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Trouble to the East: Implications for European Trade and Investment

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With the Crimean crisis ongoing, any European companies that continue to trade with and operate in Russia and Ukraine will face increasing difficulties. In Russia, these are principally politically motivated. In Ukraine, they arise from the risk of insolvency and the fallout from the Crimean crisis. In the short term, the EU should mitigate costs for businesses, and strive to restore confidence in Ukraine's economy in the longer term. EU Member States should also act together to counter any economic retaliation by Moscow to European sanctions and actions in Ukraine.

The conflict in Ukraine is set to have far-reaching implications for European trade and investment in Russia and Ukraine, some of which are already being felt. This is particularly true for Member States such as Poland, for which the two countries are important trade and investment partners. Now these investment and trade relationships are at risk—in Russia due to political and military manoeuvring, and in Ukraine mostly due to financial instability and uncertainty.

Russia: Political Risk. Russia's already shaky business environment is compounded by the Ukrainian political crisis. Even now there are predictions of capital outflow from Russia worth \$50–\$70 billion in the first quarter of 2014 (compared to \$63 billion in 2013). In economic terms, a key factor that will affect European exporters and investors is currency. The central bank has reportedly already spent more than \$16 billion to defend the rouble, which has depreciated by more than 11% this year against the dollar, inflating prices paid by Russian importers.

Western fears regarding the unpredictability of Russian policymaking are felt by the business community as much as politicians as the risk-to-reward ratio of trading and investing in Russia evolves. Foreign investors are aware of the importance of political-regulatory barriers in negotiating deals in Russia. Last week, a chocolate factory belonging to pro-EU Ukrainian oligarch Petro Poroshenko in Russia's Lipetsk was seized by riot police and closed down. In January, Russia banned all pork imports from the EU. Companies from countries that have been supportive of the Ukrainian cause, such as Poland, are particularly at risk of experiencing export bans or operational difficulties on the ground.

Western sanctions on Russia will likely present yet more hurdles for business. So far, the EU has suspended trade and visa liberalisation talks with Russia and imposed asset freezes and travel bans on 25 Russian officials. A further escalation of the situation could lead to more severe targeted economic and trade sanctions. But a Russian response should be expected. Moscow has hinted at proportional retaliatory measures and seizing Western property and assets, and has already imposed travel bans on American officials. Potential public boycotts of Western products—similar to the spontaneous boycotts of Russian vodka that are happening in the U.S.—present another risk to European businesses in Russia. Given the representations of Poland in Russian media during the Ukrainian political crisis, this is a particular concern for better-known Polish companies, e.g., those in the food sector.

Ukraine: Economic Hurdles. The political crisis in Ukraine highlighted the country's economic problems, impacting trade and investment. The financial sector is particularly affected. Currently, as the junk status of its government bonds suggests, Ukraine is close to insolvency. The national currency is weaker than ever and dangerously unstable. Moreover, banks in Ukraine constantly face the possibility of mass cash withdrawals and the risk of a dramatic increase in bad credit is casting a shadow over the banking sector. At the peak of the protests, even big European banks (e.g., Raiffeisen Bank International) temporarily closed their branches in Kiev; today some foreign banks are considering whether to stay and bear losses or leave the market. Given the financial sector's impact on trade costs and investment risk, its instability presents a severe barrier to trade and investment development.

Additionally, overall stability still has not fully returned to the country and its political future is uncertain. The Russian politics of *fait accompli* in Crimea will deter Western firms from expanding or even remaining on Ukrainian soil. Many of those willing to do business in Ukraine are prevented from doing so by their financial situation. On the Warsaw Stock Exchange, Ukrainian firms or firms operating in Ukraine have noted huge losses in value. This is the case for Ukrainian agricultural firm Kernel Holding SA, which has lost almost 25% of its value since the beginning of the year, mainly due to rising political and economic uncertainty in Ukraine.

Finally, EU trade with Ukraine—as well as Russia—is also likely to suffer due to technical reasons, such as the likely increase in trade costs. Export insurance premiums have risen, and transportation costs can be expected to grow as logistic companies seek to protect themselves against instability in Ukraine and Russia. Many small and medium-size exporters trading with Ukraine—as many as 12,000 in Poland—may suffer real losses due to unpaid outstanding bills. On top of that, the hryvnia's instability (which makes EU goods more expensive) and the financial sector crisis, which hinders trade financing, impede EU–Ukrainian exchange.

A Shaky Business Outlook. All EU countries are likely to suffer losses in trade and investment returns with both Russia and Ukraine. EU exports to Russia reached a record €123 billion in 2012 (Russia is the EU's third-largest trading partner), and European investment stock in Russia was worth €167 billion in 2011. EU exports to Ukraine amounted to almost €24 billion in 2012, and EU FDI stock in the country was worth €24 billion in 2011. Exports to both countries are dominated by machinery and transport equipment, manufactured goods, chemicals, medicines and agricultural products. European exporters and investors are likely to seek alternative markets, consistent with those sectors affected by difficulties in Russia and Ukraine. Plausible directions include Central European countries and non-EU states out of Russia's reach, such as Turkey.

The Ukrainian political crisis has also had an indirect financial impact on EU Member States that are treated as a single "Central and East European country" by financial traders. At the beginning of the global economic crisis, Poland's national currency fell in value despite the country's strong economic fundamentals. Once again, Poland has suffered an outflow of speculative capital, causing a moderate depreciation of the zloty. Although this boosts the competitiveness of the Polish economy, it makes foreign currency-denominated public and private debt more costly.

Recommendations. Despite the difficulties that the Ukrainian crisis may cause companies that operate in Russia and Ukraine, business interests should not take precedence over presenting a united front against Russian aggression in Ukraine. The Kremlin is already applying "divide and rule" tactics by implementing meat export restrictions on selected European countries. EU Member States should display solidarity in the face of Russian economic retaliation to sanctions. In the event Russia disproportionately targets Poland with trade measures, the Polish government should react through EU institutions, rather than bilaterally.

Europe's aim should be the stabilisation of Ukraine's economic situation as it restores market and exporter confidence. Due to the risk of insolvency, the restoration of Ukraine's economy should take place only through financial assistance linked to comprehensive reforms. Poland should support EU bodies in creating a special aid fund designed to ease Ukraine's reform process.

Western governments should act to mitigate any potential fallout for their national firms. Poland should continue its support programmes for Polish exporters and investors, even more vigorously promoting their activities on other foreign markets. Polish firms should seek to take part in future modernisation projects in Ukraine. To this end, the Polish government should keep Polish companies abreast of financial assistance and infrastructure development programmes being launched there.