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Economic Consequences of the Ukraine Conflict

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Abstract

The Ukraine conflict is having serious consequences not only for Russia and Ukraine, but it also potentially threatens to damage the still frail economic recovery in Europe. In Ukraine, which is the main victim of the conflict, the economy may decline by up to 8% this year. In Russia, the costs of the conflict are estimated to be in the tune of 1% of GDP in 2014 - 2016, primarily on account of increased investment risks. The effects on the individual EU countries differ depending on their exposure to the Russian market: the Baltic States, Finland and several other new EU Member States are generally most affected. The impact on Austria is expected to be relatively modest. Austria is not overly exposed to the Russian market. For the EU as a whole, there are five industries where the share of Russia in total exports exceeds 3%: textiles, pharmaceuticals, electrical equipment, machinery and transport equipment. On the assumption of a 10% loss in exports of goods and services to Russia, the estimated GDP loss would be about 0.4% for Lithuania and Estonia, and less than 0.1% for Austria. In absolute figures, Germany might lose around EUR 3 billion, followed by Italy (EUR 1.4 billion), France, Great Britain and Poland (EUR 0.8 billion each). Austria could lose close to EUR 300 million in this scenario. The estimated impact of Russia's ban on agro-food imports from the EU imposed in August 2014 is expected to be the highest in the Baltics. These losses are undoubtedly painful, yet manageable (a trade decline bigger than 10% would obviously lead to greater losses). The question is whether these losses are justifiable and will achieve the desired effects – to change Russia's behaviour in Ukraine and beyond.

Keywords: sanctions, foreign trade, economic growth

JEL classification: E61, F15, F51

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1. INTRODUCTION: A BRIEF REVIEW OF THE CONFLICT'S HISTORY

Twenty-five years after the fall of the Iron Curtain, the current grave crisis in relations between Russia and the West represents not only a major setback, but is also evolving into a dangerous geopolitical conflict. The economic consequences of the conflict are equally serious: not only for Russia (and, of course, first of all for Ukraine), but they also pose a potential threat to the still frail economic recovery in Europe. In Russia, which was already 'stuck in transition and stagnation' before the current crisis erupted, the repercussions of the conflict hamper urgently needed investments and GDP growth, hindering economic restructuring and modernisation.[1] The present note attempts to assess the trade-related economic consequences of the conflict on Russia, the European Union and its Member States, focusing on the new Member States (NMS).

Needless to say, the main victim of the conflict is Ukraine where, apart from the human and material losses already incurred, a severe economic recession has set in. Prospects of an enduring civil war, culminating in a 'frozen conflict' in eastern Ukraine – similar to that in Transdniestria, Abkhazia, South Ossetiya or Nagorno Karabakh (albeit on a much larger scale) – can now be hardly avoided. The resulting de facto disintegration of Ukraine represents a serious threat with geopolitical consequences that reach far beyond the scope of the present note.

Although in the West the blame for the conflict is usually attributed to Russia after the annexation of Crimea and subsequent interventions in eastern Ukraine, the responsibility cannot be assigned solely to Russia or even just to Mr. Putin (in Russia a fair share of the blame is put on the West). The conflict's history is much longer.[2] More recently, the EU's unfortunate (mis)guided handling of the Ukrainian crisis (preceded by the Eastern Partnership (EaP) initiative) also contributed to the present geopolitical conflict. The tug of war between Russia and the EU over Ukraine escalated in the second half of 2013, prior to the envisaged signature of Association Agreements (which included a Deep and Comprehensive Free Trade Area – AA/DCFTA) between the EU on the one hand and four EaP countries (Armenia, Georgia, Moldova and Ukraine) on the other hand, in November 2013. During the summer of 2013, both Russia and Ukraine were suddenly alerted by the possibly adverse economic consequences of AA/DCFTA signature after details of AA/DCFTA became public. Russia started once more to implement and 'test' countermeasures (and threatened with more), such as import restrictions from the EaP countries Ukraine and Moldova. The Russian threats proved partly 'effective': Armenia decided in September 2013 not to sign the AA/DCFTA with the EU and announced the accession to the Russian-

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1 For a more detailed assessment see the author's regular country reports in the wiiw Forecast Reports No. 13, March 2014 and No. 14, November 2014, as well as wiiw Monthly Report, No. 7/8, July/August 2014.

2 See, for example, Mearsheimer (2014), Myers (2014), Techau (2014), Trenin (2014b) or Speck (2014b).

led Customs Union and Eurasian Union with Belarus and Kazakhstan instead.[3] Ukraine's President V. Yanukovych announced the postponement of the AA/DCFTA signature just a few days before the Vilnius EaP Summit in November 2013 – a decision that sparked the first wave of protests.[4] The rapid sequence of events that followed the failed Vilnius Summit in November 2013 is well known: mass protests on Kyiv's Maidan turned violent in February 2014, EU-sponsored mediation between the protestors and the Yanukovych government (involving foreign affairs ministers of France, Germany and Poland), etc. Representatives of Maidan protesters, President Yanukovych and EU mediators signed a deal in February 2014 that envisaged early elections and constitutional changes to occur in the autumn. However, the ousting of President Yanukovych and his flight to Russia on the very next day, and the controversial establishment of the new transitory government in Kyiv (whose legitimacy was disputed in the eastern parts of Ukraine and Crimea, but supported by the West) led by Mr Yatsenyuk as acting Prime Minister and the new parliamentary speaker Mr Turchynov sparked the internal conflict in Ukraine.[5] The Russian annexation of Crimea triggered the first round of Western sanctions in March 2014.

In contrast to Crimea where the 're-unification' proceeded peacefully, the anti-Maidan protests in the eastern parts of Ukraine (as well as in Odessa in southern Ukraine) turned violent as the new government in Kyiv attempted to restore control over the rebellious regions by force, involving both regular military troops and freelance fighters, mostly from western Ukraine. On 26 May 2014, Mr Poroshenko, an oligarch with business interests in food and media industries, was elected president with a convincing majority vote; the vote was 'respected' by Russia though not recognised by separatists in Donbass, who do not recognise the government in Kyiv either and claim independence instead. The situation in eastern Ukraine (and the associated Western sanctions) escalated further after the tragic downing of a Malaysian passenger plane on 17 July 2014, with the responsibility for the accident so far not fully clarified. Despite a fragile ceasefire negotiated between representatives of Kyiv authorities, Moscow and Donbass separatists with the intermediation of OSCE and the EU in Minsk in September 2014, a lasting settlement of the conflict is not yet in sight. Doubtlessly, though admittedly ever more difficult since now the inclusion of separatists in the process seems inevitable, only negotiations between the representatives of Ukraine, Russia and the EU along the lines proposed earlier e.g. by Havlik (2013), and more recently also by Emerson (2014) and others, can help to de-escalate and potentially resolve the present conflict.

Both Ukraine and the European parliament simultaneously ratified the AA/DCFTA on 16 September 2014, although the implementation of trade-related provisions (DCFTA) will be postponed until end-2015, reflecting the trilateral agreement between the EU, Ukraine and Russia. The latter has confirmed that the CIS free trade regime with Ukraine will continue to apply and consultations will continue.

3 Armenia will join the Eurasian Union in January 2015. The corresponding agreement was signed in Minsk in October 2014.

4 See Havlik (2013) for more details. In the meantime, AA/DCFTAs with Georgia, Moldova and Ukraine were signed on 27 June 2014.

5 Apart from releasing Ms Tymoshenko from jail, one of the first steps of the post-Maidan parliament was the attempt to deprive the Russian language of its official status in a number of Russian-speaking regions of eastern Ukraine and Crimea. Though the respective bill was never signed by acting President Turchynov, it sufficed to trigger mass protests in these regions.

Paradoxically, one year after the failed Vilnius EaP Summit, Ukraine is now facing a similar situation with the implementation of the DCFTA being delayed, this time with the consent of the EU.[6]

2. EXISTING SANCTIONS IN BRIEF

Western sanctions aimed at 'stopping Russian action against Ukraine, restoring Ukraine's sovereignty' were initiated by the United States in March 2014 after the Russian annexation of Crimea, followed soon thereafter by the EU and other G7 countries.[7] Largely symbolic in character initially, the spiral of sanctions rapidly escalated in the subsequent weeks and months.[8] As of October 2014, the following Western sanctions, as well as Ukraine's and Russia's retaliatory measures, have been in place:[9]

BOX 1 / SANCTIONS AND RETALIATORY MEASURES AS OF OCTOBER 2014

March 2014:

USA imposes a ban on travel and transactions of 11 Russian and Ukrainian politicians involved in the annexation of Crimea, in addition to freezing their assets;

EU imposes a ban on travel and transactions of another 21 Russian and Ukrainian politicians involved in the annexation of Crimea; negotiations on visa regime liberalisation with Russia suspended;

G7 suspends Russia's G8 membership; OECD suspends activities related to the accession process of Russia to the OECD;

USA imposes a ban on travel and transactions of yet another 19 Russian politicians and businessmen, in addition to freezing their assets, as well as imposing a ban on US dollar transactions with Bank Rossiya.

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6 The trilateral ministerial meeting on 12 September 2014 between the EU, Ukraine and Russia agreed to delay the implementation of AA/DCFTA trade-related provisions until 31 December 2015 (see also Speck, 2014b). The exchange of letters between Putin and Barroso in late September/early October 2014 on the implementation of Ukraine's AA/DCFTA and related Russian threats to abolish the CIS-FTA with respect to Ukraine illustrates grave divisions within the trilateral (dis)agreements – see Financial Times, 26 September 2014, p. 1 and European Commission, Statement/14/294 from 1 October 2014.

7 See Decision of the Council of the European Union, 8049/14, Brussels, 21 March 2014.

8 For the sake of completeness, we recall that a deterioration of Russian-US/EU relations with selective travel bans and boycotts started much earlier (the Magnitsky Law in the US, Khodorkovsky and Pussy Riot trials, unofficial Western boycott of Sochi Olympic Winter Games, etc.). Russia's practice to use trade restrictions as a means of imposing political pressure (with respect to Georgia, Moldova and Ukraine) also started much earlier – see Havlik (2013).

9 According to EU Council President H. van Rompuy, sanctions are 'not a question of retaliation; they are a foreign policy tool … our goal is to stop Russian action against Ukraine, to restore Ukraine's sovereignty … we need a negotiated solution …. engage in a meaningful dialogue involving Ukraine and Russia …' (op. cit., Decision of the European Council, Brussels, 21 March 2014). Barring other developments, the sanctions are supposed to last for one year (Russian agri-food import ban until August 2015) and until July 2015 (EU economic sanctions – see Raik et al., 2014) respectively.

April 2014:

USA imposes a ban on travel and transactions of 18 more Russian politicians, in addition to banning US dollar transactions involving Chernomorneftegaz and 15 other companies in Crimea.

June 2014:

USA imposes a ban on travel and transactions for an additional 7 Russian politicians and Ukrainian separatists, in addition to freezing their assets;

Ukraine's President Poroshenko imposes a ban on military and dual-use exports to Russia on 16 June 2014.

July 2014:

USA imposes a ban on travel and transactions of another 5 Russian politicians and Ukrainian separatists and 2 entities, in addition to freezing their assets; it also imposes a ban on US dollar transactions with six military, oil and Crimea-based companies, as well as a ban on new equity or debt security transactions with over 90 days maturity involving Bank of Moscow, Gazprombank, Russian Agricultural Bank, VEB, VTB, Novatek and Rosneft;

EU imposes a ban on travel and transactions of 23 Russian politicians, Ukrainian separatists, 9 political and military entities, 9 Crimean enterprises, and 3 Russian enterprises, in addition to freezing their assets; it also prohibits new equity or debt securities transactions with over 90 days maturity involving major Russian banks (Gazprombank, Rosselhozbank, Sberbank, VEB and VTB);

Both the financing by EBRD and EIB of new projects in Russia and the implementation of EU bilateral and regional cooperation programmes are suspended (although projects dealing exclusively with cross-border cooperation and civil society are maintained).

August 2014:

EU imposes an embargo on military and dual-use equipment trade with Russia;

On 7 August Russia imposes a one-year ban on imports of a wide range of food products from Canada, Australia, EU, Norway and USA.

12 September 2014:

EU imposes a ban on travel and transactions of further individuals involved in the Russia-Ukraine crisis, in addition to freezing their assets; it prohibits new equity or debt transactions over 30 days maturity involving Gazprombank, Rosselhozbank, Sberbank, VEB, VTB, Rosneft, Gazpromneft and Transneft (previously permitted syndicated lending is also banned and permissible maturity reduced, while extending the ban on oil companies); trade ban extended to dual-use technologies; provision of services for deep-water oil exploration and production, Arctic oil exploration and production and shale oil projects is prohibited;

USA imposes a ban on new equity or debt transactions over 30 days maturity involving Bank of Moscow, Gazprombank, Russian Agricultural Bank, Sberbank, VEB and VTB, as well as on new debt transactions over 90 days maturity with Gazprom, Gazprom Neft, Rosneft, Novatek, Transneft;

New debt transactions over 30 days maturity with Rostech as well as transactions in goods, services or technology for deep-water, Arctic offshore and shale oil projects with Gazprom, Gazprom Neft, Lukoil, Rosneft, Surgutneftegaz are prohibited.

Sources: Adapted from EBRD Office of the Chief Economist (September 2014); Fact sheet on EU restrictive measures; EU Official Journal, Vol. 57, 12 September 2014; www.government.ru (7 August 2014); US Department of the Treasury (www.treasury.gov), 16 July 2014.

3. TRADE EXPOSURE TO RUSSIA

Trade exposure between the EU and Russia is hugely asymmetric (as it is in the trade relations between the EU and Ukraine as well as between Russia and Ukraine, for that matter). Whereas in 2013 the EU was Russia's main trading partner accounting for 53% of Russian exports and 39% of Russian imports (as compared to 53.7% of exports and 41.8% of imports in the first half of 2014), EU exports to Russia in 2013 accounted for just 2.6% of the total (EUR 120 billion) and imports from Russia for 4.6% of the total (EUR 207 billion).[10] About 4.5% of the Russian exports and 5% of its imports were traded with Ukraine, whereas EU trade with Ukraine was negligible (just 0.5% of EU exports and 0.3% of EU imports in 2012).[11] As far as Ukraine is concerned, Russia and the EU took on roughly equal importance in terms of trading partners up until recently: in 2012 about 25% of Ukraine's exports and more than 30% of its imports were traded with either Russia or EU (however, significant differences were to be seen in terms of commodity composition, with Ukraine's exports to Russia being more 'sophisticated' than those to the EU – see Havlik, 2013).

The above asymmetries bear a number of important policy implications, not least regarding the implementation of the AA/DCFTA with the EU and Ukraine's trade relations with the Russian-led Customs Union.[12] In the current context of mutual sanctions, one of the implications of the conflict is that given the differences in trade volume and economic magnitude, any trade measures have a greater impact on Russia (which is more dependent on the EU market than vice versa). Furthermore, the Russian economy is much smaller – a mere fifth of the EU GDP, even at purchasing power parity; it urgently needs Western technology if it is to modernise. On average, EU trade exposure to Russia is relatively low, yet a number of EU countries trade relatively extensively with Russia: the Baltic States (especially Lithuania) and other new EU Member States (NMS) and also Finland (Figure 1). Austria, by

10 For the sake of comparison, US exports to Russia were just 0.7% of the total (EUR 8 billion), US imports from Russia only 1.3% of the total (EUR 23 billion) in 2012.

11 US trade with Ukraine was marginal: just 0.12% of US exports and 0.06% of US imports were traded with Ukraine in 2012 (Havlik, 2013).

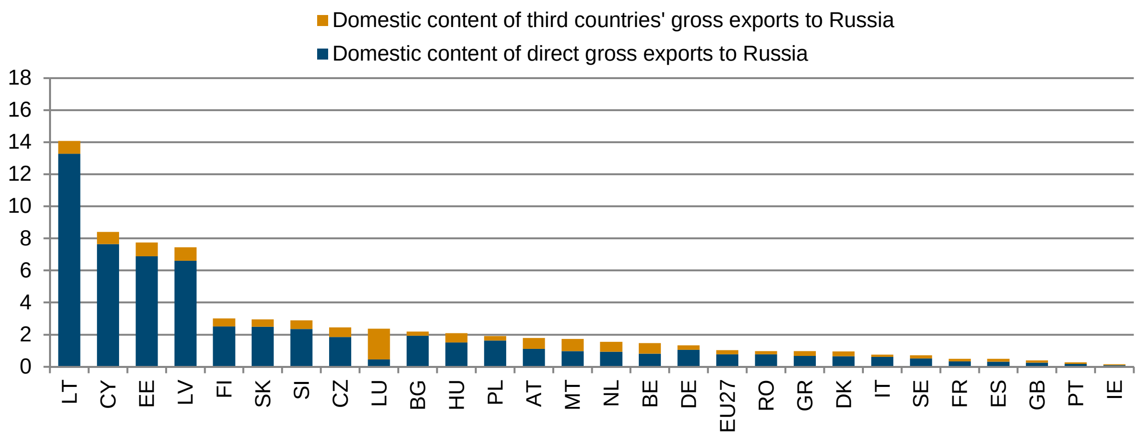
12 Russia succeeded in negotiating a delay in the implementation of the AA/DCFTA regarding Ukraine's customs-free imports from the EU until end-2015. Moreover, Russia demands a renegotiation of the DCFTA and threatens to revoke the existing free trade agreement and impose import duties on Ukraine's exports if the latter starts to implement the DCFTA (Financial Times, 26 September 2014, p. 1).

contrast, is not overly exposed in respect of gross exports to Russia: just 1.4% of Austrian GDP is exported to Russia (and only 0.6% of GDP in terms of domestic value added of exports, respectively). Cyprus, Greece, Great Britain, Portugal and Spain have minimal trade in goods with Russia.[13]

Figure 1 / Share of gross exports to Russia in % of GDP

Source: wiiw Annual Database, Eurostat Comext, Eurostat Trade in Services.

Figure 2 / Share of domestic gross exports to Russia, in % of GDP



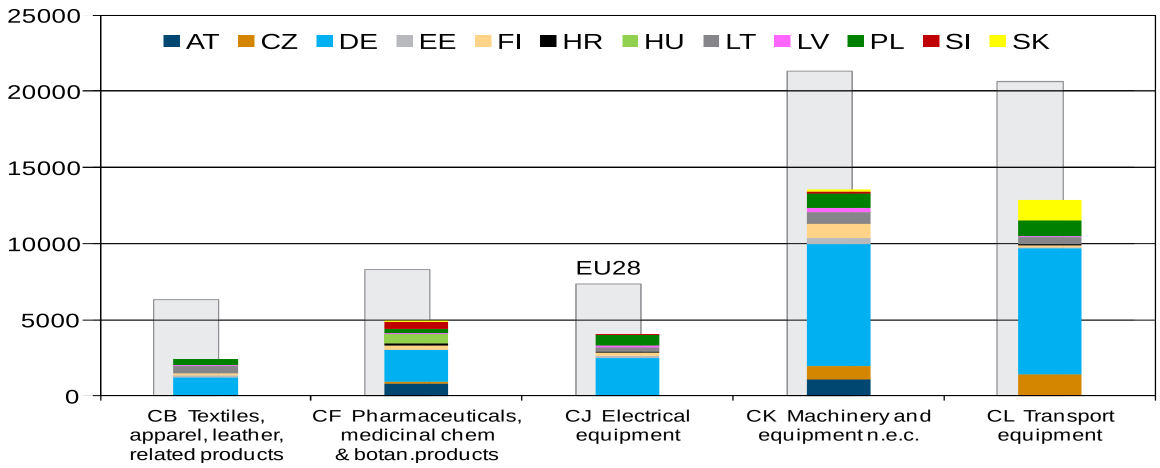
Note: Exports of both goods and services. Assuming constant export value added shares in GDP, the latest available WIOD data on domestic content of exports in terms of GDP for 2011 were applied to 2013 GDP data in order to estimate domestic content of exports in 2013.
Source: Eurostat Comext, WIOD (World Input-Output Database), own estimates.

In terms of sectoral trade exposure, there are five NACE industries (at 2-digit level) where the share of exports to Russia was higher than 3% of the EU average: textiles, pharmaceuticals, electrical equipment, machinery and transport equipment. Figure 3 illustrates the size of those sectors in 12 major EU exporting countries to Russia. In absolute terms, machinery and transport equipment are the most important export branches exposed to Russia (with more than EUR 20 billion each in 2013), followed by

[13] However, we get a different picture in trade with services. Available data (for 2012) show that Cyprus and Lithuania, with a 25% share in total services exports, are the most exposed to Russia. On EU average, transport, tourism and construction services exports to Russia accounted for more than 3% of the total.

electrical equipment. Germany is by far the most important exporter to the Russian market. In Austria, it is machinery and equipment (6%) and pharmaceuticals (11%) that play the key role in exports to Russia. It is also interesting to note that food products (banned by Russia as a retaliatory measure as of 7 August 2014) do not feature prominently among EU exports to Russia, although they are of importance to some EU countries (especially the Baltic States and Poland – see below).[14]

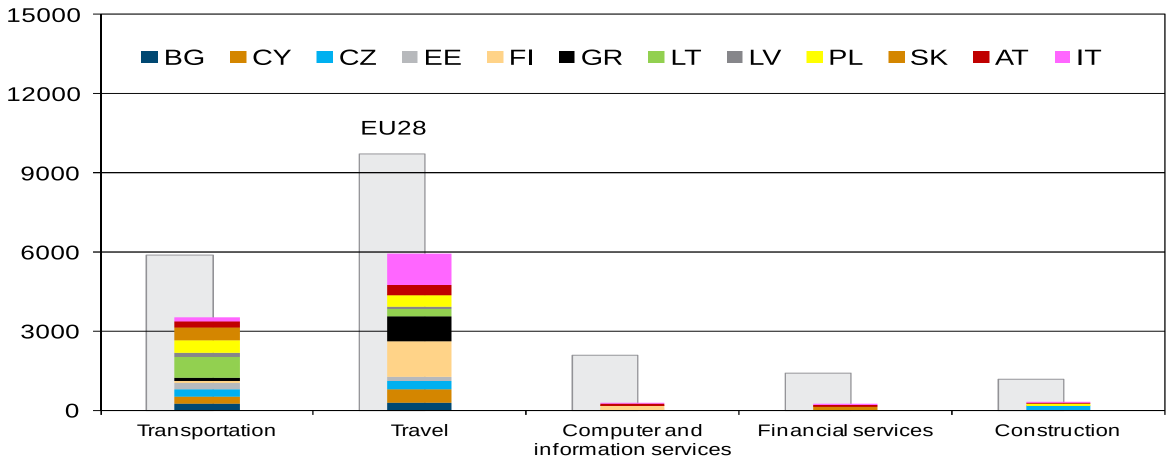
Figure 3 / EU gross goods exports to Russia: 5 key industries, 12 major exporting countries, EUR million, 2013



Source: wiiw Annual Database, Eurostat Comext.

In trade in services, the available data suggest that travel (tourism) and transportation exports to Russia are important, in particular for Cyprus, Lithuania, Estonia, Bulgaria and Greece (Figure 4).

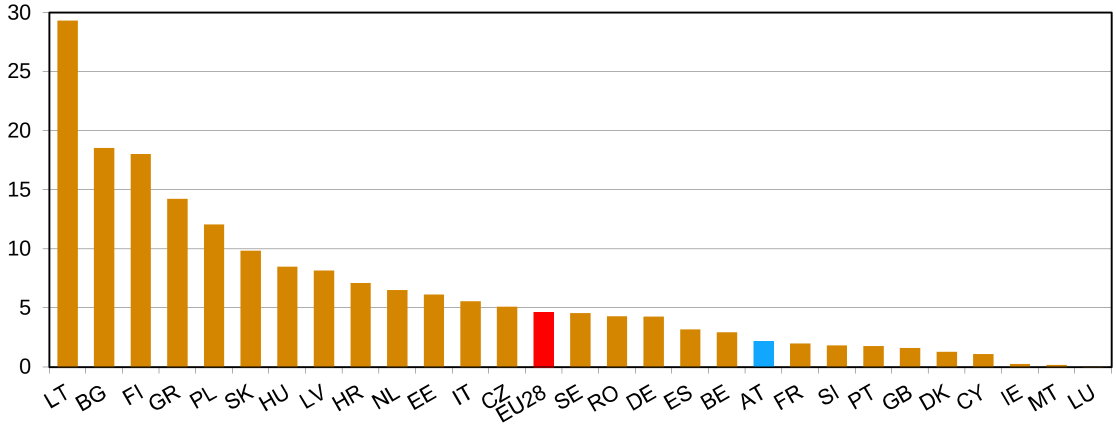
Figure 4 / EU services exports to Russia: 5 key industries and 12 major exporting countries, EUR million, 2012



Source: wiiw Annual Database, Eurostat Trade in Services.

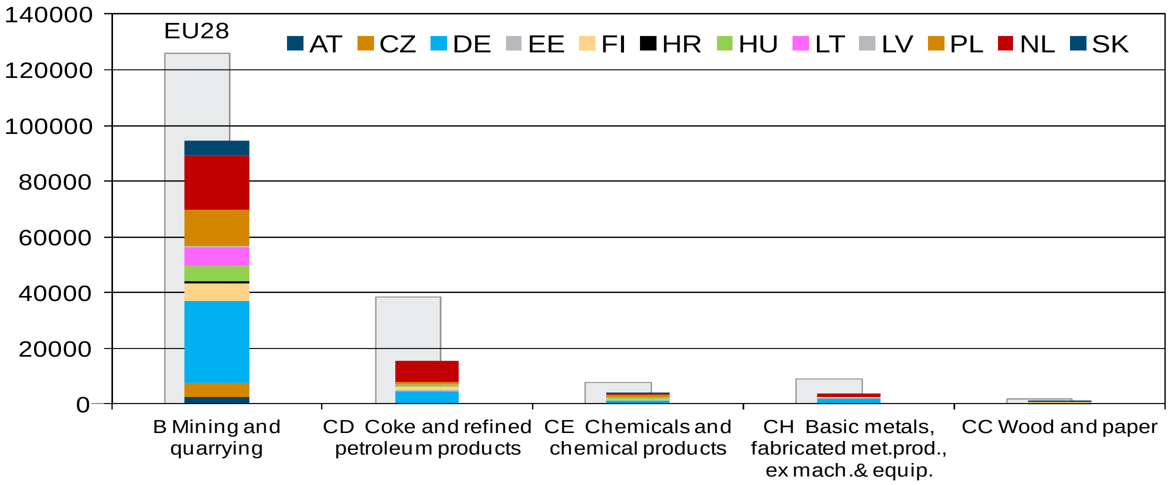
14 Less than 3% of EU agri-food exports went to Russia in 2013. For more details on Russia's import agri-food ban see EBRD News, 9 September 2014; European Commission Information Note, 3 September 2014; Russian Government Decree from 7 August 2014 (www.government.ru).

Figure 5 / Share of Russia in EU gross imports, in % of total goods imports, 2013



Source: wiiw Annual Database, Eurostat Comext.

Figure 6 / EU imports from Russia: 5 key industries and 12 major importing countries, EUR million, 2013



Note: Mining and quarrying (oil and gas): Austria, Germany and Netherlands estimated.
Source: wiiw Annual Database, Eurostat Comext.

As far as goods imports are concerned, the exposure of individual EU countries to Russia also differs widely: Lithuania imports nearly 30% of all its imported goods from Russia, Bulgaria and Finland nearly 20%, and Greece 14% – see Figure 5. The bulk of these imports – 80% on EU average – consist of energy (crude oil, natural gas and refined petroleum – see Figure 6).[15]

4. ECONOMIC IMPACTS OF THE CONFLICT

It is not easy to quantify the economic impacts of the sanctions separately. We, thus, consider the ‘effects of the conflict’ in more general terms. According to the EU, ‘sanctions are one of the EU’s tools

[15] Austrian imports from Russia reported by Eurostat show a gap of about EUR 2 billion in 2013 which is presumably attributable to gas imports. Similar reporting gaps exist also in data for Germany and the Netherlands.

to promote the objectives of the Common Foreign and Security Policy ... EU sanctions are not punitive'.[16] Beyond purely economic effects, the effectiveness of Western sanctions in terms of the targeted change in Russia's policies towards Ukraine – including a stop of intervention in eastern Ukraine and the return of Crimea – the results have so far been rather disappointing (and a revision of the annexation of Crimea is completely unrealistic).[17]

4.1. RUSSIA

The sanctions have undoubtedly augmented the negative economic developments in Russia resulting from the combined effect of the deteriorating investment climate, rouble depreciation, capital flight and reform setbacks – the country was 'stuck in transition and stagnation' already before the Ukraine crisis. Growth prospects were scaled down accordingly, by about 1 percentage point for the period 2014-2016 (compared to pre-crisis forecasts).[18] A rough estimate of economic effects owing to lower GDP growth yields a Russian GDP loss of close to EUR 20 billion in 2014 and more than EUR 30 billion in 2015 (see Table 1).

Table 1 / Estimated impacts of sanctions on Russia

	2013	2014	2015	2016
wiiw Forecast Report Spring 2014 (March)				
(1) GDP, RUB bn, current prices	66689	70000	74800	80500
(2) GDP, EUR bn, current prices	1576	1555	1626	1713
(3) Annual change in % (real)	1.3	1.6	2.3	3.0
(4) Exchange rate, RUB/EUR	42.3	45	46	47
(5) GDP, EUR bn, at 2013 prices and ER	1576	1601	1639	1688
wiiw Forecast Report Autumn 2014 (November)				
(6) GDP, RUB bn, current prices	66755	72000	77500	83000
(7) GDP, EUR bn, current prices	1578	1440	1462	1509
(8) Annual change in % (real)	1.3	0.5	1.3	1.9
(9) Exchange rate, RUB/EUR	42.3	50	53	55
(10) GDP, EUR bn, at 2013 prices and ER	1578	1583	1603	1634
Costs of the conflict, annual, EUR bn [based on difference between March and November forecasts lines (5)-(10)]	.	18	36	54

Source: Own estimates and projections.

4.2. THE EUROPEAN UNION

The economies of individual EU countries are affected to very differing degrees by the conflict, depending on their trade (and otherwise) exposure to the Russian (and Ukrainian) market. The differentiation in the economic impact and other (historical) factors also explains in part certain features

16 See EC Factsheet, Press Release, Brussels, 29 April 2014.

17 Note that we distinguish between the impacts and the effectiveness of sanctions: the latter should be assessed in view of the sanctions' purpose (cf. Gaddy and Ickes, 2014). Regarding the effectiveness of sanctions in general see, for example, DIW Roundup, 22 July 2014 as well as Emerson (2014b).

18 Similar downward revisions of growth forecasts have recently been undertaken also by EBRD, The World Bank and the IMF – see EBRD Press Office, 18 September 2014; The World Bank, 24 September 2014; IMF, 1 October 2014 (http://www.imf.org/external/np/ms/2014/100114.htm); (http://www.worldbank.org/en/country/russia/publication/russian-economic-report-32). In a pessimistic scenario, the Russian government reckons with a GDP drop by 10% in 2015.

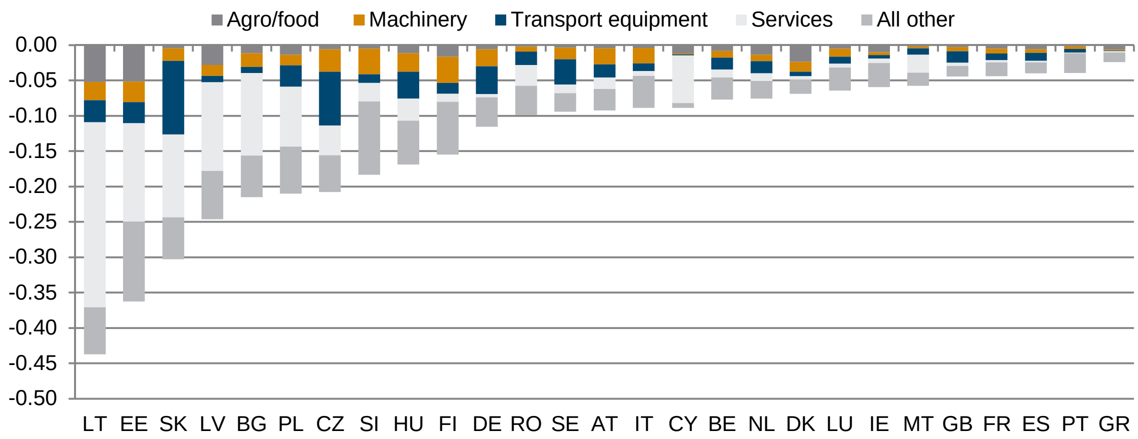
of the comparatively heterogeneous stance of the individual EU countries with respect to sanctions and other EU policies towards Russia, Ukraine and the Eastern Neighbourhood. In general, the Baltic States (as well as Finland) and other NMS are affected more than others (see Figures 1-6 above). At the same time, the Baltic States (and Poland)[19] have adopted a much 'tougher' attitude towards Russia given their historical experience, whereas Hungary, Bulgaria, Slovakia, the Czech Republic (as well as Austria, Greece and Cyprus) favour a 'softer' approach.

In order to assess the economic impact of the conflict, we take into account the varying trade exposure of individual EU countries towards Russia and construct two alternative scenarios:

(I) exports to Russia decline by 10%;
(II) exports to Russia decline by 50%.

Scenario (I) corresponds more or less to the present situation, with Russian imports from the EU dropping by 9% in nominal EUR terms in the first half of 2014.[20] Scenario (II) illustrates a more extreme escalation of the conflict with far-reaching economic and political consequences. This scenario would most likely be associated with the interruption of Russian gas supplies to the EU, confiscation of Western assets in Russia, wholesale travel bans and similar measures. Contrary to other studies (Moody's, 2014; EBRD, 2014; Deutsche Bank Research, 2014; Kholodilin et al., 2014), we take into account trade in both goods and services, but do not consider all sector-specific effects (e.g. financial flows) owing to major uncertainty and/or the lack of data.[21] Moreover, in the case of exports, we distinguish between gross exports and the domestic value added in exports;[22] we also quantify separately the impact of the food import ban imposed by Russia on 7 August 2014.

Figure 7a / Estimated loss of GDP (in %) if gross exports to Russia drop by 10%



Source: Estimates based on Eurostat Comext and WIOD data (calculations by R. Stehrer, wiiw).

[19] See N. Copsey and O. Pomorska (2014) for an interesting analysis of the Polish case.

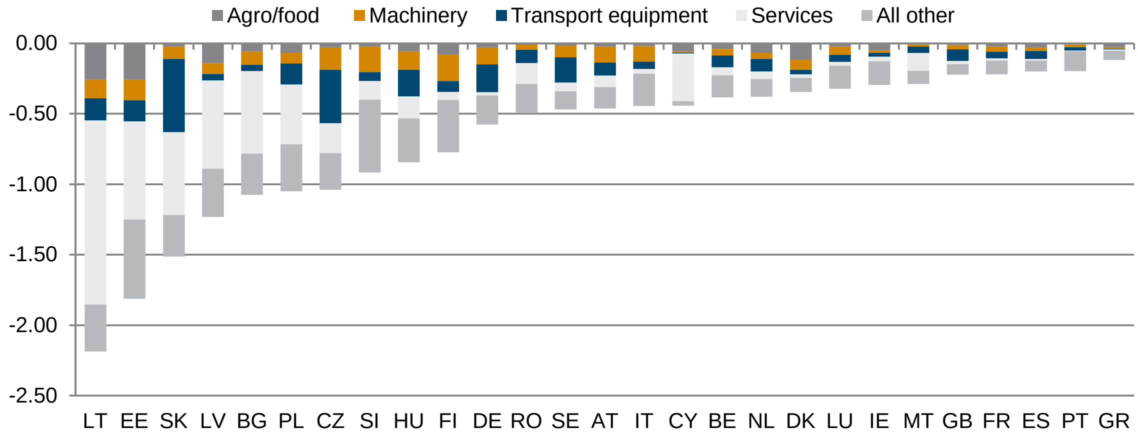
[20] This decline resulted not solely and directly from Western sanctions, but represents a combination of lower domestic demand, currency depreciation by nearly 20%, etc. There seems to be some indication that Russian imports started to diversify away from the EU, the Customs Union and Ukraine in 2014.

[21] The exposure of major Austrian banks (UniCredit Bank Austria and Raiffeisen Bank International) to Russian counterparts amounted to nearly EUR 30 billion in 2013 according to their annual reports quoted by OeNB.

[22] For a more detailed assessment of trade linkages between the EU and Russia see Benkovskis et al. (2014).

The estimation results, in terms of percentage losses of 2013, are presented in Figures 7a (Scenario I) and 7b (Scenario II). Background data and key results are summarised in Table 2.

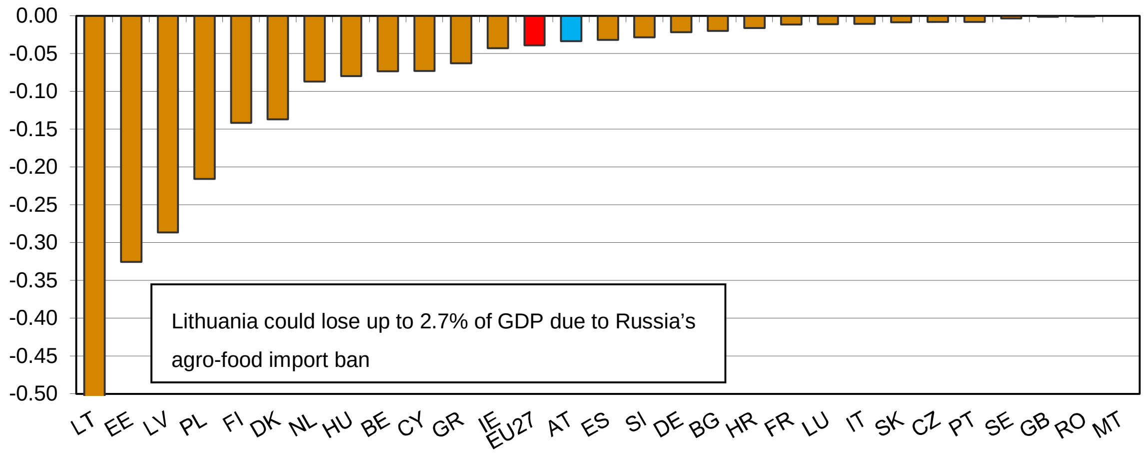
Figure 7b / Estimated loss of GDP (in %) if gross exports to Russia drop by 50%



Source: WIOD database, calculations by R. Stehrer (wiiw).

With respect to gross exports (both goods and services) the estimated loss of GDP would be highest in Lithuania (0.4% of GDP), followed by Estonia (0.36%) and Slovakia (0.3%). Austria would lose less than 0.1% of GDP – a fairly small amount which is comparable to the EU average. In absolute numbers, Austria's GDP loss would amount to less than EUR 300 million; for the whole EU about EUR 11 billion (Table 2). In the extreme (and unlikely) Scenario II, the effect of a 50% loss in exports of both goods and services to Russia would be correspondingly bigger (Figure 7b and Table 2). Lithuania and Estonia would lose some 2% of GDP; Austria less than 0.5% of GDP. In absolute figures, Germany would lose nearly EUR 16 billion in this scenario, followed by Italy (EUR 7 billion), France, Great Britain and Poland (EUR 4 billion each). Austria could lose close to EUR 1.5 billion in this scenario (gross exports of both goods and services to Russia drop by 50% – see Table 2).

Figure 8 / Estimated loss of GDP (in %) resulting from Russia's agro-food import ban



Source: Own estimates based on Eurostat databases (http://ec.europa.eu/agriculture/statistics/trade/2012/annex4 en.pdf).

Finally, Figure 8 illustrates the estimated impact of Russia's retaliatory measure – the ban on meat, dairy products, fruit, vegetable and fish imports imposed on 7 August 2014 (for 1 year).[23] According to the European Commission, the banned products amounted to more than EUR 5 billion of EU exports to Russia in 2013, with Lithuania, Poland, Germany and the Netherlands exporting the most in absolute terms. Austrian exports of banned agro-food products amounted to just EUR 100 million in 2013.

5. SUMMARY CONCLUSIONS

The Ukraine conflict bears serious consequences not only for Russia and Ukraine, but it also poses a potential threat to the still frail economic recovery in Europe. The Western sanctions imposed on Russia since March 2014 are no longer of a purely symbolic character: apart from travel bans and asset freeze of more than 100 individuals, there are now (end-October 2014) bans on borrowing by the leading Russian banks and companies, as well as restrictions on the exports of military and dual-use goods and oil extraction technologies to Russia. Russia has retaliated with a ban on agro-food imports and restricted travel to the West. The general climate between Russia, Ukraine and the West has been seriously damaged.

Clearly, Ukraine has been the main victim of the conflict. In Donbass, which used to account for 16% of Ukraine's GDP and a quarter of its exports, the war-related damage is currently estimated at some EUR 6 billion (or 6% of GDP), and industrial production has nearly come to a standstill, largely as a result of power cuts and railway disruptions. On top of that, the enacted ban on exports of military and dual-use goods to Russia has further contributed to the export decline. At the same time, domestic private consumption has been eroded by the spike in inflation and the IMF-imposed austerity measures. All in all, Ukraine's economy may contract by 8% this year, and the stabilisation prospects are unclear.

In Russia, the country which was 'stuck in transition and stagnation' already before the Ukraine crisis, the impact of the conflict is increasingly felt as well. The Western (first of all financial) sanctions and the related heightened political risks are hampering investments, economic growth and modernisation still further. A crude estimate of economic effects – lower GDP growth by about 1 percentage point compared to the pre-conflict scenario – yields a loss of Russian GDP close to EUR 20 billion in 2014, and more than EUR 30 billion in 2015 and EUR 50 billion in 2016.

The effects on the individual EU countries differ depending on their varying exposure to the Russian (and Ukrainian) markets. Despite the relatively low EU trade exposure to Russia (and especially Ukraine) on average, there are a number of EU countries which trade quite a lot with Russia: the Baltic States (in particular Lithuania; part of it is transit trade), other NMS and also Finland. Austria is not overly exposed: just 1.7% of Austrian GDP was exported to Russia in 2013 (and only 0.6% of Austrian GDP in terms of domestic value added of exports, respectively). Cyprus, Greece, Great Britain, Portugal and Spain have very little goods trade with Russia, though the two former have extensive exposure in tourism and finance.

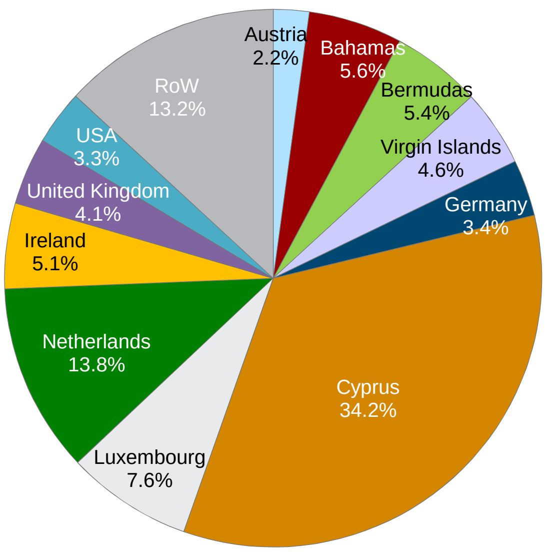
For the EU as a whole, there are five industries where the share of Russia in total exports exceeds 3%: textiles, pharmaceuticals, electrical equipment, machinery and transport equipment. In Austria it is machinery, equipment and pharmaceuticals which play the key role in exports to Russia. Food products

23 See Government Decree No. 778 of 7 August 2014 as well as EBRD (2014b).

(banned by Russia as a retaliatory measure since August) do not feature prominently among EU exports to Russia. In EU services exports, travel (tourism) and transportation are important, and the number of Russian tourists has already suffered a blow in 2014, by 20% in some cases. The import exposure of individual EU countries to Russia differs as well: Lithuania imports nearly 30% of all goods from Russia, Bulgaria and Finland nearly 20%, Greece 14%. The bulk of these imports – 80% on the EU average – consist of energy: crude oil, natural gas and refined petroleum.

On the assumption of a 10% loss in gross exports of goods and services to Russia, the estimated GDP loss would be in the order of 0.5% for Lithuania, 0.4% for Estonia, and less than 0.1% for Austria. In absolute figures, Germany might lose more than EUR 3 billion, followed by Italy (EUR 1.4 billion), France and Poland (EUR 0.8 billion each). Austria could lose close to EUR 300 million in this scenario. The estimated impact of Russia's ban on meat, dairy products, fruit, vegetable and fish imports from the EU imposed in August 2014 is expected to be the highest in the Baltic States. The banned products amounted to more than EUR 5 billion of EU exports to Russia, with Lithuania, Poland, Germany and the Netherlands affected the most in absolute terms. Austrian exports of banned agro-food products amounted to only EUR 100 million in 2013. In the case of an escalating spiral of sanctions, trade disruptions would result in bigger losses for the EU (see Scenario II as the extreme case). Furthermore, Russia might consider imposing an embargo on car imports from the EU, restrict state purchases of pharmaceuticals or even freeze some Western assets as a retaliatory measure.[24] The losses incurred so far are undoubtedly painful, yet manageable (a decline in trade bigger than 10% would obviously lead to correspondingly greater losses). The question is whether these losses are justifiable and will achieve the desired effects – to change Russia's behaviour in Ukraine and beyond.

Figure 9 / Russian inward FDI stocks (USD 566.5 billion) and shares of main investing countries, end-2013



Source: Central Bank of Russia, September 2014 (www.cbr.ru).

[24] As of end-2013, FDI stocks in Russia amounted to USD 566 billion according to the Central Bank of Russia (Figure 10). Excluding round-tripping of Russian flight capital via offshore havens (e.g. Cyprus, Bermuda, Bahamas and Virgin Islands) the remaining FDI stocks would still be considerable – about USD 250 billion.

Table 2 / EU trade exposure towards Russia and estimated effects of the conflict

	Exports of goods EUR mn gross	Share of RU in total exports gross (%)	Exports of services EUR mn 2012	Share of RU in total (%)	Goods exports (gross) in % of GDP	Services exports in % of GDP 2012	VA exports domestic in % of GDP	VA exports other count. in % of GDP	VA exports total in % of GDP	Scenario (I) Exports -10% Value added total GDP loss in %	Scenario (I) Exports -10% Value added total GDP loss EUR mn	Scenario (II) Exports -50% Value added total GDP loss in %	Scenario (II) Exports -50% Value added total GDP loss EUR mn	Agro-food exports banned by RU EUR mn	Agro-food import ban in % of GDP
EU28	119763	2.62	29309	1.99	0.92	0.22	.	.	.	-0.08	-10953	-0.42	-54766	5098	0.04
AT	4313	3.28	1087	2.31	1.38	0.35	0.57	0.35	0.92	-0.09	-290	-0.46	-1448	104	0.03
BE	5117	1.45	797	1.01	1.34	0.21	0.42	0.35	0.77	-0.08	-294	-0.38	-1471	281	0.07
BG	569	2.56	590	10.28	1.42	1.48	1.89	0.26	2.15	-0.22	-86	-1.08	-429	8	0.02
CY	24	1.62	1543	25.02	0.14	9.35	0.81	0.08	0.89	-0.09	-15	-0.44	-73	12	0.07
CZ	4475	3.68	643	3.74	2.99	0.43	1.57	0.51	2.08	-0.21	-311	-1.04	-1555	12	0.01
DE	36095	3.30	4710	2.24	1.32	0.17	0.90	0.26	1.16	-0.12	-3159	-0.58	-15795	594	0.02
DK	1562	1.87	876	1.70	0.63	0.35	0.47	0.22	0.69	-0.07	-172	-0.34	-858	341	0.14
EE	1404	11.44	482	11.33	7.62	2.61	3.22	0.40	3.62	-0.36	-67	-1.81	-334	60	0.33
ES	2818	1.18	1805	1.68	0.28	0.18	0.26	0.14	0.40	-0.04	-411	-0.20	-2055	326	0.03
FI	5354	9.58	2070	9.43	2.77	1.07	1.29	0.25	1.54	-0.15	-300	-0.77	-1498	274	0.14
FR	7721	1.77	2095	1.24	0.37	0.10	0.30	0.14	0.44	-0.04	-908	-0.22	-4539	233	0.01
GB	4667	1.14	2380	1.04	0.25	0.13	2.29	0.15	2.44	-0.04	-846	-0.22	-4230	21	0.00
GR	406	1.48	1147	4.17	0.22	0.63	0.17	0.07	0.24	-0.02	-44	-0.12	-218	114	0.06
HR	282	3.16	260	2.80	0.65	0.60	.	.	.	.	.	.	.	7	0.02
HU	2537	3.12	196	1.24	2.59	0.20	1.22	0.47	1.69	-0.17	-166	-0.84	-828	78	0.08
IE	633	0.74	-332	-0.37	0.39	-0.20	0.33	0.26	0.59	-0.06	-97	-0.30	-486	70	0.04
IT	10797	2.77	1721	2.10	0.69	0.11	0.72	0.17	0.89	-0.09	-1388	-0.44	-6940	163	0.01
LT	4870	19.83	1132	24.67	14.06	3.27	4.12	0.25	4.37	-0.44	-151	-2.19	-757	922	2.66
LU	156	1.13	233	0.41	0.34	0.51	0.12	0.52	0.64	-0.06	-29	-0.32	-147	5	0.01
LV	1749	16.04	301	8.47	7.49	1.29	2.19	0.28	2.47	-0.25	-58	-1.23	-288	67	0.29
MT	36	1.35	67	1.76	0.50	0.93	0.32	0.26	0.58	-0.06	-4	-0.29	-21	0	0.00
NL	7940	1.59	1215	1.17	1.32	0.20	0.45	0.30	0.75	-0.08	-456	-0.38	-2281	523	0.09
PL	8110	5.33	1109	3.76	2.08	0.28	1.79	0.31	2.10	-0.21	-819	-1.05	-4095	840	0.22
PT	264	0.56	142	0.74	0.16	0.09	0.27	0.13	0.40	-0.04	-65	-0.20	-327	13	0.01
RO	1382	2.79	88	1.05	0.97	0.06	0.77	0.22	0.99	-0.10	-141	-0.49	-704	1	0.00
SE	2728	2.16	482	0.87	0.65	0.11	0.66	0.28	0.94	-0.09	-395	-0.47	-1975	13	0.00
SI	1190	4.63	104	2.01	3.37	0.29	1.49	0.34	1.83	-0.18	-65	-0.92	-323	10	0.03
SK	2564	3.95	519	9.32	3.55	0.72	2.54	0.48	3.02	-0.30	-218	-1.51	-1092	6	0.01

Sources: wiiw estimates based on Eurostat Comext, Eurostat Trade in Services and WIOD databases.

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