The economics of the Ukraine crisis

Economic commentary

10 March 2014

Highlights

- Europe remains an important market for Russian natural gas, but the dependence is not as great as it was a decade ago, and will reduce further as new infrastructure is built.
- Russia does not face balance of payments issues in the way that Ukraine does, but its economy is not in great shape, with many structural issues still to be tackled.
- Trading links between Russia and the EU have expanded rapidly in recent years, but these flows are only big enough to impact on overall economic performance in the Baltic States and Ukraine itself.
- Russia and Ukraine are both significant exporters of grain to the world market. Any difficulties in moving grain through the Black Sea ports are likely to cause prices to spike.

The occupation of the Crimea region of Ukraine by Russian troops following the overthrow of Ukraine's President, Viktor Yanukovich on 21st February, has precipitated a major international diplomatic crisis.

Something similar occurred in 2008 when Russian forces took control of the Georgian region of South Ossetia, and the Kremlin still has soldiers stationed in the breakaway region of Transdniestria in Moldova. But this latest incident is more serious. It was not the result of a direct military attack of the sort that was attempted by Georgia, while the Crimea is important strategically, both as the home to Russia's Black Sea fleet and as an export channel for Ukraine's agricultural produce. It also marks a ratcheting up of a long-standing tussle between Russia and the west for influence over Ukraine, which started back in 2004 with the so-called 'Orange Revolution', and which took its latest turn in November when President Yanukovich's government bowed to pressure from Moscow and decided not to sign a Partnership Agreement with the EU.

How the crisis unfolds from here is anybody's guess. But there is now a distinct possibility that when all this is over Ukraine will not be one country, with one or more portions either breaking away as independent nations with close ties to Russia or even becoming an integral part of the Russian Federation.

Suffice to say, that while military forces from Russia and Ukraine remain in tense proximity, there is a clear risk of something flaring up and of people getting killed. Should that happen, then the crisis will take a decided turn for the worse, with pressure then mounting for Russia to face economic and trade sanctions, as well as diplomatic isolation. If the situation on the ground can be contained and even defused, then any sanctions might well stop at travel restrictions on a handful of high-ranking Russian and Ukrainian officials and their families.

But given the risks of some form of escalation in the days, weeks, and months ahead, it is worth considering and quantifying the economic relationships between Russia, Ukraine, and the global economy. The most obvious area is Russia's position as a major supplier of both oil and natural gas. But it also shouldn't be forgotten that much of this has to transit across Ukrainian territory, while Ukraine is in its own right a major supplier of grain to the world market.

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There was a swift reaction from financial markets to the deployment of Russian troops in Crimea, with sharp falls in the value of the rouble and in the MICEX stock market index. There were also spikes in benchmark prices for oil and grain. With the rouble reaching an all-time low against the dollar in early trading on 3rd March, the Bank of Russia stepped in to stabilise the situation via an increase of 150 basis points, to 7.00%, in its policy interest rate. This followed reports that it had already spent some $10 billion of foreign exchange reserves defending the rouble in the week after President Yanukovich was ousted.

Financial markets are prone to panic and to over-react, but they can be quite good at absorbing bad news: it's uncertainty that they don't like. It's therefore no surprise that markets have stabilised, and even rallied, in the past few days. But all bets would be off if the present stand-off between Russian and Ukrainian soldiers were to turn into a shooting war.

Gas War III

In terms of the wider economic consequences of a prolonged diplomatic wrangle, most attention is focused on the potential impact of supplies of Russian natural gas to Europe being reduced or cut off. But things have changed somewhat since the first two so-called 'Gas Wars' between Russia and Ukraine in 2006 and 2009, which both caused supplies to be curtailed. To begin with, Europe is less dependent on Russian gas these days. Russia remains the largest supplier to EU countries, but now accounts for less than 30% of EU imports, rather than 45%
a decade ago.

European dependence on Russian gas …

	Energy and gas consumption 2012		
	% share of total energy consumption from natural gas	% of total gas consumption from Russian natural gas	**% of total energy consumption from Russian natural gas**
Ukraine	35.6	60.0	**21.4**
Slovakia	31.8	63.4	**20.2**
Hungary	40.0	49.1	**19.7**
Turkey	35.0	52.8	**18.5**
Czech Rep.	17.6	80.5	**14.1**
Austria	24.6	52.2	**12.8**
Belgium	25.1	43.4	**10.9**
Finland	10.5	102.3	**10.7**
Germany	21.7	39.9	**8.7**
Poland	15.3	54.3	**8.3**
Italy	38.0	19.9	**7.6**
Greece	13.1	54.0	**7.1**
France	15.6	17.1	**2.7**
Netherlands	36.8	5.7	**2.1**
Spain	19.5	-	**-**
UK	34.6	-	**-**

Source: BP Statistical Review of World Energy 2013

On top of that, an EU Directive has required all countries to increase their energy storage capacity. In any case, with spring approaching and this winter being mild stocks are at a relatively high level, with stocks in the UK, for instance, being about a quarter higher than is normal for this time of year. Finally, there are now alternative pipeline routes which bypass Ukraine. So even if Russia cut off supplies to Ukraine, this would not affect shipments via the two new pipelines which now take gas to Poland and Germany. So while about 80% of the EU's natural gas imports transited Ukraine a decade ago, that figure has now fallen to about a half, and will fall much further later in the decade when Gazprom completes its South Stream pipeline under the Black Sea.

Nonetheless, some European countries are still heavily dependent on Russian gas. Germany and Poland rely on it for 40-50% of their gas supplies, while in the case of Finland Russia is the only supplier. For many countries in central and eastern Europe, meanwhile, Russian gas makes up a sizeable proportion of total primary energy consumption, accounting for around a fifth in the cases of Ukraine, Slovakia, Hungary, and Turkey, and for 10-15% in the cases of the Czech Republic, Austria, and Finland.

The UK is in the fortunate position of not needing to import any of its natural gas directly from Russia. Although it has been a net importer since 2004, imports come predominantly from Norway, Qatar, the Netherlands, and Belgium. Nonetheless, energy companies in Britain would find themselves having to pay higher prices for gas if supplies from Russia were restricted.

In recent years Britain has seen considerable investment in the infrastructure for importing and storing gas, the catalyst being the first 'gas war' in 2006 which caused wholesale prices to soar. Since then, two new pipelines have been constructed across the North Sea (making four in total), one to the Netherlands and one to Norway, while a huge investment has been made to build a facility at South Hook in Pembrokeshire which can import large quantities of liquefied natural gas (LNG) from Qatar.

LNG is generally more expensive than standard natural gas, but it is seen as offering a way of diversifying supplies at a time when Britain's production from the North Sea is in long term decline. The South Hook plant, together with two other LNG facilities could handle up to 50% of the UK's demand for gas, although they tend to operate at lower levels depending on market prices. Nonetheless, Qatar has become an important source of natural gas to the UK since 2009, although Norway is still the largest supplier.

UK imports of natural gas

UK imports of natural gas: values (£bn) and shares of UK total (%)

	Total UK imports	of which, from							
		Norway		Qatar		Netherlands		Belgium	
	£ bn	£ bn	%	£ bn	%	£ bn	%	£ bn	%
2006	**2.5**	1.2	49.6	0.0	0.4	0.1	3.5	0.6	24.2
2007	**2.9**	1.8	61.9	0.0	0.9	0.8	29.3	0.1	2.5
2008	**6.4**	4.3	66.2	0.0	0.6	1.7	26.9	0.2	3.6
2009	**4.8**	2.8	58.3	0.5	11.2	0.8	17.4	0.1	1.9
2010	**6.8**	2.9	41.7	1.8	26.9	1.4	20.8	0.2	3.4
2011	**9.1**	2.7	29.4	4.3	47.0	1.4	15.1	0.1	0.9
2012	**7.7**	3.0	38.9	2.7	35.0	1.6	21.0	0.3	4.1
2013	**8.3**	3.3	39.6	2.0	24.0	2.0	24.2	0.9	11.1

Source: HMRC

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Yet even if the present tensions are successfully defused, there are likely to be long term consequences, particularly in the energy sector. Although Russia hasn't been the easiest place for western energy companies to do business, it has been easier for them to repatriate their profits than from many other emerging economies. But recent events may cause some of them to review their appetite for investing in Russia over the long term.

More important, governments and energy suppliers across the rest of Europe will be even more focused on reducing their dependence on supplies from Russia. Investments in LNG plants will suddenly look more attractive, with plans already afoot for a facility in Poland and with Lithuania investing in a smaller-scale floating facility, which is under construction in Korea. Work will also be hastened to reconfigure the gas and electricity supply grids, so that countries in central and eastern Europe have alternatives to the Soviet-era pipeline network. This will involve new pipelines to bring supplies from Azerbaijan and Kazakhstan without crossing Russian territory, or investment in renewable alternatives. Such infrastructure investment is expensive, and will take many years. But there will now be added incentive to move ahead with these projects, so that by the 2020s Russia is likely to find its share of the European market squeezed further. Even if the stand-off in Crimea is quickly resolved, the process of reshaping Europe's energy supply infrastructure is irreversible, and will probably gather pace.

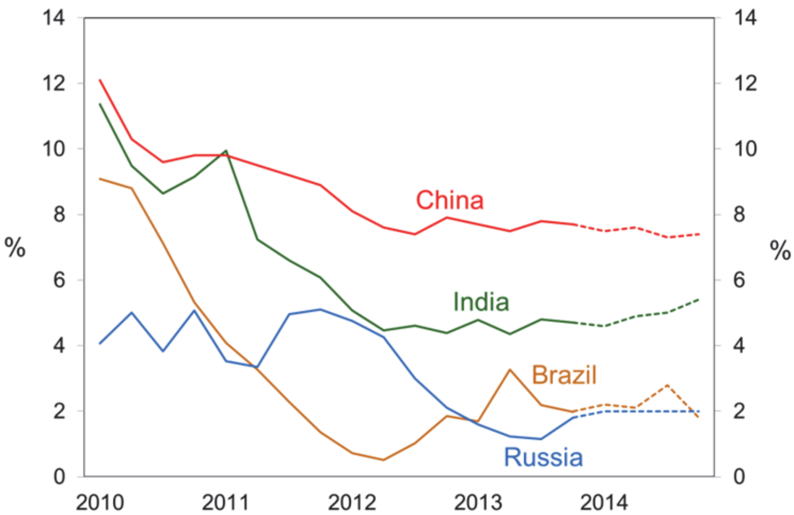
A wilting economy

Although restricting the supply of gas to Europe would clearly hurt some countries and would certainly increase prices, it's not in Russia's interest to do so. About half the government's revenues come from incomes derived from exporting oil and gas, and the Russian economy has hardly been in good shape of late.

After several years of strong growth pre 2008, GDP slumped in the wake of the global financial crisis, and although this was followed by a brisk recovery, output has expanded at a distinctly lacklustre pace in the past year or so. The economy's performance is strongly correlated to the price of oil, which has tended to drift down since peaking in 2011. Rosstat's preliminary estimate for growth in 2013 came in at a disappointing 1.3% (slower than in either the US or the UK), compared with 3.4% in 2012, and HSBC is forecasting unspectacular growth of 2% this year and next. Russia may be one of the so-called BRIC countries, but that of itself is no guarantee of dynamism.

In view of this already-weak outlook, there is clearly a risk that the fall-out from the Ukraine crisis could push the Russian economy into mild recession. Much will depend on whether the hike in interest rates by the Bank of Russia on 3rd March is enough to stabilise the rouble and whether it is quickly reversed. If not, then it will tend to depress domestic economic activity, while the recent weakening of the currency will add impetus to inflation.

Lagging behind the other BRICs



Source: Thomson Datastream

But even if the Russian economy stagnates, or worse, in the months ahead, it doesn't face the risk of an imminent balance of payments crisis in the way that Ukraine does. The Bank of Russia is sitting on a huge stash of foreign-exchange reserves of nearly half a trillion dollars, and it would take many months of sustained pressure to make a meaningful dent in its reserves. But in the longer term Russia clearly faces some stiff challenges. The size of the current account surplus is dwindling, and is expected to move into deficit from next year, while the government now needs an oil price of around $115 a barrel to balance the budget. Meanwhile, capital continues to flee the country as Russian citizens and businesses prefer to keep and invest their money abroad, not to mention their fondness for buying expensive properties overseas (especially in London) and sending their children to expensive foreign schools. All of this suggests that Russia needs to entice foreign investors rather than making life hard for them.

The bonds of trade

The reluctance of many EU countries to impose harsh sanctions on Russia stems not just from their need for its gas, but also from a desire to protect trading links. Europe's trade with Russia has expanded rapidly in the past decade, with businesses across the continent standing to lose out if Russia is either subjected to trade restrictions or if its economic performance worsens. In 2012 exports of goods from EU countries to Russia were valued at €123.1 billion, having nearly quadrupled over the preceding decade.

Not surprisingly, Germany is the EU's largest supplier of goods to Russia, with exports in 2012 worth €34 billion. With the value of this flow tripling in a decade, Russia now accounts for more than 3% of Germany's merchandise exports. But in truth Russia is still not one of Germany's major trading partners. It ranks only 11th, and is less important than some of Germany's smaller neighbours, such as Poland, Austria, Switzerland, Belgium, and the Netherlands.

Europe's exports to Russia 2002 and 2012

	Exports to Russia (€m)		% of exports		% of GDP	
	2002	**2012**	**2002**	**2012**	**2002**	**2012**
Austria	1,060	3,906	1.3	3.1	0.5	1.3
Belgium	1,256	4,816	0.6	1.4	0.5	1.3
Bulgaria	97	539	1.6	2.6	0.6	1.4
Czech Rep.	543	4,025	1.3	3.3	0.7	2.6
Estonia	458	1,500	10	12.7	5.9	8.6
Finland	3,153	5,536	6.6	9.8	2.2	2.9
France	2,399	8,034	0.7	1.9	0.2	0.4
Germany	11,394	33,980	1.8	3.3	0.5	1.3
Hungary	470	2,375	1.3	3.0	0.7	2.4
Italy	3,809	9,791	1.4	2.6	0.3	0.6
Latvia	141	1,949	5.8	18.2	1.4	8.8
Lithuania	703	4,312	12.1	19.0	4.7	13.2
Netherlands	2,602	7,999	1.0	1.6	0.6	1.3
Poland	1,410	7,169	3.2	5.1	0.7	1.9
Romania	43	1,041	0.3	2.3	0.1	0.8
Slovakia	152	1,744	1.0	2.9	0.6	2.4
Spain	787	2,876	1.4	2.6	0.3	0.6
Sweden	1,203	2,063	1.4	1.6	0.5	0.5
Switzerland	601	2,453	0.6	1.4	0.2	0.5
Turkey	1,241	5,197	3.3	4.4	0.5	0.8
Ukraine	3,377	13,715	17.8	25.6	7.5	10.0
UK	1,575	3,718	0.5	1.1	0.1	0.2

Sources: IMF Direction of Trade Statistics and World Economic Outlook Database.

For some of Russia's immediate neighbours, however, the trading links are much more important. In the Baltic States and Ukraine, all of which were once part of the Soviet Union, shipments of goods to Russia not only account for a sizeable share of total exports, but the flows are equivalent to between 9% and 13% of GDP. Yet it is also remarkable that other ex-Communist countries in central and eastern Europe now have only a limited exposure to Russia. In Poland, just over 5% of its exports are destined for Russia; for the others, the share is under 4%.

As for the UK, the generally woeful performance of exports is in this instance a silver lining. Exports of goods to Russia account for just over 1% of the total, a lower proportion than for any other major European economy. If sales of services worth some £1.7 billion are added in, then the total for 2012 came to £7.35 billion. But it seems that 2013 was not a good year, perhaps partly as a result of the weakening of the Russian economy, with exports of goods (data for services aren't yet available) falling by 6.9% to £5.2 billion.

Europe's bread basket

Finally, it shouldn't be forgotten that Russia and Ukraine are both major producers of grain, with most of their exports leaving via Sevastopol and Odessa on the Black Sea coast. Between them they account for about a tenth of world wheat production, but for about 15% of exports, while in the case of coarse grains they account for only about 5% of production but for about a sixth of exports, with Ukraine accounting for most of this.

Major exporters of grain (2013/14 harvest year (million metric tonnes)

	Wheat		Coarse grains	
	Production	exports	Production	Exports
World	711.9	159.4	1,260.0	146.2
United States	58.0	32.0	369.4	45.0
European Union	142.9	27.5	159.0	8.3
Russia	52.1	16.5	34.7	5.6
Ukraine	22.3	10.0	39.9	21.2

Source: US Department of Agriculture, WASDE, February 2014.

The agricultural sector is still important to the Ukrainian economy. It contributes close to 5% of GDP and accounts for nearly a quarter of total exports. In the case of both wheat and coarse grains Ukraine exports a relatively large share of its production. Given its proximity to markets in western Europe, North Africa, and the Middle East, it is an important part of the global supply chain on account of its ability to quickly meet short term requirements. With last year's harvest being generally good, and with inventories rising, there is little imminent risk of western consumers having to pay more for their bread and breakfast cereals. But concerns will clearly mount if the tensions persist and if Russian and/or Ukrainian grain is unable to transit to and through the Black Sea ports.

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