the macroeconomic level, the effect from cooperative relations doesn't have a significant influence, but it has quite a significant impact on individual enterprises and socio-economic development of the south-eastern regions of Ukraine. In addition, Ukraine's cooperation possibilities remained mainly for products, which, due to the high consumption of materials and energy or the shortage of skilled labor, can't be replaced at Russian enterprises during the medium term.

The focus on the diversification of export, based mainly on Russia, is confirmed by the survey of unions, associations, organizations and definite corporations and enterprises (46 subjects) to assess their perspectives in foreign economic activity according to two areas of integration (the development of a deep and comprehensive free trade area (FTA) with the EU under the Association Agreement between Ukraine and the EU and the Customs Union of EurAsEC) in the short, medium and long term. For that Ukraine needs to implement investment projects of restructuring the economy through modernization of production and especially social infrastructure, environmental protection, technical support of reforms and the Agreement with the EU provides such possibilities and we should use them in the national interests.

The research results show warnings, which must be considered for the effective implementation of opportunities of the Agreement for Ukraine and for the minimization of losses in trade conflicts with Russia. Firstly, improved trade regimes with the EU provides benefits for domestic producers and stands out as an impetus for additional economic growth only in the short term, so not only increasing of access to markets should be the fundamental aim to Ukraine, but also the usage of the Agreement possibilities for the Ukrainian economy reformation in order to improve its competitiveness. The implementation of this task will require institutional and structural reforms relating to medium and long term and in the short term can cause a decrease in economic growth due to the refusal of the Government of Ukraine from the adoption of populist radical solutions in regards to the economic restructuring. Secondly, although the significance of the steps of the EU towards Ukraine is undeniable, yet it is necessary to understand that in addition to the tariff regulation, there are various non-tariff instruments, phytosanitary, environmental requirements, technical regulations which exist, so adaptation of domestic production to the highest international standards will require significant investment in technology changes and, perhaps, a longer adaptation period than specified in the Agreement. For business it should submit a positive message in regards to the self-determination by Ukraine the new implementation schedule (in accordance with Article 57 «The convergence of technical regulations, standards and conformity assessment»), if such a need will become imminent.

In addition, people should be informed about the possibilities of a joint representative bodies, such as the Council of Association (according to Articles 461, 464, 467 of the Agreement) and the Committee of the Association who are represented by members of the Government of Ukraine on the one hand, and members of the European Union Council and the European Commission on the other, representatives of both sides at the level of senior government officials, members of the Parliament of Ukraine and the European Parliament members. Thus Ukraine and the EU have one vote and only its consent enables the decision approval.

Hopefully this scientific report will be useful in developing of the state economic policy in Ukraine.