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European focus

Entering into the Association Agreement — achievements and challenges



On December 15, 2014, the first inaugural meeting of the Association Council, founded in accordance with Article 461 of the EU-Ukraine Association Agreement, will be held. Given the fact that certain provisions of the Association Agreement have been coming into force since November 1 2014, Ukraine's relations with the EU switch from the format "partnership and cooperation" to the model "political association and economic integration".

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It is perfectly obvious that Ukraine has to deal with unprecedentedly complex document, implementation of which will influence all spheres of life and sectors of the economy. However, the willingness of the government to take advantage of the opportunities offered by the Association agreement raises some doubts. As a rule, while signing Association Agreements with the EU, other Eastern and

Central Europe countries created a clear vertical and horizontal of public authorities responsible for their implementation. The fact that most of them acquired official candidate status for EU membership and subsequently became full members of the EU in the result of such Agreements proves that institutional support for European integration is a key factor, which determines success of state policy in European integration.

On the eve of the Association Council meeting, it is advisable to draw first intermediate conclusions on achievements and shortcomings of this issue in Ukraine. The creation of the Government European Integration Office and launching posts of deputy ministers in most ministries are considered to be achievements.

Nevertheless, there are much more minuses than pluses. Firstly, the political office of the (first) Deputy Prime Minister for European Integration has not been introduced within 9 months after the Revolution of Dignity. As

European integration remains a policy that is separated from reform process

a result, European integration remains a policy that is separated from the reform process and implemented by a small group of enthusiastic experts and government officials without systemic support from the government.

Secondly, the Government Office for European Integration, with staff of only 30 employees, even in comparison with the Coordination Bureau for European and Euro-Atlantic Integration, which likewise existed in the secretariat of Ukraine's Cabinet of Ministers as a department, has very limited powers in horizontal coordination of European integration.

Thirdly, in most central executive bodies, as well as in regional, Kyiv city and state administrations, there are no updated units for European integration. Consequently, the relevant jurisdiction belongs to various departments and offices, which have quite different priorities.

Finally, the government has not waged a massive awareness campaign for the benefits Ukrainian society and business will obtain with reaching the Association Agreement. Civil society partly fills this gap, but it is obviously not enough.

In addition, a huge negative impact on public perception of the Association Agreement is made by the Russian Federation external aggression, whose leadership accuses the EU and Ukraine of signing the Association agreement without consulting with the Kremlin and allegedly contrary to Russia's interests. The fact that, according to generally recognized rules of international laws, every country by virtue of its sovereignty has the right to conclude any international agreements with other states and international organizations is totally ignored. The lack of systemic reforms that would demonstrate the public benefits from European integration policy may significantly reduce the level of Ukrainian public support.

Taking into consideration the above mentioned, the President, government and Verkhovna Rada

should urgently address a number of priority issues as regards European integration:

First of all, to assign the (first) Deputy Prime Minister for European Integration — Minister for European Integration. Meanwhile, in the mode off the record, some officials indicated that such idea was plausible but untimely due to considerable cost saving. However, as it is well known, “a miser pays twice”. Saving on the body, which is supposed to become a driving force for pro-European changes in Ukraine, at a time when the country is on the verge of default, seems strange. In particular, it is irrelevant in the light of questionable decision to form the Ministry of Information Policy and to keep a huge number of agencies and committees that are not beneficial for the state.

Secondly, to conduct an intensive information campaign on benefits that the Association Agreement provides for business.

Thirdly, to create small units for European integration in the central executive bodies and regional administrations. At the same time, the incumbent Government Office for European Integration has to facilitate horizontal coordination of their activities, while relevant (first) Deputy Prime Minister and a specialized body — the State Committee for European Integration will do it in the future.

Moreover, it is also essential to ensure compliance of all laws and regulations adopted in the process of reform implementation with EU norms and standards. In order to turn the Association Agreement into effective tool of systemic transformations in Ukraine, it is strictly necessary to ensure the establishment and efficient functioning of a comprehensive coordination system for European integration policy, as well as availability of relevant institutions and units with sufficient authorities.

**Reforms
have to comply
with EU norms
and standards**

Regional and global focus: implications for Ukraine

Global coal mosaic and Ukraine



In global energy market, coal is considered as relatively cheap and stable energy source. Total world coal production reaches about 5 billion tons of coal annually. Developments in eastern Ukraine transformed Ukraine from a coal exporter into a coal importer. Moreover, due to a number of political factors, in November anthracite coal reserves in thermal power plants' storages shrank by a quarter, which threatens to disrupt energy supplies during the heating season in 2014/2015.

Global coal market is more competitive than oil and gas markets owing to significant coal deposits to be found in almost every country in the world. The largest coal producers are China, the US, India, Russia, Poland, Ukraine, and Czech Republic. However, in many countries coal industry receives state subsidies. The majority of European countries decided against coal production. The UK was the first country to have refused to produce coal, considering that it was cheaper to import black gold rather than support domestic coal production.

Among the EU member states, Poland is the largest coal producer. The main advantage of Polish coal industry is relatively cheap coal production in comparison to other European countries, which is predetermined by favourable geological conditions. Today, the productive capacity of Polish coal industry is equal to total coal production in the UK, Germany, Spain and France combined. However, under the current financial crisis, the Polish government refused to grant subsidies for domestic coal producers, which led to an increase in domestic energy prices. As a result, several Polish mines were shut down, and coal production decreased. In 2013, Poland signed an agreement on coal imports with Russia. In particular, the largest Russian coal exporter Siberian Coal Energy Company (SUEK) supplied 1 million tons of coal to Poland. According to the Eurostat, from

Ukraine was transformed from a coal producer to a coal importer due to hostilities in eastern Ukraine

1 January to April 2014 Poland increased coal imports from Russia by one-third — up to 2.5 million tons of coal.

Warsaw's pro-Russian orientation caused a crisis in coal mining industry and led to Polish miners' protest against Russian coal imports in September 2014. The protest was taking place on the border with Kaliningrad region. More than 200 persons blocked railway tracks near a Polish city of Branevo and prevented Russian coal shipments from entering Poland. There are many factors that contributed to miners' strike, namely Polish mining companies' bankruptcy, unemployment, reluctance of state authorities to negotiate and compromise. Polish miners demanded that certificates of conformity for imported coal be introduced and laws to protect domestic coal industry be adopted. Information campaign, which was launched in regard to miners' strike, was aimed not only at criticising Government's actions as to the shutdown of mines, but rather at condemning Warsaw for its cooperation with Moscow. Strictly speaking, Polish journalists underlined that by purchasing coal from Russia, Warsaw was indirectly supporting Russia's aggressive foreign policy. Various analysts and experts maintain that though Poland imports mainly gas and small quantities of oil from Russia, the purchase of Russian coal in addition to gas and oil will threaten Poland's energy security.

Like Poland, until recently, Ukraine has been a large coal producer. However, as a result of the latest developments in the East of Ukraine, transport infrastructure and mines located in central and northern parts of Donetsk region and southern part of Luhansk region were destroyed. Thus, Ukrainian government has no other choice but to turn to other countries to ensure energy supplies. Ukraine needs UAH 1.5 billion by the end of 2014 to cover a coal deficit worth 8 million tons of coal, Ukraine's former Minister of Energy and Coal Industry Yuriy Prodan informed. At the same time, last year Ukraine exported 7 million tons of coal. As a result of hostilities in Donbas, Ukraine lost more than 80 mines, which account for 55% of Ukrainian energy balance.

Today, Ukraine is suffering from a shortage of anthracite coal and lean coal. In fact, anthracite coal, which is used by half of 14 major Ukrainian thermal power plants, is a rare energy source on a global scale. It accounts for 1% in global coal reserves. For

example, last year the Republic of South Africa exported only about 2 million tons of anthracite coal out of 72 million tons available. In addition, coal deliveries from South Africa were under threat of disruption due to a coal scandal and non-transparency of the signed agreement on coal supplies. According to the head of Ukrainian representative office of Steel Mont Trading company Rajesh Kumar Saraiya, Steel Mont Trading company may back out of the deal with Ukraine in order to save the company's reputation. The first and foremost reason for such a controversy is improper quality of South African coal. Steel Mont Trading company undertook to supply coal belonging to the anthracite coal category, the so-called "semi-anthracite". Its energy density is much lower than that of "A" anthracite coal. After all, the conflict over the coal from South Africa only deepened Ukraine's coal crisis, with Russia turning this situation to its advantage.

For the first time since Ukraine gained independence, it has experienced a sharp coal deficit. Ukraine was transformed from a coal exporter into a coal importer. At the same time, private energy producers, namely "Tsentrenerg" and DTEK, signalled their readiness to import coal from Russia, saying that Russian coal supplies would be economically expedient and much easier in terms of logistics. Thus, in addition to Ukraine's heavy dependence on Russian gas and fuel for autonomous nuclear power plants, Ukraine became also dependent on Russian coal. At the end of November 2014, Russia suspended coal deliveries to Ukraine citing some technical issues, which Moscow refused to explain. Due to the unreliable nature of Russian coal supplies, Ukrainian energy system experienced a lack of electricity resources, which, coupled with other factors, became the reason for power cuts all over Ukraine. It raises no doubt that Russian "partners" aim to aggravate a very difficult energy situation in Ukraine, fuel social tensions and disrupt Ukrainian economy (In view of possible gas supply disruption, production facilities of most companies were reoriented towards power supply. However, now those companies have faced disrupted power supply, for

In order to avoid becoming dependent on Russian coal, a technical reconstruction of domestic electricity generation infrastructure is needed

example, bakeries, oil mills, etc). A coal deficit resulted in electricity deficit. In order to balance Ukrainian energy system, Kyiv authorities have no other choice, but to seek Russian power supplies. It looks like Russia developed a scenario for such a situation a long time ago, and it is only now that this scenario is being played out. Russia puts it as a condition that Ukraine will receive Russian power supplies providing Ukrainian authorities promise to ensure regular power supplies to Crimea.

In order to avoid becoming dependent on Russian

coal, a technical reconstruction of domestic electricity generation infrastructure is needed. The main precondition for such reconstruction is thermal power plants using liquid and gaseous fuels (black oil, coke and blast furnace gas, biomass) instead of solid fuel (such as coal). When choosing energy generation type, the principle of localization should be applied, i.e. every Ukrainian region will have to reconstruct its thermal energy infrastructure depending on its physical and geographical conditions.

Sanctions and oil price put pressure on Russian economy

The current situation in global oil market, together with sanctions imposed earlier, continues to have a negative impact on Russian economy in general and Russian FX reserves in particular.

Last week, the oil cartel OPEC refused to cut oil production by keeping it at the 2011 level, i.e. 30 million barrels per day. Over the last months, oil prices fell by 30%, and oil producers such as Iran and Venezuela, whose economy is suffering from a decrease in oil revenue, expected some agreement between oil producers on the reduction of oil production. There is a high likelihood that there will be no decision on the reduction of oil production over the next six months, which will only drive down oil prices. The reasons for a decrease in oil prices are European economic stagnation, the slowdown of economic growth in China and rise in shale oil production in the US. As a result of the OPEC decision, the January futures contracts for crude WTI oil rapidly fell to USD 69.05 a barrel and for crude Brent oil to USD 72.58 a barrel.

Russia did not welcome the OPEC decision. Together with oil prices going down, the Russian rouble fell against the US dollar and euro. The Russian currency sank to 61 against the euro and to 49 against the US dollar. Such a tendency puts additional pressure on Russian FX reserves.

At the beginning of November, the Central Bank of Russia refused to intervene in FX market to prop up the rouble. However, in the event of a state of emergency the Central Bank is ready to

step in. It should be noted that as of 1 December 2014, FX reserves amounted to USD 418.9 billion. Since the beginning of 2014, the FX reserves reduction has reached almost USD 100 billion.

Russian FX reserves shrank by almost USD 100 billion

Given the drop in oil prices, Russia has no other choice but to purchase gold. This is largely caused by international sanctions against Russia, which make it impossible for Russia to sell this gold abroad. In Russian market, gold is purchased by major state banks, such as Oschadbank and VTB Bank, which later sell this gold to the Central Bank of Russia for roubles. To purchase the US dollar, the Central Bank prints new roubles and give them to financial institutions. Such a scheme weakens the rouble and partly lowers the value of gold. It should be noted that gold accounts for about 10% of the Central Bank reserves while its absolute share in the reserves structure is increasing, unlike FX reserves.

Russian and Western analysts state that Russia may be faced up with more serious threats to its economy if FX reserves fall to USD 300-200 billion. Russian government is trying to calm the fears of Russian business and citizens by saying that FX reserves are large. However, there are reasons to think that the real size of Russian FX reserves is lower than that announced by Russian authorities.

Russia may be faced up with more serious threats to its economy if FX reserves fall to USD 300-200 billion

First of all, when talking about the size of Russian FX reserves, gold should not be considered. The

same applies to Russia's position in the IMF, measured by special drawing rights (SDR). According to official data, as of December 1, foreign currency in Russian reserves amounted to USD 361.4 billion. Taking into account that the Central Bank of Russia may spend up to USD 1 billion within one week without the introduction of the state of emergency, the Central Bank's position seems quite shaky.

Also, it should be stressed that Russian companies have significant obligations to their Western creditors. According to *The Economist*, external debts of Russian companies amount to USD 500

billion, with USD 130 billion to be repaid next year. Russia failed to restructure its debt in Western markets due to imposed sanctions. In addition, in September Russian government decided to fill budget holes by using reserve funds. Budget holes may appear quite significant, as Russian budget for 2015-2017 is calculated based on Brent oil price, which is USD 96 a barrel.

Under such conditions, the likelihood of Russian government's refusal to fulfil its debt obligations to Western creditors in relation to geopolitical and domestic economic problems is high.

The aim of the publication is to provide analysis of Ukraine's foreign policy in the context of global processes in the region and the world, as well as an overview of major world events that may have an impact on the further development of Ukraine and the region. Special attention is paid to the European integration of Ukraine, in particular implementation of Ukraine–EU Association Agreement.

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