



Ukraine between two regional integration blocks

Analysis and Recommendations

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Overview

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1. 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



2. 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 (not to be expected before Ukraine's parliamentary elections)
 - 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



Goal 1: Favourable investment climate

- Key components of improved investment and business environment:
 - Technical regulation and SPS systems aligned with international practices
 - Streamlined state aid policy
 - Streamlined public procurement policy
 - Streamlined competition policy
 - Improved protection of intellectual property rights

- **Thus:** DCFTA stimulates domestic regulatory reform in line with international practices resulting in a better investment climate in the country



Goal 2: Improved access to EU market

- EU market:
 - 500 m consumers
 - USD 14 trillion market access
- Key components of improved access:
 - Nullification of industrial tariffs
 - Liberalisation of agricultural tariffs
 - Service trade liberalisation
 - Harmonisation of technical regulations and standards
 - Harmonisation in SPS standards
- **Thus:** DCFTA ensures better access to the largest regional market; this is in line with Ukraine's economic goals



Goals 4 & 5: Sustainable and socially inclusive development

- Key components of sustainable and socially inclusive development:
 - Provisions regarding alignment with EU ecological standards
 - Adherence to minimal social standards
- **Thus:** DCFTA cares about sustainable and socially inclusive growth



Expected benefits and costs of DCFTA (1)

- Our modelling reports net welfare gains for Ukraine in case of DCFTA between Ukraine and the EU
- Specifically, the establishment of DCFTA with the EU will (ceteris paribus) increase total welfare of Ukraine by:
 - 4.3% in the medium run and
 - 11.6% in the long run
- Economic gains are generated by:
 - Improved access to a large market
 - Lower non-tariff barriers
- Additional benefits include:
 - Better business and investment climate
 - Improved access to markets of third countries



Expected benefits and costs of DCFTA (2)

- Costs associated with the implementation of DCFTA include:
 - Increased domestic competition resulting in market restructuring and reallocation of factors of production;
 - Higher costs of standard obedience, as the EU standards are generally more stringent and thus compliance with them would require more efforts and expenses;
 - Spending associated with legal and administrative adjustments
- Some of these costs are likely to be shared with the EU, as it is ready to provide the necessary technical assistance



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
- Notes:
 - Energy independence and efficiency (Goal 3) is tackled in the already enacted EU-Ukraine Agreement ; Ukraine is a member of the Energy Community
 - DCFTA doesn't preclude conclusion of any other FTAs and thus creates no constraints on reaching intermediate goals with other means



3. 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:
 - 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



Status of regional integration within Russia, Belarus and Kazakhstan

- 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
- Launch of Single Economic Space (SES) in 2012

Note: CU and SES regulated by supranational bodies, and thus respective policy areas are set at supranational level



Trade policy areas regulated in 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 phyto-sanitary 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

- 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 will gain from Russia's WTO accession



Future of relations between Ukraine and RBK CU/SES

- Status quo:
 - Bilateral FTAs with RBK
- Options for the future:
 - **Option 1:** Ukraine signs FTA with RBK CU/SES
 - **Option 2:** Ukraine joins RBK CU or SES
- Question: What is better for achieving the ultimate and intermediate goals of Ukraine?



Goal 1: Favourable investment climate

- Currently, bilateral FTAs don't offer means for improving investment climate
- Given that RBK don't have a reputation as leading economic reformers, regulatory convergence could result in investment climate deterioration
- **Option 1:** Ukraine signs FTA with RBK CU/SES
 - New FTA with common regulatory approximation to best international practices might contribute to improvement of business climate
- **Option 2:** Ukraine joins RBK CU or SES
 - Roundabout approach: Eventual harmonisation with international TBT/SPS standards through harmonisation with RBK TBT/SPS standards that approach international standards
- **Thus:** Regional integration within RBK could result in improvement of business climate only if all partners converge to best international practices



Goal 2: Improved access to RBK market

- RBK market:
 - 170 m of consumers
 - USD 1.5 trillion market access
- Ukraine has already benefited from good market access thanks to bilateral FTA and establishment of CU
- **Option 1:** 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
- **Option 2:** Ukraine joins RBK CU or SES
 - In comparison to Option 1, the main additional benefit in terms of market access of a CU/SES membership is the abolishment of border/customs control

- **Thus:** Regional integration in form of FTA (Option 1) is sufficient to achieve better access to RBK market



CU and energy trade (1)

- Regional integration has no direct impact on gas agreements with Gazprom and thus on gas prices
 - There might be ways to overcome agreements, but they should be studied separately
- Export tariff preferences could serve as main ‘carrot’ of regional integration with RBK
 - Export tariffs cover 42.6% of Ukraine’s imports from Russia (2011)
 - Key product categories subject to export tariffs: Mineral fuels, petroleum refinement products, wood
 - Weighted average export tariff rate is 23%
 - Russia’s WTO accession will have minor impact of the level of export tariffs



CU and energy trade (2)

- **Option 2:** CU membership could offer:
 - Elimination of Russia's export tariffs for products consumed by Ukraine
 - Application of export tariffs for benefit of Russia on the border of Ukraine
- CGE modelling results:
 - **Scenario:** FTA with RBK + Ukraine's import tariffs vis-à-vis EU and ROW reach RBK CU level + RBK export tariffs are eliminated for exports to Ukraine
 - **Welfare increase:** 1.3% over medium term horizon
As said above: EU DCFTA offers 4.3% welfare increase over medium term horizon
- **Note:** Elimination of export tariffs could be part of a FTA package, but it seems that Russia is not inclined to accept this



Goal 3: Reduced energy vulnerability

- **Option 2: CU membership**
 - No positive impact on reduction of Ukraine's energy vulnerability
 - Modelling results:
 - Further increase in imports of energy from Russia
 - Reduction of domestic energy production
- Potential reduction in imported price of energy would:
 - Increase dependency on Russia as source of energy
 - Provide disincentives to develop domestic energy extraction
 - Provide disincentives to invest in energy-saving technologies
- **Thus:** 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



Goals 4 & 5: Sustainable and socially inclusive development

- Regional integration with RBK doesn't provide incentives to:
 - Environment-friendly (i.e. sustainable) growth
 - Reduced multi-dimensional social exclusion



Further implications of CU/SES membership (Option 2)

- **Burden of renegotiations & compensations within the WTO:**
 - Ukraine's bound import tariffs are generally lower than in RBK CU
 - 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)
- **Lost of independence in trade policy**, including right to negotiate free trade agreements with other countries, like the DCFTA with the EU.
 - The Commission of the RBK CU is entitled to conduct new foreign trade related negotiations on behalf of the member states
- **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



Conclusion on regional integration with RBK

- **Conclusion:** Membership in CU/SES (Option 2) doesn't help Ukraine to meet its intermediate and ultimate economic policy goals
- Moreover, membership in CU/SES (Option 2) 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 (Option 1) would help Ukraine to pursue its intermediate and ultimate economic goals



4. Conclusions and recommendations

- 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 all economic goals
- Regional integration with RBK CU/SES
 - FTA with RBK CU/SES (Option 1):
 - Positive contribution in pursuing economic goals
 - Joining of RBK CU/SES (Option 2):
 - Negative contribution to most of economic goals of Ukraine
- **Recommendations:**
 - Ukraine should cooperate with both regional integration blocks
 - In which form? DCFTA with EU and FTA with RBK CU/SES (Option 1)



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