

- **The EU.** On June 27, leaders of Ukraine, the European Union (EU), and 28 EU Member States signed an essential part of the long-awaited Association Agreement (AA) between the EU and Ukraine. Specifically, the parties signed the remaining four chapters of the agreement that were not signed in March. Those chapters cover economic cooperation, including establishment of a free trade area between Ukraine and the EU, cooperation in the areas of justice and security, and sector cooperation. The agreement will become effective after ratification by all parties, including 28 EU Member States, which may take at least several months. But a part of the agreement, the implementation of which is within the authority of the EU (including establishment of a free trade area), is expected to be applied provisionally from November. The signing of the agreement is an indication that Ukraine firmly embarked on the path towards European integration, putting aside its long standing policy of balancing between the EU and Russia. President of Ukraine Petro Poroshenko stated that the ultimate goal of Ukraine is to obtain membership in the EU. The agreement, however, may trigger a new trade war with Russia, which persistently tries to draw Ukraine into its sphere of influence.
- **Terrorist attack.** In June, Ukrainian government failed to make significant progress in suppressing the pro-Russia terrorists' attacks that began in April in the East of Ukraine. The Government forces launched several offensives against terrorists, and cleared a few towns and villages of them, including the town of Mariupol, a large industrial centre with a population of 460,000. However, the terrorists continued to control about a third of the territory of Donetsk and Luhansk regions (together referred to as Donbas). Representatives of Ukrainian government and Russia conducted negotiation with representatives of terrorists, but it did not yield any apparent result. The events confirmed that the military conflict in Donbas may be likely to be long lasting. The weak progress in suppressing the attacks can be partly explained by the fact that Russia, which tried to use the conflict as a tool of pressure on Ukrainian government, provided significant support to the terrorists, including unofficial supplies of heavy weapons. But the support was limited because Russia tried to avoid sector sanctions from Western countries.
- *Since April the Ukrstat publishes data excluding temporarily occupied territory of the Autonomous Republic of Crimea and Sevastopol. The statistical base was also revised in order to make like-to-like comparison available.*
Sectoral trends. Decline in industrial output in May decelerated to 2.1% yoy primarily due to statistical base effect. Output in extraction industry decreased by 3.3% yoy, which might be explained by unrest in Donetsk and Lugansk regions. Output in manufacture dropped by 3.9% yoy due to weak domestic and external demand. The drop in production of metallurgy decelerated to 2.0% yoy from 12.8% yoy in the previous month due to statistical base effect. Machine building output declined by 15.3% yoy. Production of locomotives and railway carriages more than halved due to low demand from Russia. In particular, Russia installed own capacities in this subsector of machine building, which can largely cover its residual demand for railway produce after implementation of large modernisation project. Output in chemical production declined sharply by 20.8% yoy as domestic and external demand remain weak. Besides, this is partially explained by stoppage of operation of two large chemical plants in Donetsk region in April, 2014 ("Stirol" in Gorlovka and "Azot" in Severodonetsk). Rapid drop in construction continued (by 18.7% yoy in May). This is explained by restricted public and private financing as well as high economic and political uncertainty. Agricultural production in May grew by 3.8% yoy as livestock production continued growing. At the same time, herd of cattle declined, while the number of sheep and goats increased.

Between January and May retail trade turnover growth decelerated to 2,9% yoy. This reflects decline in real consumption in April and May. Retail sales of enterprises in May dropped by 7.7% yoy.

- **Energy. Another gas war with Russia**

Natural gas. Ukrainian Naftogaz and Russian Gasprom sued each other in Stockholm Arbitrage Court. The Gasprom accused the Naftogaz of not paying USD 4.5 bn and switched the Naftogaz to prepaid regime since June 16. The Naftogaz requested the renegotiation of the gas contract, i.e. the recalculation of the gas price and the compensation of overpayment of USD 6 bn since 2010.

After Russia stopped gas supplies to Ukraine the Naftogaz more than doubled its reverse gas flows from Hungary (from 3.0 m to 7.5 m cubic meters of gas daily). Overall, Ukraine in June imported 317 m cubic meters of gas from Hungary and Poland. As of July 4, Ukraine had 14.4 bcm of gas in storages in comparison to 9 bcm in July 2013 and 15.7 bcm in August 2012. According to the Naftogaz this volume will be sufficient for covering demand till autumn, when it expects to start gas deliveries from Slovakia.

Legislation. The Verkhovna Rada finally cancelled the 35% export duty on natural and liquefied gas to members of the Energy Community. This law brings Ukrainian legislation in accordance with the Energy Community requirements which envisage that no export duty should be taken on gas and electricity deliveries from Ukraine to the EU countries.

Utility tariffs. Starting July 1, the Government increased tariffs on heating and water supply to cost-covering levels and, simultaneously, cancelled compensations from the state budget to utility companies. According to the Naftogaz, utility companies were entitled to compensations at UAH 7.9 bn in 2012 and UAH 12 bn in 2013 but did not receive the money from the state budget. Such budget arrears increased their indebtedness before the Naftogaz and prevented them from allocating funds to maintenance and modernisation of utility networks. The new mechanism is expected to solve these problems.

Ukraine: Economic Indicators 2011 - 2014

		2011	2012	2013	Q1 14	March	Apr*	May*	June*
GDP (real)	% yoy	5.2	0.3	0.0	-1.1				
Industrial production (real)	% yoy cum.	7.3	-0.5	-4.7	-5.0	-5.0	-5.3	-4.6	
Agricultural prod. (real)	% yoy cum.	17.5	-4.5	13.7	6.0	6.0	5.0	4.7	
CPI	% yoy eop	4.6	-0.2	0.5	3.4	3.4	6.9	10.9	12.0
Current account	% GDP. cum.	-5.7	-8.1	-9.0	-1.8				
Fiscal balance	% GDP	-1.8	-3.6	-4.4	0.1				
External state debt (total)	% GDP eop	22.8	22.0	20.6					
Gross international reserves	USD bn eop	31.8	31.4	20.4	14.2	15.1	14.2	17.9	17.1
Exchange rate (official)	EUR aop	11.09	10.27	10.61	12.14	13.69	16.08	16.00	16.04

Source: IER.

*Data exclude Crimea

For further information: Institute for Economic Research and Policy Consulting (link: <http://www.ier.com.ua>).

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