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Russia – Ukraine gas negotiations: exploring compromise

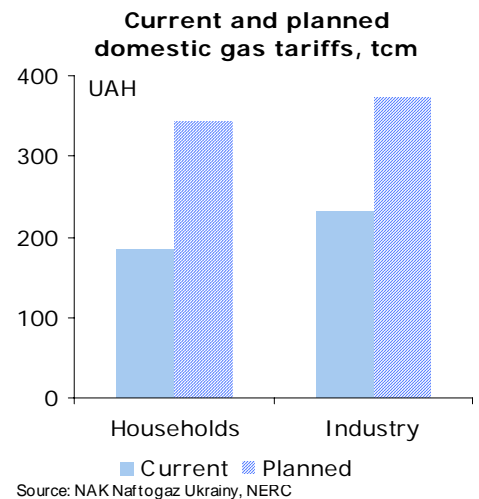
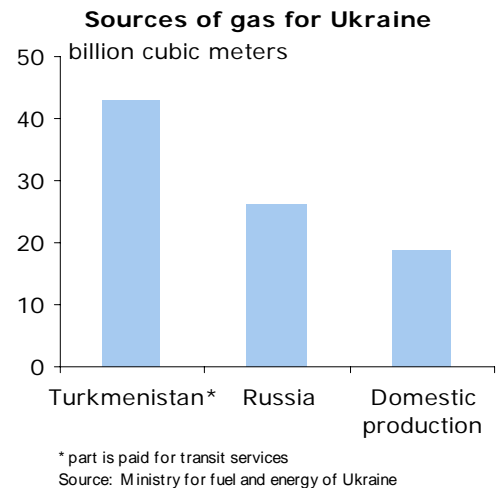
Throughout November Ukraine and Russia continued to conduct negotiations on the terms and conditions of the Russian gas supply to Ukraine and on fees for Russian gas transit through Ukrainian territory. From press-releases and negotiation reports virtually no progress is made through and parties remain at the negotiation tables with the same proposals not moving an inch to compromise.

Currently Ukraine receives about 23 bcm of Russian gas, about one third of its domestic consumption, as a barter payment for the transit services that Ukraine renders to Gazprom, transporting about 80% of Russian gas exports to Europe. Currently the indicative prices are USD 50 for 1 thousand cubic meters (tcm) of gas and USD 1.09 per transporting 1 tcm per 100 km. Russia offers a new price of USD 160 per tcm of gas for Ukraine and a transit tariff of USD 1.75 per tcm per 100 km. For Ukraine such a change would worsen terms of trade and decrease welfare in the short term, provided payment for gas under such pricing will be larger than payment for the transit services. Ukraine thus insists on maintenance of the status quo deal with barter. Russia wants to review current agreements on gas not to lose profits it can get from rising energy prices, while Ukraine is willing to preserve the system of cross-subsidization of the domestic gas consumption with the help of the gas transit system operation.

In the long term Ukraine would benefit from separating the issues of gas transit and domestic consumption, making the sector more transparent. Such a separation will help to avoid underinvestment into the gas pipelines with transit fees being directed to the maintenance of the transit system instead of being used as a subsidy to the domestic consumption, which is currently the case. Such an increase in price would introduce incentives in the economy for the rational energy use. However, prior to the parliamentary elections tariff reforms in the gas sector would definitely harm short-term election prospects of political forces in power.

The move from the current barter system to a fully transparent monetized relationship between Russia and Ukraine in the questions of gas supply and transit service provision is up to negotiations. Certainly, provided the high degree of interdependence between the parties some compromise will be reached, but its specific attributes depend on the strengths of the negotiating positions of the partners. Slow progress of the negotiations is explained by the fact that neither party has so far entered in purely economically motivated talks and both sides appear to be exploring the limits of the other side's patience and strength. It is likely that both parties are trying to bring "supporting" arguments to the negotiation table, for instance Ukraine could raise the issue of the fees for usage of underground gas storages, rent for the Russian military base in Crimea or at least it can insist on the higher than USD 1.75 tariff for transit of Russian gas. Russia can call attention of its Western partners to the "difficulties" of dealing with Ukraine in transit issues as an argument in increasing capacity of alternative transit routes, such as, for instance pipeline to be built across the Baltic sea connecting Russia and Germany directly.

It is very likely that some transition conditions representing a compromise between the status quo and an ideal transparent market-based relationship will be signed for 2006 with the negotiations continuing onwards. Such a step would allow Ukraine to regroup domestically increasing tariffs for households and enterprises, which will allow the payment of the market price for the Russian gas, at the same time other treatise with Russian can be brought to the table to be checked for the transparency and their market value. Such a process of revising the economic cooperation between the two countries is unavoidable, provided political dimension in the relationship wanes and is superseded by pragmatic approach.



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Quarterly Trends

| National accounts ** | | Q3 02 | Q2 03 | Q3 03 | Q4 03 | Q1 04 | Q2 04 | Q3 04 | Q4 04 | Q1 05 | Q2 05 |
|---|------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| GDP | UAH bn | 64.1 | 60.0 | 75.6 | 77.1 | 64.7 | 79.0 | 100.5 | 100.6 | 82.5 | 95.0 |
| GDP (real) | % yoy | 4.3 | 10.0 | 6.8 | 12.1 | 12.7 | 13.7 | 14.0 | 8.5 | 5.0 | 3.2 |
| Households consumption (real) | % yoy | 8.9 | 14.4 | 11.2 | 13.6 | 14.6 | 16.8 | 13.1 | 16.2 | 16.4 | 14.6 |
| State consumption (real) | % yoy | -18.8 | 17.8 | 19.2 | 9.0 | 3.3 | 1.0 | 5.0 | 10.1 | 5.2 | 2.2 |
| Gross fixed capital formation (real) | % yoy | 3.8 | 20.4 | 24.3 | 9.0 | 18.4 | 6.5 | 4.6 | 12.9 | -2.6 | -0.9 |
| Exports of goods and services (real) | % yoy | 15.3 | 9.8 | 9.8 | 11.6 | 18.1 | 19.9 | 10.5 | 8.6 | 0.1 | -2.5 |
| Imports of goods and services (real) | % yoy | 10.4 | 16.2 | 17.4 | 17.7 | 13.8 | 7.3 | 6.7 | 7.8 | 6.6 | 2.1 |
| Agriculture, hunting, forestry (real)* | % yoy | 2.1 | -13.7 | -22.5 | 6.7 | -4.4 | 0.9 | 35.7 | 9.9 | 5.9 | 8.5 |
| Manufacturing industry (real)* | % yoy | 8.0 | 15.4 | 23.0 | 20.1 | 23.9 | 16.3 | 12.5 | 9.4 | 7.8 | 3.2 |
| Construction (real)* | % yoy | -1.2 | 24.8 | 30.9 | 16.9 | 29.9 | 30.6 | 16.4 | 3.9 | -5.9 | -9.0 |
| Trade, repair services (real)* | % yoy | 8.8 | 15.1 | 22.6 | 29.6 | 23.6 | 35.0 | 2.7 | 13.7 | -1.5 | -3.2 |
| Transport (real)* | % yoy | 7.9 | 11.5 | 15.9 | 11.7 | 10.1 | 8.0 | 12.3 | 10.5 | 7.3 | 6.8 |
| Balance of payments | | | | | | | | | | | |
| Current account balance | USD bn | 0.8 | 0.7 | 0.7 | 0.4 | 1.6 | 2.3 | 1.7 | 1.2 | 1.7 | 0.6 |
| Current account balance | % of GDP | 6.4 | 7.0 | 5.0 | 3.0 | 13.5 | 15.5 | 8.8 | 6.2 | 10.8 | 3.2 |
| Trade balance in goods | USD m | 155 | -42 | -155 | -381 | 933 | 1552 | 774 | 482 | 1051 | -228 |
| Trade balance in services | USD m | 247 | 399 | 362 | 409 | 332 | 153 | 377 | 270 | 257 | 355 |
| Current transfers | USD m | 517 | 526 | 574 | 584 | 475 | 758 | 720 | 623 | 624 | 692 |
| Direct investment (FDI) | USD m | 156 | 454 | 390 | 329 | 334 | 614 | 422 | 345 | 231 | 355 |
| Portfolio investments | USD m | -592 | 640 | -444 | -293 | 60 | -406 | 781 | -511 | -114 | -86 |
| Gross international reserves | USD bn | 4.1 | 6.2 | 6.7 | 6.9 | 7.9 | 9.6 | 12.1 | 9.5 | 12.0 | 13.1 |
| Fiscal indicators | | | | | | | | | | | |
| Consolidated fiscal revenues | % of GDP | 28.2 | 31.7 | 30.1 | 28.6 | 27.2 | 26.9 | 26.3 | 25.9 | 32.1 | 35.1 |
| Personal income tax | % of GDP | 4.9 | 5.7 | 5.3 | 5.1 | 4.4 | 4.1 | 3.8 | 3.8 | 4.3 | 4.4 |
| Enterprise profits tax | % of GDP | 4.1 | 5.1 | 4.8 | 5.0 | 3.9 | 4.0 | 4.1 | 6.1 | 4.8 | 5.9 |
| Value-added tax | % of GDP | 6.4 | 6.3 | 5.8 | 4.8 | 6.2 | 5.7 | 5.1 | 4.1 | 8.6 | 9.2 |
| Excise tax | % of GDP | 1.9 | 2.2 | 2.1 | 2.0 | 2.1 | 2.1 | 2.0 | 1.8 | 2.0 | 2.0 |
| Consolidated fiscal expenditures | % of GDP | 26.4 | 29.2 | 27.9 | 28.8 | 25.3 | 26.5 | 26.8 | 35.2 | 28.3 | 36.4 |
| Current expenditures | % of GDP | na | 26.3 | 24.2 | 24.3 | 22.4 | 22.7 | 21.7 | 27.2 | 26.5 | 33.6 |
| Capital expenditures | % of GDP | na | 3.0 | 3.7 | 4.4 | 2.9 | 3.8 | 5.1 | 8.0 | 1.8 | 2.7 |
| Consolidated fiscal balance | % of GDP | 1.7 | 2.5 | 2.2 | -0.2 | 1.9 | 0.4 | -0.5 | -9.3 | 3.7 | 1.0 |
| Privatisation receipts | % of GDP | 0.3 | 1.0 | 1.0 | 0.8 | 1.5 | 3.7 | 3.5 | 1.0 | 0.2 | 0.6 |
| Labour market | | | | | | | | | | | |
| Average wage (real) | % yoy | 21.2 | 19.1 | 19.9 | 14.9 | 19.9 | 18.6 | 14.7 | 15.4 | 15.0 | 19.0 |
| Household income (real) | % yoy | 100.8 | 8.6 | 10.0 | 8.7 | 11.7 | 16.3 | 11.3 | 16.6 | 24.0 | 28.0 |
| Unemployment rate (ILO methodology) | % | 9.2 | 8.8 | 9.2 | 9.0 | 9.3 | 8.3 | 8.1 | 8.7 | 8.7 | - |
| Banking system | | | | | | | | | | | |
| Monetary aggregate M0 | % yoy cum | 46.0 | 37.0 | 30.5 | 25.3 | 29.1 | 25.6 | 37.1 | 27.9 | 28.2 | 39.1 |
| Monetary aggregate M2 | % yoy cum | 46.5 | 54.6 | 49.9 | 47.6 | 45.4 | 44.8 | 51.5 | 32.3 | 38.9 | 37.4 |
| Household deposits in national currency | % yoy cum | 103.6 | 74.7 | 65.0 | 66.1 | 69.4 | 67.3 | 67.9 | 26.2 | 28.3 | 31.6 |
| Household deposits in foreign currency | % yoy cum | 55.1 | 70.2 | 70.4 | 77.5 | 67.0 | 61.7 | 55.2 | 54.3 | 51.8 | 45.4 |
| Com. bank credits in national currency | % yoy cum | 42.3 | 71.2 | 73.0 | 61.7 | 56.8 | 52.1 | 44.3 | 29.4 | 28.3 | 32.6 |
| Com. bank credits in foreign currency | % yoy cum | 37.3 | 48.4 | 57.7 | 60.9 | 63.6 | 56.2 | 43.5 | 32.2 | 33.1 | 36.8 |
| Long-term com. bank credits | % yoy cum | 85.8 | 156.4 | 164.0 | 157.9 | 141.7 | 102.7 | 82.7 | 57.1 | 49.5 | 53.0 |
| Long-term com. bank credits | % of total | 25.3 | 37.4 | 40.1 | 45.0 | 47.4 | 49.3 | 50.9 | 54.2 | 54.4 | 56.1 |
| Average lending rate on national cur. credits | % p.a. | 23.5 | 17.2 | 17.2 | 17.7 | 17.2 | 16.6 | 17.0 | 17.6 | 17.0 | 15.4 |
| Average lending rate on foreign cur. credits | % p.a. | 11.9 | 12.6 | 11.7 | 10.9 | 12.2 | 12.1 | 12.6 | 12.2 | 12.1 | 11.0 |

SOURCES: National Bank of Ukraine, State Committee of Statistics, State Treasury, Ministry of Finance, IER estimates

* change in value added

** preliminary

Notes:
yoy year on year change

p.a. per annum