

# Trade liberalization and regional integration: a goal-oriented approach

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# Overview

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1. Motivation for regional integration
2. Current trade regime with the EU vs. Customs Union of Russia, Belarus and Kazakhstan
3. Impact of various regional integration options
4. Conclusions



# Motivation for regional integration

- Regional integration is not a goal per se. It is a tool for achieving the ultimate goal of economic policy
- Key questions:
  - What is the ultimate goal of Ukraine?
  - What does Ukraine want to achieve in long-run?
- The answer should form economic policy decisions, including decisions on directions and deepness of regional integration
- Ukraine's ultimate economic goal could be formulated as:

***Socially inclusive and sustainable economic prosperity of the country***



# Intermediate goals of economic policy

- To achieve this ultimate goal, the following intermediate goals should be met:
  1. *Favourable domestic business and investment environment*
  2. *Improved access to external markets (access as free as possible to as many markets as possible)*
  3. *Reduced energy vulnerability (through increased energy independence and efficiency)*
  4. *Environment-friendly (i.e. sustainable) growth*
  5. *Reduced multi-dimensional social exclusion*
- Opportunities provided by different regional integration options should be assessed against the background of intermediate goals



# Forms of regional economic integration

Stage of integration	Elimination of tariffs and quotas among members	Common tariff and quota system, common trade policy	Elimination of restrictions on factors movements	Harmonization and utilization of economic and social policies, and institutions
Free Trade Area	Yes	<u>No</u>	<u>No</u>	<u>No</u>
Customs Union	Yes	Yes	<u>No</u>	<u>No</u>
Common Market	Yes	Yes	Yes	<u>No</u>
Economic Union	Yes	Yes	Yes	Yes



# Ukraine-EU trade regime:

## Current status

- Partnership and Cooperation Agreement (1998):  
Most Favoured Nation (MFN) regime
- EU Generalised System of Preferences (GSP):  
High level of utilization by Ukraine (85%)
- WTO rules and practices (since 2008)

### Stumbling blocks:

- Rather high agro-food tariffs
- Non-tariffs measures



# Status of EU-Ukraine DCFTA

- DCFTA talks started in February 2008 and completed in 2011
- Association Agreement between Ukraine and the EU including DCFTA was initialled in March 2012.
- Next steps:
  - Signature (expected in November 2013)
  - Ratification

*Note: Ratification of the DCFTA and several other economy-related issues will be in the competence of the European Parliament, while the rest of the Association Agreement will undergo ratification by the national parliaments of the EU member countries*



# Features of EU-Ukraine DCFTA

## Duty-free trade in industrial products:

- Duty free exports to the EU for industrial products starting the date when the Agreement comes into force;
- Duty free exports to Ukraine for industrial products with *transition periods* for tariff liberalisation in Ukraine;
- *Special regimes* for imports of motor vehicle (HS code 8703) and for second-hand clothes in Ukraine under so called "*bilateral protection measures*";
- Gradual elimination Ukraine's export duties, but introduction of *temporary surcharges* on exports of nonferrous metal scrap under so called "*bilateral protection measures*";





# Features of EU-Ukraine DCFTA

## Significant trade liberalization for agricultural products:

- Significant quotas on duty-free exports of selected agricultural products, including dairy products, grain and cereals, and sugar, to the EU;
- Duty free exports to Ukraine for majority of agro products with *transition periods* for tariff liberalisation in Ukraine;
- Abandonment of EU agricultural exports subsidies in trade with Ukraine;
- Gradual elimination Ukraine's export duties, but introduction of *temporary surcharges* on exports of sunflower oil seeds and skins under so called "*bilateral protection measures*";



# Features of EU-Ukraine DCFTA

**Freedom of establishment**

**Service trade liberalization**

**Strong regulatory rapprochement component:**

- Competition policy
- State aid
- Public procurement
- Sanitary and phyto-sanitary measures
- Technical regulation
- Protection of intellectual property rights
- Sustainable development issues (ecological issues, labour and social issues)



# The Customs Union (CU) of Russia, Belarus and Kazakhstan (RBK)

- CU is a part of Eurasian Economic Community (EurAzEC)
  - the Treaty on the Establishment of the Common Customs Territory and the Formation of the Customs Union was signed in October 2007
- CU establishment steps in 2010-2011
  - January 1, 2010: Implementation of the common tariff scheme
  - July 1, 2010: Customs Code of the CU came into force, the CU Commission became active, and customs clearance of goods originated in countries-members were abolished
  - July 2011: A common border control in the CU has been established

**Note:** The CU is regulated by supranational body, and thus respective policy areas are set at supranational level



# Trade policy areas regulated 12 in CU RBK at supranational level

- **Trade policy areas** regulated by the CU at supranational level:
  - Tariffs on foreign trade
  - Non-tariff measures for trade in goods with third countries, including establishment of quantitative measures, licensing, trade defence instruments, development of common technical regulations, and sanitary and phytosanitary standards etc.
  - Unified customs regulation and customs procedures
  - Establishment of an unified regime for trade with third countries
- **In SES:** CU policy areas + macroeconomic policy, competition policy, state aid, protection of intellectual property rights, exchange rate policy, migration policy
- **Thus:** In case Ukraine joins the CU/SES, a wide range of decisions on economic policy will have to be delegated to a supranational authority.



# WTO membership of Russia and RBK regional integration

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- WTO commitments of Russia are mandatory for CU members
  - Treaty on the Functioning of the Customs Union in the Framework of the Multilateral Trading System (2011)
- Benefits from Russia's WTO accession include:
  - Increased predictability of trade environment
  - Alignment of countries' trade-related legislation with same international principles
  - Emergence of independent platform for solving trade disputes
  - Improved access to market of services
- **Thus:** Ukraine gains from Russia's WTO accession



# Ukraine-RBK Customs Union trade regime: Current status

- In 2010-2011, the Customs Union has been established:
  - Common border and import tariff
  - Common trade defence measures and other non-tariff measures
- **But:** Bilateral FTAs signed in the first half of 1990s are still in force + new CIS FTA in October 2011 (on WTO rules):
  - FTA coverage: Trade in goods
    - Zero import tariffs with exemptions
    - No quantitative restrictions
  - FTA doesn't cover trade in services, investments, IPR, etc.
  - Peculiarities: export tariffs allowed, frequent trade conflicts related to non-tariff sphere
- **Thus:** There is potential for a wider FTA between Ukraine and RBK



# Future of relations between Ukraine and RBK CU/SES

- **Status quo:**
  - Bilateral / plurilateral FTAs with RBK
- Options for the future:
  - **Option 1:** Ukraine eventually signs FTA with RBK CU/SES
  - **Option 2:** Ukraine joins RBK CU or SES



# Methodology

- Macroeconomic modeling:
  - Medium-term / long-term impact of policy change
- Analysis of potential institutional / regulatory changes





# CGE model: brief overview

*Model was developed with the project "Analysis of the Economic Impact of Ukraine's WTO Accession" conducted by Copenhagen Economics, Denmark; Institute for East European Studies Munich, Germany; and Institute for Economic Research and Policy Consulting, Ukraine, in 2005 (Copenhagen Economics et al., 2005)*

- Production: 38 sectors: 27 CRTS, 7 IRTS in goods and 4 IRST in services
- Production factors are assumed to be perfectly mobile except for coal mining
- The model distinguishes between public, investment and intermediate consumption as well as final household consumption
- Exports and imports are disaggregated into different trading partners.
- Static and steady state formulations of the model



# Scenarios

**Scenario 1:** Deeper integration with the EU within the FTA framework

- Sc1a: tariff liberalization only
- Sc1b: tariff + non-tariff barriers liberalization

**Scenario 2:** Deeper integration with Russia, Belarus, and Kazakhstan in the framework of the Customs Union

- Sc2a: common tariff

**Scenario 3:** No regional integration



# Results of simulation

	Simple FTA with EU		DCFTA EU		RBK CU		No FTA with RBK	
	static	ss	static	ss	static	ss	static	ss
Change in welfare	1.3	4.6	4.3	11.8	-0.5	-3.7	-0.1	-0.7
Change in imports	1.0	2.4	2.6	5.9	-2.9	-4.3	-0.8	-1.4
Change in exports	1.0	2.5	2.8	6.3	-3.1	-4.6	-0.8	-1.4
Change in unskilled wage	0.5	2.5	1.2	5.7	-0.9	-2.8	-0.5	-1.3
Change in skilled wage	0.4	2.3	1.2	5.5	-0.9	-2.8	-0.5	-1.2
Change in return to capital	1.2	0.1	2.2	-0.4	-0.6	0.6	-0.4	0.0
Unskilled labor adjustment	2.3	2.5	2.9	3.5	0.5	0.5	0.1	0.2
Skilled labor adjustment	0.8	0.9	1.0	1.3	0.2	0.2	0.1	0.1
Capital adjustment	0.8	0.4	0.9	0.2	0.2	3.2	0.1	1.2
Capital stock change		3.6		8.1		-3.4		-1.2



# Goal 1: Favourable business and investment climate

DCFTA with the EU	Customs Union with RBK
<p>Key components of improved investment and business environment:</p> <ul style="list-style-type: none"><li>• Technical regulation and SPS systems aligned with international practices</li><li>• Streamlined state aid policy</li><li>• Streamlined public procurement policy</li><li>• Streamlined competition policy</li><li>• Improved protection of intellectual property rights</li></ul> <p><b>Thus:</b> DCFTA stimulates domestic regulatory reform in line with international practices resulting in a better investment climate in the country</p>	<p>Given that RBK are not among leading economic reformers, regulatory convergence will not improve the investment climate significantly</p> <p><b>If</b> Ukraine signs FTA with RBK CU/SES, new FTA with common regulatory approximation to best international practices might contribute to improvement of business climate</p> <p><b>If</b> Ukraine joins RBK CU or SES, it will be roundabout approach: eventual harmonisation with international TBT/SPS standards through harmonisation with RBK TBT/SPS standards that approach international standards</p> <p><b>Thus:</b> Regional integration within RBK could result in improvement of business climate <u>only</u> if all partners converge to best international practices</p>



# Goal 2: Improved access to external markets

DCFTA with the EU	Customs Union with RBK
<p>EU market:</p> <ul style="list-style-type: none"> <li>500 m consumers</li> <li>USD 14 trillion market access</li> </ul> <p>Key components of improved access:</p> <ul style="list-style-type: none"> <li>• Nullification of industrial tariffs</li> <li>• Liberalisation of agricultural tariffs</li> <li>• Service trade liberalisation</li> <li>• Harmonisation of technical regulations and standards</li> <li>• Harmonisation in SPS standards</li> </ul> <p><b>Thus:</b> DCFTA ensures better access to the largest regional market; this is in line with Ukraine's economic goals</p>	<p>RBK market:</p> <ul style="list-style-type: none"> <li>170 m of consumers</li> <li>USD 1.5 trillion market access</li> </ul> <p>Ukraine has already benefited from good market access thanks to bilateral / plurilateral FTAs</p> <p><b>If</b> Ukraine signs FTA with RBK CU/SES, new FTA with no exemptions and lower non-tariff barriers based on best international practices could provide better access, thus helping to achieve ultimate goal</p> <p><b>If</b> Ukraine joins RBK CU or SES, the main additional benefit in terms of market access of a CU/SES membership will be abolishment of border/customs control</p>



# Goal 3: Reduced energy vulnerability

DCFTA with the EU	Customs Union with RBK
<p>The energy markets are to be crafted in accordance to Ukraine's obligations in the Energy Community</p> <p>Expected outcomes:</p> <ul style="list-style-type: none"> <li>• Unbundling of vertically integrated monopolies, competitive energy markets and prices, independent regulators</li> <li>• Non-discriminated access to upstream sector and energy infrastructure</li> <li>• Clear targets for RES development and energy efficiency (EU-like 20/20/20)</li> </ul> <p><b>Thus:</b> More competition -&gt; better energy efficiency, cleaner energy production in long-run, and diversification of energy imports</p>	<p>Regional integration has no direct impact on gas agreements with Gazprom and thus on gas prices. Reduction is concession-based</p> <p>Export tariff elimination is not included in 'standard CU package' and thus also subject to negotiations</p> <p>Even if energy price reduced, the reduction would:</p> <ul style="list-style-type: none"> <li>• Increase dependency on Russia as source of energy</li> <li>• Provide disincentives to develop domestic energy extraction</li> <li>• Provide disincentives to invest in energy-saving technologies</li> </ul> <p><b>Thus:</b> Membership in the CU results in increased energy dependency and reduces incentives to energy savings. Consequently, it doesn't support the intermediate goal of lower energy vulnerability</p>



# Goals 4 & 5: Sustainable and socially inclusive development 23

DCFTA with the EU	Customs Union with RBK
<p>Key components of sustainable and socially inclusive development:</p> <ul style="list-style-type: none"><li>Provisions regarding alignment with EU ecological standards</li><li>Adherence to minimal social standards</li></ul> <p><b>Thus:</b> DCFTA cares about sustainable and socially inclusive growth</p>	<p>CU with RBK doesn't include regulations that concern environmentally-friendly growth and social inclusion</p> <p>Regional integration with RBK doesn't provide incentives to:</p> <ul style="list-style-type: none"><li>Environment-friendly (i.e. sustainable) growth</li><li>Reduced multi-dimensional social exclusion</li></ul> <p><b>Thus:</b> CU with RBK doesn't stimulate sustainable and socially inclusive growth</p>



# Other implications of regional integration options

DCFTA with the EU	Customs Union with RBK
<p>Compatible with Ukraine's WTO obligations</p>	<p>Burden of renegotiations &amp; compensations within the WTO as Ukraine's bound import tariffs are generally lower than in RBK CU</p> <p>The revision of these commitments is cumbersome and costly, as other member countries have a right to request compensation or impose additional duties on Ukrainian goods or services (as compensation for the losses caused by the change in commitments)</p>
<p>Independent trade policy vis-à-vis the rest of the world</p>	<p>Lost of independence in trade policy, including right to negotiate free trade agreements with other countries, like the DCFTA with the EU. The Eurasian Economic Commission is entitled to conduct new foreign trade related negotiations on behalf of the member states</p>
<p>Cheaper imports of machines and equipment</p> <p>Better protection of IPRs that stimulates innovations</p> <p>Increased investment attractiveness</p> <p>Better access to the EU capital</p>	<p>Slower pace of modernisation as increased tariffs on investment imports from the third countries, including the EU, would hamper renewal of fixed assets and imports of new technologies and know-how</p>





# Conclusion on DCFTA with EU

**Conclusion:** DCFTA helps Ukraine to reach most intermediate goals and thus brings the country closer to its ultimate goal

- Question: Could these goals be reached by other means other than DCFTA with EU?
  - Only partially
  - Regulatory approximation could be done unilaterally, but at higher cost
  - Access to EU market cannot be obtained without DCFTA
- Note:
  - DCFTA doesn't preclude conclusion of any other FTAs and thus creates no constraints on reaching intermediate goals with other means



# Conclusion on regional integration with RBK

- Membership in CU/SES doesn't help Ukraine to meet its intermediate and ultimate economic policy goals
- Note:
  - Membership in CU/SES undermines other forms of regional integration for Ukraine, thus constraining its choice on reaching intermediate goals by other means
- BUT: The signature of a FTA with RBK CU/SES would help Ukraine to pursue its intermediate and ultimate economic goals



## 4. Conclusions

- Ukraine lies between two regional integration blocks and needs to make important decisions
- Key question for any decision on regional integration: Positive or negative contribution for achieving the economic goals of the country?
- DCFTA with EU: Positive effect for achieving major economic goals
- Joining of the RBK CU/SES: Negative contribution to most of economic goals of Ukraine
- Risk of economic losses in case of elimination of free trade between Ukraine and RBK, but lesser than from joining the RBK CU/SES
- **Thus:** Ukraine should aim to cooperate with both regional integration blocks in form the DCFTA with EU and FTA with RBK CU/SES



# Thank you!

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