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Trade policy in Ukraine:

Strategic aspects and next steps to be taken

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Trade policy in Ukraine: Strategic aspects and next steps to be taken

Executive Summary

Two years after Ukraine's WTO accession in May 2008, policy makers have once again to take strategic decisions as to future trade policy of the country. It is hard to overestimate the importance of such decisions, since they do not only affect trade flows, but also the speed of structural reforms, an issue of practically same importance as trade itself.

Two main options are on the menu: the establishment of a far-reaching free trade arrangement with the European Union ("FTA+") and the participation in a customs union between Russia, Belarus and Kazakhstan, the formation of which was started on January 1, 2010. While many policy makers seem to favour both ideas, in reality these two approaches are not compatible with each other. Thus, there is a need to take a strategic decision regarding Ukraine's future trade and regional integration policy.

The establishment of a FTA+ wit the EU would clearly be in the economic interest of the country. Ukraine's exporters would have a better access to a very large and stable market and, at the same time, Ukrainian companies would be able to import advanced capital goods at relatively lower prices, thus improving their competitive position. The adoption of juridical norms and technical standards clearly involves costs for Ukraine, but this would also contribute to a better access both to the EU and to the third countries' markets, since EU standards are international standards.

The participation of Ukraine in a customs union with Russia and other CIS countries would bring only limited advantages to exporters, since Ukraine already enjoys free trade with the CIS countries. The biggest appeal for Ukraine seems to be cheap energy imports from Russia. But, in our view, cheap energy imports are unlikely in the long-term, despite the recent agreement with Russia on gas prices. Besides, this benefit is of a debatable character, since it would create a higher energy dependency and slow down the modernisation of the country regarding energy efficiency.

Consequently, the strategic decision should be clearly in favour of establishing a FTA+ with the EU. At the same time, Ukraine should maintain good trading relations with Russia and other CIS countries, since they do matter for Ukraine's economy. If possible, existing bilateral FTA with the CIS countries should be further elaborated to include trade in services and other trade-related topics.

Concerning the FTA+ with the EU, Ukraine should take the following next steps to facilitate negotiations. In trade in goods, more progress in technical regulation and sanitary and phyto-sanitary reforms in line with Ukraine's WTO commitments is clearly needed. In trade in services, the primary goal would be to continue improving access under the mode 3 of service supply (commercial presence). Finally, intellectual property rights protection improvement is mandatory to facilitate innovations and ensure long-run stable economic development of the country.

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1. Introduction

The WTO accession in May 2008 was a milestone of Ukrainian trade policy. Though there are still some critics of this move, practically all experts agree on the positive long-term effect of accession on Ukraine, both for external as well as for internal reasons (i.e. for implementing domestic reforms).

As of today, i.e. roughly two years after the WTO accession, a new public debate regarding the future trade policy and issues of regional integration of the country is taking place. On the one hand, policy makers support the establishment a free trade agreement with the European Union (EU), including the adoption of legal norms and technical standards from the EU ("deep integration" or "FTA+"). Official negotiations on the FTA+ already started two years ago. On the other hand, in January 2010 the establishment of a custom union between Russia, Kazakhstan, and Belarus was launched, and Ukraine is invited to join this regional trade agreement (RTA). As it looks, many policy makers do support this initiative.

The co-existence of these two approaches is not easy to understand, at least on economic terms, since they seem to contradict each other. Thus, there is little clarity for business and investors as to the future strategic trade policy direction.

In this paper, we deal with these strategic trade policy issues by analysing the relative merits of both approaches. After dealing with such strategic questions, the paper goes on reviewing concrete practical steps to be taken in order to implement a coherent trade strategy. Thus, the paper deals with both strategic and implementation issues of trade policy.

2. Current trade policy in Ukraine and its effects

Below we provide a brief overview of Ukraine's current trade regime framed by the WTO membership, as well as applied in foreign trade with major partners – the EU and the CIS countries.

2.1 WTO membership: general framework for trade policy

Ukraine became a member of the WTO in May 2008 after more than fourteen years of negotiations. These long talks ensured that many changes embedded in Ukraine's accession agreements had been introduced well before accession. In merchandise trade, import duties were significantly reduced in 2005, and a new Customs Code aligning customs valuation procedures with the WTO rules entered into force in 2004.[1] In services, pre-accession changes include among other things a removal of nationality requirements for auditors and lawyers; establishment of independent national regulator in telecommunication sector; increase in the permitted share of foreign capital in the charter funds of information agencies.[2]

The membership in the WTO made these changes irreversible. Ukraine's import tariffs were bound, and specific and mixed tariffs were mostly replaced by more transparent ad-valorem tariffs. Average bound import duty for agricultural products is equal to 10.66%, and for industrial products 4.95%. Export tariffs have been scheduled for gradual reduction, and quantitative export restrictions were eliminated.

In addition, Ukraine took wide and rather liberal commitments in service sectors. According to the Ministry of Economy, Ukraine committed to provide a full access to 80%

[1] Movchan V. (2008) "Ukraine is in the World Trade Organisation, almost". Supplement to Monthly Economic Monitor of Ukraine, No. 3 (89), March. – www.ier.kiev.ua

[2] Burakovsky I. et al. (2010). "Ukraine's WTO accession: service sectors." Presented on the WBI/JVI workshop "International Trade in Services for CIS Countries" in Vienna, February 22-26, 2010

of service sectors for mode 1 of service supply (cross-border trade), 97% for mode 2 (consumption abroad), and 85% of mode 3 (commercial presence).

Ukraine committed to conduct a considerable technical regulation reform. According to the Working Party Report[3], "upon accession all existing national and regional standards in Ukraine would be voluntary, except those referred to or set out in technical regulations intended inter alia to protect national security interests, prevent deceptive practices, protect the life and health of people, animals or plants, as well as protect the environment". Ukraine also committed to ensure that by the end of 2011, all of its technical regulations use relevant international standards as a basis.

As of mid-March 2010, there have been 30 technical regulations adopted by the Cabinet of Ministers and based on the relevant EU directives. Several regulations have come into force already, but about a half of them will become mandatory only in or after 2011. More regulations are in preparation. The adoption of technical regulations will allow significantly reduce the list of products subject to mandatory certification in line with the WTO commitments. However, the implementation of technical regulations is to be complemented by market surveillance mechanisms to ensure reform efficiency.

2.2 Description of major agreements of Ukraine with its trading partners

2.2.1 Current trade regime with the EU

The current relations between Ukraine and the EU are based on the Partnership and Cooperation Agreement (PCA) concluded in 1994 but entered into force only in 1998, for an initial period of ten years.[4] The PCA establishes the framework of corporation between the countries in political, economic, and other spheres. However, the PCA contains neither explicit plans, nor mechanisms of cooperation, nor the tool to assess progress in the cooperation. Thus, it does not replace a traditional "Association Agreement" that has EU membership as its final aim.[5]

In commodity trade, Ukraine's access to the EU market is less preferential than for many other countries. According to the PCA, the countries trade under the most favoured nation (MFN) regime. Also, Ukraine is a beneficiary under the Generalized System of Preferences (GSP)[6] since 1993. The GSP allows for lower duties than the MFN rates on over 6000 products. Currently there are two categories of products covered by the scheme: non-sensitive, for which duties are suspended, and sensitive, for which rates are reduced. The scheme allows high proportionate reduction for most industrial products, but relatively low proportionate reductions for agricultural products. Ukraine is qualified neither for the GSP+ recently introduced by the EU, nor for EBA ('everything but arms').

There had been also several agreements between the EU and Ukraine that regulated trade in textile, and in iron and steel. However, all quantitative restrictions and licensing requirements imposed by these agreements had been lifted by now.

In 2005, the EU granted Ukraine a market economy status. This status ensures that possible anti-dumping investigations against Ukrainian exporters to the EU are conducted applying normal value of exports based on the prices paid or payable in Ukraine, and not in the third country, as it is required for non-market economies. However, this decision did not eliminate the use of the commercial defence instruments between trading partners. As of April 2010, there have been six anti-dumping measures in the EU against

[3] The Report of the Working Party on the Accession of Ukraine to the World Trade Organisation WT/ACC/UKR/152, 25 January 2008. – www.wto.org

[4] The Agreement on Partnership and Cooperation signed on June 16, 1994 between the European Union and Ukraine

[5] Vinhas de Souza, L., Schweickert, R., Movchan, V., Bilan, O., Burakovsky, I. (2005) "*Now so near, and yet still so far: Economic Relations between Ukraine and the European Union*", Kiel Discussion Paper No. 419

[6] Council Regulation (EU) No 732/2008 of 22 July 2008: see details at http://ec.europa.eu/trade/wider-agenda/development/generalised-system-of-preferences/

the products originated from Ukraine. In turn, there have been three anti-dumping measures against products from selected EU countries, and six safeguard measures concerning all trade partners including the EU.

Among stumbling block in Ukraine-EU trade, standards regulation has been the most important. According to the State Committee for Technical Regulation and Consumers Protection, as of the end of 2009, there have been only about 25% of national standards harmonized with the EU and international standards. Many Ukraine's husbandry products cannot be exported to the EU due to standards mismatch.

Summing up, the current trade concessions between Ukraine and the EU are rather limited. It could be expected that the successful conclusion of the on-going FTA negotiations would bring important gains both in terms of the access to the EU market, increase in trade and investments, and also better access to the third-countries market.

2.2.2 Current trade regime with the CIS countries

The low efficiency of a 'wide' integration within the CIS resulted in the active sub-regional integration processes.[7] In particular, it led to a series of bilateral agreements on free trade among the CIS members, including the agreement between Ukraine and Belarus signed in 1992, between Ukraine and Russia in 1993[8], and between Ukraine and Kazakhstan in 1994.

The texts of the agreements are rather similar.[9] They stipulate duty-free trade in all goods, while allowing for unspecified potential exemptions. The core exemptions, frequently introduced in the protocols of bilateral agreements, include sugar, tobacco and cigarettes, alcohol and sometimes non-alcohol beverages. In addition, there is a practice of reciprocal exemptions in the response to export duties set by a trading partner. For instance, currently the list of reciprocal exemptions include around 115 positions for Russian exports, including fishery products, mineral products, fertilizers, etc.[10], and several for Ukrainian exports, namely cattle, skins, and metal scrap. It is important that none of these bilateral FTAs covered service sectors or other trade-related topics including intellectual property rights protections.

Countries intensively use trade defence measures to protect specific sectors against unfair competition practices (anti-dumping measures) and excessively growing imports (safeguard measures). As of end of March, Ukraine applies five anti-dumping measures against imports from Russian Federation, and three against imports from Belarus. In March 2010, Ukraine launched a new anti-dumping investigation against imports of tires from Belarus. In addition, Ukraine applies six safeguard measures independent from the country of origin.

In turn, Ukraine's exporters face three anti-dumping duties and two safeguard measures in Russia, and one anti-dumping duty in Belarus. Moreover, Russia has launched three safeguard investigations in 2009-2010 that concern also Ukrainian producers, and Kazakhstan launched two such investigations.

Trade relations with Russia have not been smooth. The most pronounced example of tensed trade relations between two countries had been a ban on exports of livestock products to Russia introduced in January 2006.[11] The formal reason for banning livestock products' exports was violations of Russian veterinary legislation by Ukrainian meat

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[7] Burakovsky I. (2003) Economic Integration and Security in the Post-Soviet Space // *Swords and Sustenance: The Economics of Security in Belarus and Ukraine*. Edited by Robert Legvold and Celeste A. Wallander

[8] The agreement was never ratified, but nevertheless it entered into force via the exchange of letters between ministers

[9] Freinkman, L., Polyakov E. and Revenco C. (2004). "*Trade Performance and Regional Integration of the CIS Countries*" Policy Research Working Paper 38. Washington, DC: World Bank

[10] http://www.exportsupport.ru/1:ru/law/tarif/tarif

[11] Nivyevskiy, O. (2006) "*Ukraine's dairy industry lost access to its largest export market*", IER MEMU Supplement No.3, http://www.ier.kiev.ua/English/MEMU/2006/memu2006_eng.cgi

exporters. However, it remained unclear why this ban has been extended to dairy products instead of tackling meat products directly, as no complaints on dairy products were filed. This decision significantly harmed Ukraine's dairy production, inflicting losses to both dairy industry and raw milk producers.

Standards have been lesser problem in trade with the CIS countries that with the EU due to initially common standards dataset inherited from the Soviet Union. However, all CIS countries have been gradually modifying standards with their economic and security needs and harmonizing them with international practices. As a result, a share of common standards among the CIS countries has been gradually diminishing as standards has been diverting.

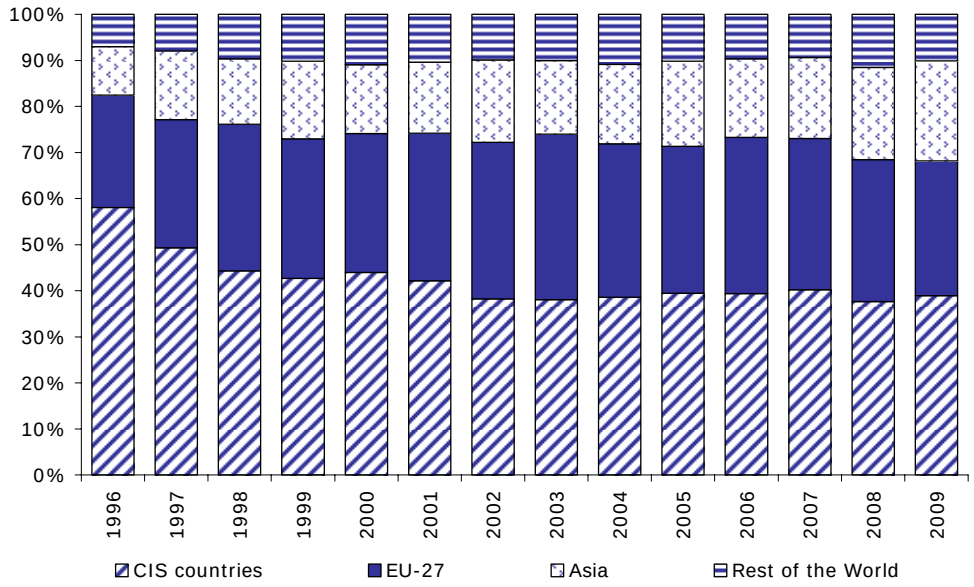
Summing up, the framework of trade relations between Ukraine and the CIS is officially more favourable than between Ukraine and the EU. However, numerous tariff exemptions and non-tariff barriers make the trade regime less certain, and thus less attractive than could be otherwise.

2.3 Effects of trade policy on regional patterns of trade

Despite existing FTA within the CIS, Ukraine's merchandise trade has exhibited clear reorientation pattern from the CIS counties to the EU-27 and especially to Asia[12] over the last fourteen years. While in 1996 the share of the CIS in Ukraine's merchandise trade turnover was 58%, it reduced to 39% in 2009. The share of Ukraine's trade with the EU increased from 24% in 1996 to 29% in 2009. However, this share has remained substantially below the share of other Central and Eastern European countries in trade with the EU several years before they joined the Union in 2004.[13] The trade with Asia grew faster as its share doubled from 11% in 1996 to 22% in 2009.

Figure 1

Ukraine's merchandize trade: regional structure



Source: Derzhkomstat, author's calculations

The reorientation was more pronounced in imports as the share of imports from the CIS countries dropped from 63% in 1996 to 43% in 2009. The decline occurred mostly in the

[12] Excluding Cyprus

[13] Vinhas de Souza, L., Schweickert, R., Movchan, V., Bilan, O., Burakovsky, I. (2005) "*Now so near, and yet still so far: Economic Relations between Ukraine and the European Union*", Kiel Discussion Paper No. 419

imports of energy products, as the economic development resulted in higher demand for non-energy products, first of all investment and durable goods.

Summing up, during the years of independence Ukraine has significantly reoriented its trade flows, loosening the links with the CIS and intensifying the links with other partners, specifically the EU and Asia. This regional diversification could be an important stabilising factor in case of regional economic problems, though could not shield from the global crisis.

Regional reorientation happened despite formally better trade regime that Ukraine has with the CIS than with the EU and Asian countries. Thus, it is especially interesting to investigate how the future changes in trade regimes could affect Ukraine's economy.

3. FTA+ with EU vs. customs unions with Russia, Belarus and Kazakhstan

In this section of the paper, we consider pros and cons of two regional integration options currently faced by Ukraine, namely the deeper economic integration with the EU and joining the customs union with Russia, Belarus and Kazakhstan.

3.1 Pros and cons of FTA+ with EU

Official negotiations between the EU and Ukraine regarding the establishment of the FTA were launched in February 2008, almost immediately after the General Council of the WTO announced a successful completion of Ukraine's membership negotiations. Unofficial consultations started several years before. For Ukraine, key principles of negotiations are expected to be parity, non-discrimination, approximation of Ukraine's regulatory environment to the EU standards and norms, absence of non-grounded limitations, and gradual introduction of commitments. Aimed at strengthening bilateral economic relations and securing competition, the FTA should ensure progressive implementation of free movement of goods, services, capital and labor.

According to the EU authorities,[14] the EU-Ukraine FTA should become the first of a new type of "deep and comprehensive" trade agreements covering a wide array of trade-related issues ("comprehensive") and aiming at eliminating 'behind the border' obstacles to trade through processes of regulatory approximation, thus partially opening/extending the EU internal market to Ukraine ("deep").

Benefits for Ukraine from the establishment of the FTA+ include the following:

- **Better access to the richest market in the neighbourhood** as gains from any regional trade integration project are capped by the size of the market with which this integration occurs (larger market would render higher potential gains);
- **Levelling of the playing field with other EU neighbours** as currently most other countries have better access, thanks to more preferential trade regimes provided. Better market access is very important for exporters to boost their competitive position on the EU market;
- **Harmonization of standards with the EU** and thus acquisition of internationally acceptable standards that would stimulate not only trade with the EU, but also improve access to third-country markets and reduce costs of imports;
- **Better domestic business climate** as the adjustment to the EU regulations would means changes in national legislation. In turn, these changes would result in transparent and set of rules familiar to foreign investors that would make domestic environment more attractive for them providing higher economic growth potential.

[14] http://ec.europa.eu/delegations/ukraine/eu_ukraine/trade_relation/free_trade_agreement/index_en.htm

Among the costs of the establishment of the FTA+ the following should be highlighted:

- **Increased domestic competition** due to elimination of tariff barriers and a significant reduction of non-tariff barriers resulting in market restructuring and reallocation of factors of production. Although higher competition is definitely beneficial for the country in the medium-term, short-term effects of reallocations could be painful;
- **Higher costs of standard obedience,** as the EU standards are generally more stringent and thus compliance with them would require more efforts and expenses. The experience of Poland shows that higher standards could even drive some business out of specific market segments;
- **Spending associated with legal and administrative adjustments** taking into account that immediate costs could be rather high (establishment of independent regulatory bodies, introduction of new – likely technologically more advanced – procedures, etc.) while benefits could be long-term or even associated with the EU membership that is not an option now.

Quantitative estimates confirm that benefits of the FTA+ are generally higher than costs though the latter should be definitely taken into account, and the EU technical assistance should be attracted to mitigate them. There have been several studies assessing Ukraine's welfare gains of the FTA+ with the EU, and all of them showed that the deep FTA is welfare-improving mainly thanks to harmonisation of standards and trade facilitation actions. Specific gains vary from 1-2%[15] to 4-7% in additional welfare growth[16] depending on scenarios formulation.

3.2 Pros and cons of customs union with Russia, Belarus and Kazakhstan

The formation of the customs union between Russia, Belarus and Kazakhstan was started on January 1, 2010 with the implementation of the common tariff scheme. The next major step is expected on July 1, 2010[17] when the Customs Code of the Customs Union shall come into force, the Commission of the Customs Union shall become active, and customs clearance of goods originated in countries-members shall be abolished (Figure 2). It should be emphasized that this customs union is focused on trade in goods primarily, leaving aside trade in services and other trade-related issues that nowadays generate the most of trade-related welfare gains.

This tripartite customs union seems to be a follow-up of the previous regional integration initiative, namely the establishment of the Single Economic Space (SES) between Russia, Ukraine, Kazakhstan, and Belarus, launched in 2003[18]. As followed from the agreement, the SES was aimed at the establishment of the customs union among its members with common trade policy. However, the members of the SES – especially Ukraine - had different perception of the desired progress in integration. While Ukraine insisted on gradual integration with the establishment of the FTA without exemptions as the first stage[19], Russia wanted faster integration. The discrepancy hampered the realization of the SES project.

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[15] Jakubiak, M., Kolesnichenko, A. (eds.) (2006) *Prospects for EU-Ukraine Economic Relations*. CASE Reports No. 66/2006

[16] CEPS (2006). *The Prospect of Deep Free Trade Between the European Union and Ukraine*. Report prepared by Centre for European Policy Studies (CEPS), Brussels; Institut fur Weltwirtschaft (IfW), Kiel; International Centre for Policy Studies (ICPS), Kyiv

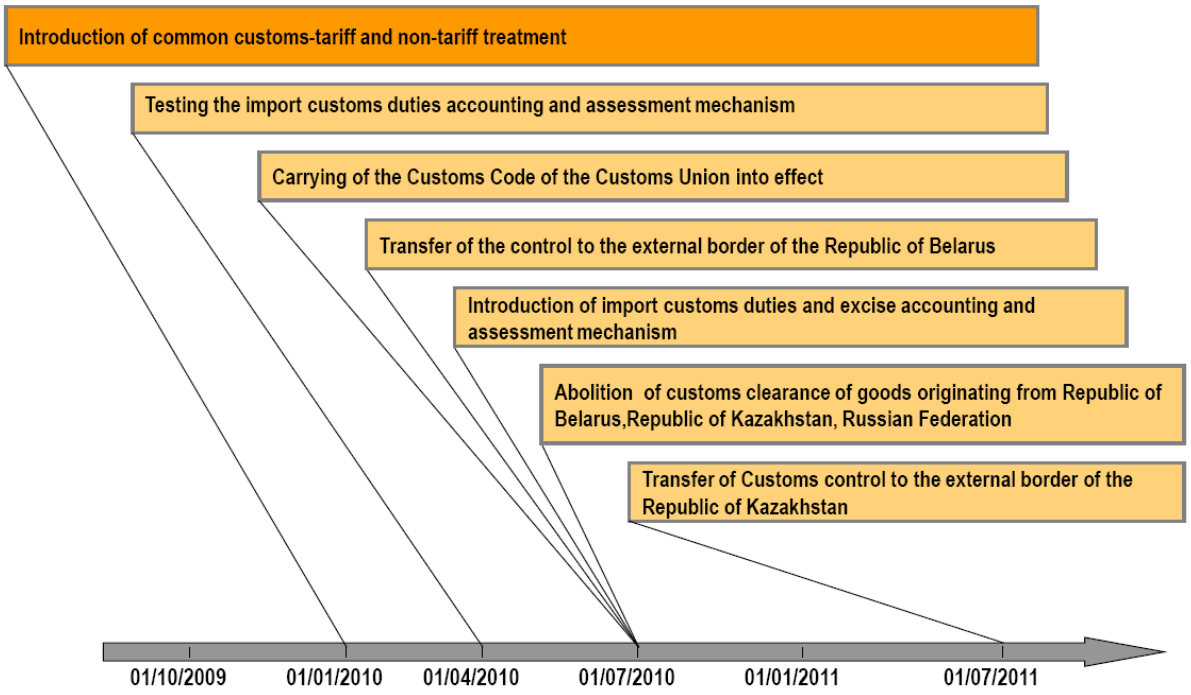
[17] http://tsouz.ru/news/Documents/Custom_Union_Glaziev1.pdf

[18] The agreement was ratified by Ukrainian Parliament in 2004 with the reservation that the SES agreements don't contradict the Constitution of Ukraine.

[19] FTA with exemption has *de-facto* existed among these countries already, as they have signed mutual bilateral free trade agreements

Figure 2

Customs Union Schedule of Implementation



Source: http://tsouz.ru/news/Documents/Custom_Union_Glaziev1.pdf

Taking into account existing Ukraine's FTA with Russia, Belarus and Kazakhstan[20] and narrow focus of the customs union on merchandise trade issues, potential benefits from a membership in the customs union for Ukraine are rather limited. Among the most of them could be the following:

- **IF preferential gas prices are considered** in the package with the customs union membership, Ukraine might conclude the agreement envisaging cheaper imported gas. However, Ukraine managed to agree on gas contract amendments lowering prices without joining the customs union[21];
- **IF elimination of Russian export duties on oil is considered** in the package with the customs union membership, Ukraine might get cheaper raw oil. However, the experience of Belarus, for which the reduction or elimination of these duties was a major economic interest, showed that export duties are very unlikely to be a part of customs union deal.

Thus, it sees that Ukraine is very unlikely to get noticeable economic gains from joining the customs union. Moreover, cheaper energy – if provided – would endure country's energy dependence and could hamper reforms that envisage energy-saving and diversification, potentially making the economy less competitive in the long-run.

However, if Ukraine joins the union, it is likely to bear additional costs. Being a member of the WTO, the country committed to bind its import duties, and revision of these commitments is theoretically possible, but costly as other member countries have a right to claim compensations of losses caused by the change of the commitments. Thus, to evaluate Ukraine's costs of joining the customs union, it is necessary to make an assumption regarding what import duties schedule would be used in the union with

[20] Available information allows concluding the existing bilateral FTA of countries-members of the customs union will remain in force until the FTA with the customs union will be concluded. See http://tsouz.ru/news/Documents/Custom_Union_Glaziev1.pdf

[21] http://www.president.gov.ua/news/16964.html

Ukraine. If Ukraine's bound tariff schedule is used, then Ukraine would not violate its tariff commitments. However, if currently applied customs union tariff schedule is used as a basis, then Ukraine would have to negotiate these changes with any interested WTO member countries and pay compensations as custom union tariffs tend to be higher than bound rates in Ukraine (Table 1).

Table 1

Imports duty on selected products in Ukraine and in the customs union between Russia, Belarus, and Kazakhstan*

HS code	Product description	Final bound rate (Ukraine)	Import duty (Customs Union)
870323	Motor cars and other motor vehicles principally designed for the transport of persons (cylinder capacity 1500-3000 cubic cm)	From 5% to 10%	From 30%, but not least as 1.5 euro per 1 cubic cm to 4 euro per 1 cubic cm
271000	Petroleum oils and oils obtained from bituminous minerals (other than crude)	From 0% to 10%	5%
260200	Manganese ores and concentrates	2%	5%
710813	Gold, other semi-manufactured forms	From 2% to 5%	20%
870324	Motor cars and other motor vehicles principally designed for the transport of persons (cylinder capacity exceeding 3000 cubic cm)	From 5% to 10%	For vehicles for medical purposes: 0% For other vehicles: from 35%, but not least as 2.8 euro per 1 cubic cm to 5.8 euro per 1 cubic cm
870710	Bodies (including cabs), for the motor vehicles of headings 8703	From 1% to 10%	From 0% to 15%, but at least 5000 euro per 1 unit
270112	Bituminous coal	2%	5%
270400	Coke and semi-coke of coal	0%	5%
300490	Medicaments, other	0%	10%
840734	Spark-ignition reciprocating or rotary internal combustion piston engines, of cylindrical capacity exceeding 1000 cubic cm	From 5% to 12%	From 0% to 10%
151110	Crude palm oil	0%	From 0% to 15%, but at least 0.12 euro per 1 kg
390760	Polyethylene terephthalate	6.5%	5%
640299	Other footwear with outer soles and uppers of rubber or plastics, other	10%	10%, but at least 1 euro per 1 pair

Sources: Ukraine's import duties schedule (www.wto.org), Customs Tariff of the Customs Union (http://www.tsouz.ru/db/ettr/tnved/Pages/default.aspx)

Note: The list of products was formed as top Ukraine's imports in 2008 by separate countries, excluding imports from the countries with which Ukraine signed the FTAs

Moreover, higher import tariffs in customs union mean that Ukraine in case of joining would face higher costs of imports and thus changes in regional trade patterns towards Russia, Belarus, and Kazakhstan, likely causing trade diversion. Taking into account that the EU is the major supplier of investments and durable goods in Ukraine, more expensive imports from the EU would cause slower modernisation and hamper long-term economic development.

In addition, the membership in the customs union with Russia, Belarus, and Kazakhstan would be hardly compatible with a continuation of FTA+ talks with the EU, as the customs union has its own Commission that is entitled to conduct new regional integration negotiations on behalf of the union member states.

Summing up, from the economic point of view it seems unreasonable for Ukraine to become a member of the customs union, joining Russia, Belarus, and Kazakhstan in this regional integration initiative.

3.3 Regional integration choice for Ukraine

Above analysis allows making several important conclusions regarding Ukraine's future trade policy choice.

Conclusion 1: The FTA+ with the EU and the customs union with Russia, Belarus, and Kazakhstan are not compatible with each other.

As discussed above, the membership in the customs union would mean that trade policy making – at least regarding trade in goods – would be transferred to a supranational authority, the Commission of the Customs Union. In this case, any future FTA with the EU should be negotiated with the Commission, and not by individual member states.

Taking the incompatibility of two abovementioned regional integration options, which one should Ukraine choose?

Conclusion 2: Ukraine would get net long-run welfare gains in case it establishes the FTA+ with the EU, while the participation in the customs union with Russia, Belarus and Kazakhstan is mostly likely to cause net welfare losses.

Analysis of pros and cons of two options allows concluding that the FTA+ with the EU is definitely preferable for Ukraine from the economic point of view. Closer economic ties with the EU allow better access of Ukrainian exporters to rich and populated market with transparent and predictable business environment, bringing welfare gains. Moreover, the FTA+ results in harmonisation of regulatory environment in Ukraine ensuring better domestic business environment crucial for investors and thus economic development.

At the same time, the participation in the customs union with Russia, Belarus and Kazakhstan might result only in short-term and debatable benefits in terms of cheaper energy resources. In the long run, net effect is likely to be trade diversion and slower technological modernisation as investment imports would be more expensive.

Conclusion 3: Ukraine has to be explicit and consistent in its regional integration policies to maintain investors' trust as ambiguity has opportunity costs for the country in terms of foregone investments.

Uncertainty caused by intensified public debate regarding potential participation of Ukraine in the customs union and thus possible change in trade policy strategy is harmful for the country, as investors interested in Ukraine are not sure about its future regulatory regime and thus access to neighbouring markets. Thus, it is recommended to make explicit what trade policy the country pursues.

Conclusion 4: Ukraine's strategic interest is to deepen economic relations with Russia, Belarus and Kazakhstan in the framework of the FTA.

As of relations with the newly established customs union, the strategic interest of Ukraine is to deepen links within the FTA framework. In its regional integration strategy, Ukraine may want to use the experience of Chile that conduct broadly diversified trade policy establishing a network of various regional trade agreements around the globe.

Box 1

Chilean experience in regional and global trade cooperation

As for April 2010, Chile has 18 WTO notified RTAs and most of them cover both goods and services. Chile has negotiated free trade agreements (FTAs) with more than 57 countries in the last 20 years, negotiating agreements with all Latin American countries and FTAs with the European Union, the United States, South Korea, and EFTA countries among others. In 2005 it has finalized the Pacific Four Agreement (P4) with Singapore, New Zealand and Brunei Darussalam[22] and later completed negotiations on agreements with India and the People's Republic of China. This proves the broad diversification of Chilean trade policy, covering both regional and global cooperation.

FTAs subscribed by Chile are fully consistent with WTO provisions under Article XXIV of the GATT and Article V of the GATS. However, Chile's FTAs go beyond WTO commitments, not only by eliminating tariffs and having a comprehensive scope in services, but also by taking on areas not addressed at the WTO, and by agreeing to commitments that go beyond WTO commitments in areas such as Trade Facilitation, Transparency, Intellectual Property Rights, SPS, TBT, etc.[23]

FTAs subscribed by Chile within the context of the ALADI – Latin American Integration Association – and P4 include an accession clause, which provides for possible accession of third parties.

Provisions on periodic review of the agreements allow adjusting them to changing global environment. Chile-Mexico Partial Scope Agreement shows the enhancement of cooperation after periodic review of agreements. Chile-Mexico Agreement was subscribed in 1991, which latter evolved into a comprehensive FTA in 1999, and now it is negotiated to become an Association Agreement. [24]

Figure B1.

Chile's FTA network



Source: http://www.bilaterals.org/IMG/rubon130.gif

4. Next steps towards the conclusion of the FTA+ with EU

The main trade-related regulatory issues to be brought in line with the EU's *acquis communautaire* are intellectual property rights, public procurement, state aid, and anti-trust issues. Regulatory convergence is essential in areas, relevant for the regulation of the EU's Internal Market. Convergence in other issues, for example, environmental,

[22] http://aimp.apec.org/Documents/2005/CTI/FTA-RTA/05_ftarta_wksp1_016.doc

[23] http://aimp.apec.org/Documents/2005/CTI/FTA-RTA/05_ftarta_wksp1_016.doc

[24] http://aimp.apec.org/Documents/2005/CTI/FTA-RTA/05_ftarta_wksp1_016.doc

which are among the most costly for harmonization, may not be mandatory for finalization of the FTA+. Taking into account growing global tendency in trade through commercial presence, the EU is interested in improvement of investment conditions and stability on the Ukrainian market, ensured by legal harmonization.

To facilitate the FTA+ negotiations with the EU, we would recommend the following:

A) Adopt Laws on State Aid and Public Procurement

Ukraine should adopt the Law on State Aid in line with the EU practices. In particular, state aid should not distort competition, be transparent and fair to all market players. Most of the EU aid is channelled for environmental purposes and energy conservation, research and development and SMEs support. These, of course, are not expected to fully become Ukraine's priorities for the state aid, however, they should get the share of state support.

Another important legislative act to be adopted in Ukraine refers to public procurement issues. Adjustments in this area should touch first of all tender procedures and increased transparency, non-discrimination and competition. This step will lead to higher level of participation of foreign firms in tenders for public contracts and improvement of quality and cost reduction of public services offered by Ukrainian government. Ukraine should establish independent review body in line with the Directive 89/665 and ensure sufficient administrative capacity to provide effective remedies.

B) Increase intellectual property rights protection

Protection of intellectual property rights remains the core issues in negotiations. Enforcement of legislation on trademarks and geographical indication, combating piracy, implementation of sanctions for infringements of intellectual property rights, establishment of associations of rights holders are the main policy issues to be targeted by Ukraine.

C) Complete technical regulation and SPS reforms

Technical barriers to trade (TBT) issues are on the agenda for a long time. Ukraine's WTO commitments changed the system proclaiming that all standards are voluntary except for those used in technical regulations. However, the country solely empowers state authority Derzhpsozhyvstadard to handle standardization, certification and conformity assessment instead of distributing these tasks among different bodies in order to avoid conflict of interest in correspondence with the EU practice. Standards themselves also require further adjustments.

Adjustment of the food safety norms to the EU SPS requirements will improve access for Ukrainian food sector to the European Internal Market. Ukrainian legislation on food safety and security today doesn't obligate producers to use hazard analysis and critical control point principles and thus bringing local food safety standards in line with the EU and international requirements on food safety control.

D) Improve customs in line with Kyoto Convention and the EU Modernized Customs Blueprint

Customs-related legislation should be further harmonized with the EU practice in terms of provisions on customs control, counterfeit and pirated goods, dual use goods and cultural goods. Ukraine should improve functioning of customs services, modernise and simplify customs procedure on the border and inland. Single window approach for international trade related documentation and increase of cooperation between all border agencies will significantly contribute to trade facilitation. The WCO Revised Kyoto Convention should be fully implemented. Moreover, the EU Modernized Customs Blueprint could be used as a benchmark in customs reforms.

E) Improve competition legislation to facilitate trade via commercial presence

The operation of companies can mostly be improved by the adoption and implementation of effective competition and bankruptcy legislation by Ukraine. Progress was made by the

adoption of the Law of Ukraine on Joint Stock Companies that matches EU *acquis*. However, Ukraine should move forward in creating a public and open unified state register of legal entities and physical persons-entrepreneurs, with organisational and financial information on the entities. Legislative norms on accounting and corporate governance are to be further approximated.

Special attention in the services trade liberalization is to be paid to transport and communication services sectors. Issue of the state monopoly, which often hampers competitions and is a distinctive feature of transport, telecommunication and postal sectors of Ukraine, could be addressed by introducing open public-private partnership opportunities and changes in regulatory environment, which would enhance competition.

During the 8th round of negotiations in October 2009 areas on customs reforms and intellectual property rights were ready to be provisionally closed. The chapter of anti-trust has been progressing, while issues like public procurement, SPS and tariffs and quotas were still the subject for debates.[25] More work is to be done to form the stable institutional and regulatory requirement in Ukraine, which would be supportive for the effective implementation and enforcement of the FTA+ with the EU.

5. Conclusions

The economic analysis above allows us to draw clear-cut conclusions on Ukraine's future trade policy. A fundamental insight concerns the question of a strong regional integration versus a multilateral approach to trade policy. For the time being, we strongly recommend to Ukrainian policy makers to maintain the so far very successful multilateral approach. This approach has, as in the case of Chile, contributed to a diversified regional trade pattern, which has to be considered as a clearly stabilising factor for an open economy such as Ukraine.

What does this mean in practical terms? First, it means that Ukraine should go ahead with negotiations concerning the establishment of a FTA+ with the EU, since the benefits from such a move clearly outweigh its costs. Second, Ukraine should try to improve the free trade arrangements with major partners in the CIS, including Russia. Ukraine should seek to deepen existing FTA with Russia, Belarus, and Kazakhstan, which are very important trade partners of the country, and seek to conclude a FTA with the customs union. But as explained above, the participation in such a customs union would not be in the economic interest of Ukraine. If any, Ukraine could only receive short-term advantages from the union, such as cheap energy. But strategic decisions should not be based on short-term and not sustainable benefits.

To facilitate its global trade standings and taking into account existing strong regional diversification, Ukraine should also try to conclude FTA with other countries and trading blocs, in particular in Asia.

As for the immediate steps to speed up the establishment of a FTA+ with the EU, we highlight several issues. In trade in goods, more progress in technical regulation and sanitary and phyto-sanitary reforms in line with Ukraine's WTO commitments is clearly needed. Also, custom procedures are to be simplified in line with the Kyoto Convention, which Ukraine joined several years ago. To facilitate trade via commercial presence, further improvements in competition legislation are needed. Moreover, laws on state aid and public procurements are to be passed aligned with the EU regulations. Finally, intellectual property rights protection improvement is mandatory to facilitate innovations and ensure long-run stable economic development of the country.

[25] www.icps.com.ua. European Focus, November 2009, Julia Langbein. The EU-Ukraine FTA: Plus or Minus?

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