Ukraine between East and West

Perspectives for free trade with both sides

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Berlin/Kyiv, April 2014

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Structure

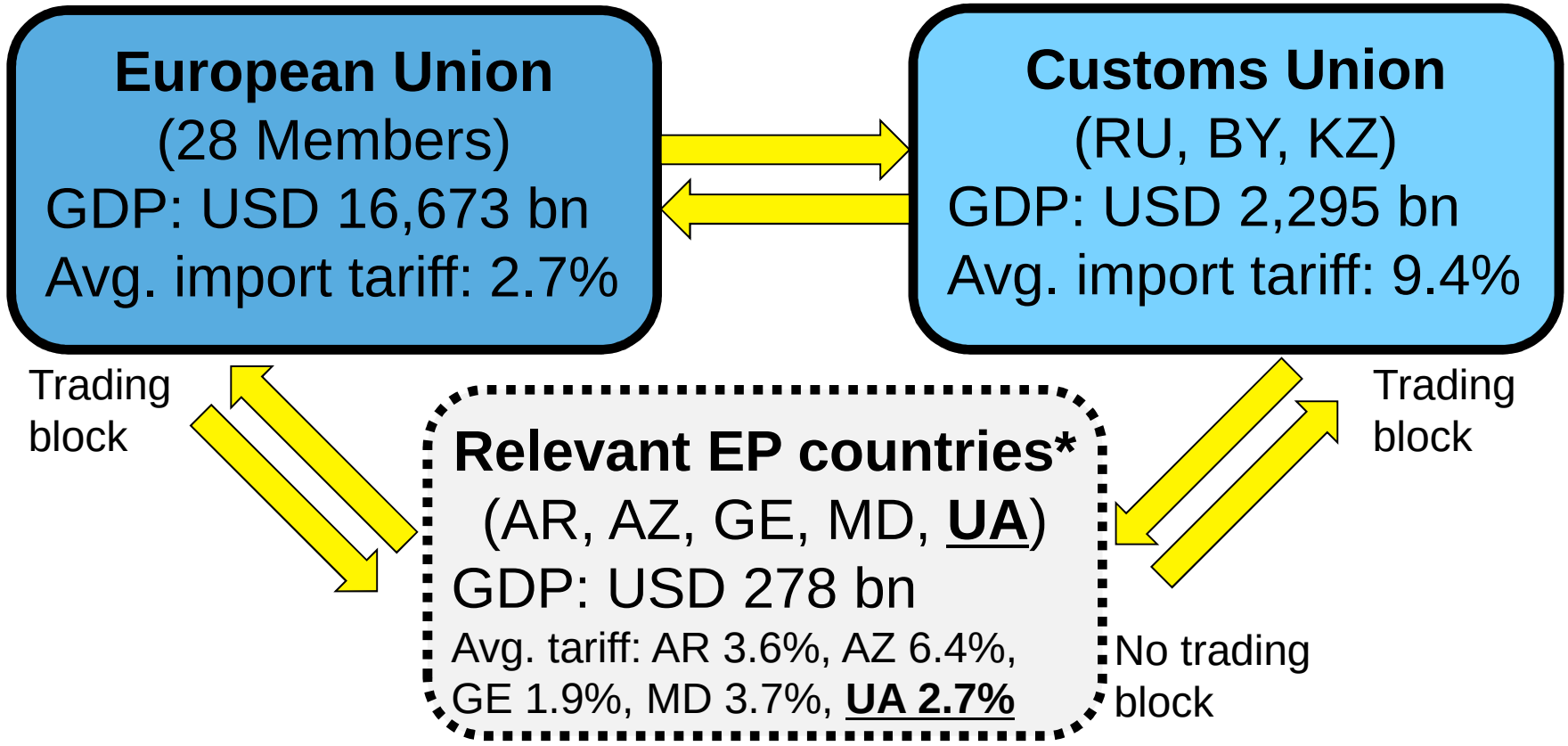
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1. Three groups of countries

Broad topic: Free trade perspective from Lisbon to Vladivostok
Key fact: Not 2, but **3 groups** of countries



*Source: IMF, WTO. Data GDP for 2012. * For our purposes only those Eastern Partnership (EP) countries are relevant, which do not belong to a trading block. Since Belarus is a member of the Customs Union, it is not a relevant EP country for our research.*

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Two separate issues

Implications of having three groups of countries:

- Not just one issue to be analysed; question is not just how to achieve “free trade between East and West”
- Instead: **Two distinct issues** need to be looked at

  - How can Ukraine (as a relevant EP country) establish free trade with the two trading blocks (EU & CU)?
    → **Part 2 of presentation**

  - What are the perspectives for free trade between the two trading blocks (EU & CU)?
    → **Part 3 of presentation**

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2. Ukraine: Free trade with both blocks?

	AR	AZ	GE	MD	UA
GDP, USD bn	9.9	68.8	15.8	7.3	**176.2**
Openness (exports + imports)/GDP, %	57.4	48.6	64.5	101.7	**87.0**

Source: IMF, International Trade Centre, data for 2012.

Ukraine:

- Very open economy
- On top: Very diversified regional trade structure, with significant share of exports to EU (26,5%), CU (30,3%) and third countries (43,2%)
- Openness and diversification are positive features

Objective of trade policy and how to achieve it

Objective of trade policy:

- Securing openness and diversified trade structure
- In particular: Free trade with both trading blocks, EU and CU

Instrument for achieving objective:

- Free trade agreement (FTA) is the appropriate instrument, since FTAs are purely bilateral agreements and thus full compatible with each other

Conclusion: UA can have parallel FTAs

FTA with CU **AND** **FTA with EU**

→ There is a way to achieve free trade with EU **AND** CU

→ Parallel FTAs is the only way to achieve this objective

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Perspectives

Trade with **CU**
• Ukraine already has FTAs with CU countries

Trade with **EU**
• DCFTA initialled; signature expected in 2014

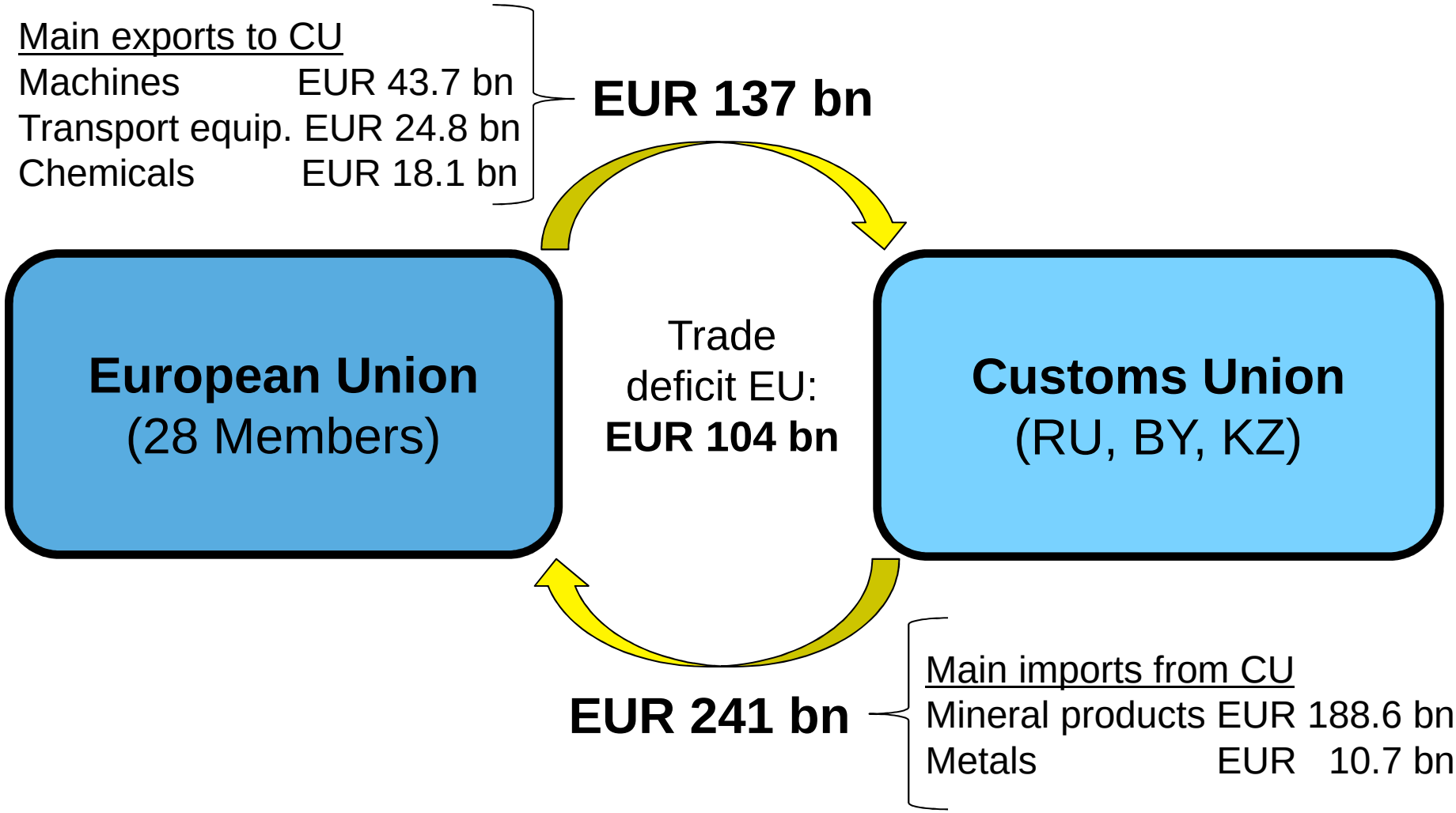
→ **Parallel FTAs are feasible in the short term**

Main **challenges**:
Trade with **CU**
• Short term: Making sure free trade with RU is maintained
• Medium term: Inclusion of energy, services, intellectual property right and procurement into FTAs with CU countries
Trade with **EU**: Proper implementation of DCFTA

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3. Free trade between the EU and CU?



Source: European Commission, data for 2012.

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Perspectives for a EU-CU FTA

EU: Strong economic interest in FTA

- Sizeable bilateral trade deficit with CU
- EU exports goods to CU, which would profit from a FTA

CU: Situation rather **ambiguous**

<u>On the one hand:</u>

- FTA with EU is the only effective way to modernise the economy and to reduce dependency on energy sector
- Political announcements in favour of a FTA with EU

<u>On the other hand:</u>

- For current exports FTA with EU not crucial, since energy exports do not require FTAs

→ **Substantial economic interest in the EU, but ambiguous situation in CU**

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Challenges for FTA EU-CU

Formal hurdle:

- Two members of CU (BY and KZ) not in WTO

Key hurdle: High import tariffs in CU

- Average tariff: 9.4%; for comparison EU: 2.7%
- Moderate schedule (WTO) for reduction: 7.2% until 2019
- On top: WTO implementation in RU far from ideal

→ **Unrealistic to expect the necessary tariff reduction in the medium term; FTA is a long term vision**

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Measures to support FTA vision

Necessary condition for serious FTA dialogue:
- High level decision in CU to liberalise trade
- Strict implementation of decision

Arguments **for trade liberalisation** in CU:
- Objective of economic policy in CU should be:
  - Modernisation of economy in the near future
  - Not conservation of existing economic structures

How to **achieve** this objective?
- Only through a more liberal trade policy, incl. FTA with EU

→ **Modernisation requires a modern trade policy**

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4. Appendix

A1. What would happen if Ukraine joins the CU?

A2. Compatibility DCFTA & CU?

A3. Why no compatibility between CU membership & DCFTA?

A4. The case of Turkey as a member of the EU customs union

A5. Free trade with EU via CU membership?

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A1. Impact of Ukraine joining the CU?

Main implication:

- Huge **increase** in average import tariffs, from currently 2.7% (UA) to 9.4% (CU)

Impact on foreign trade*:

- Lower exports: - 4.6%
- Lower imports: - 4.3%

- Furthermore: WTO re-negotiations would be necessary
- Discontinuation of existing (non-CIS) FTAs necessary
- No new FTAs possible, including DCFTA with EU
- **Result:** Less diversified regional trade structure

Joining CU not in the economic interest of Ukraine

** Source: German Advisory Group Ukraine/IER Kiev*

A2. Compatibility DCFTA & CU?

Crucial: Separation of two issues

i. **Full compatibility** of DCFTA with existing trade regime

- DCFTA is fully compatible with existing FTAs between Ukraine and CU countries
- Thus: EU did not force Ukraine to decide for one side or the other

ii. **No compatibility** of hypothetical CU membership & DCFTA

- If Ukraine were to join the CU in the future, then it could not conclude any FTA (incl. DCFTA); only exception: FTAs with CIS countries
- Thus: Membership in CU and FTAs (incl. DCFTA) are not compatible with each other

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A3. Why no compatibility between CU membership & DCFTA?

In general: A customs union features common external import tariffs; thus, a member country cannot conclude a FTA with a third country; only the customs union can do this

Illustration with an example:

- DCFTA: Import tariff in UA for a certain EU good: 0%
- CU: Tariff in CU (incl. UA) for same EU good: 10%
- Possible: Company in UA imports EU good at 0% and resells it to RU at 0% (no certificates of origin needed in a customs union; key feature of a customs union)
- Result: 10% import tariff of CU circumvented
- RU companies could take legal actions

For legal reasons: Import tariffs have to be unambiguous; not the case if CU membership and DCFTA would coexist

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A4. The case of Turkey

But what about Turkey?

- Member of EU customs union since 1996
- At the same time: FTAs with third countries
- Are memberships in customs union and FTAs compatible after all?

Turkey: Very special case

- Turkey is obliged to adopt EU import tariffs, including new import tariffs resulting from bilateral EU FTAs
- Turkey can conclude FTAs with third countries which also have FTAs with the EU, but the import tariffs are given (not subject of negotiations)
- Thus: Turkey has practically no independent foreign trade policy; special case with no relevance for Ukraine

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A5. Free trade with EU via CU membership?

Idea:

- Ukraine joins the CU
- Later: CU concludes a FTA with EU
- Thus: Ukraine achieves free trade with both blocks by joining the CU

However: Timing is crucial

- DCFTAs between Ukraine and EU are imminent (2014)
- FTA between CU and EU only possible in the long term
- Thus: Not a realistic perspective for Ukraine

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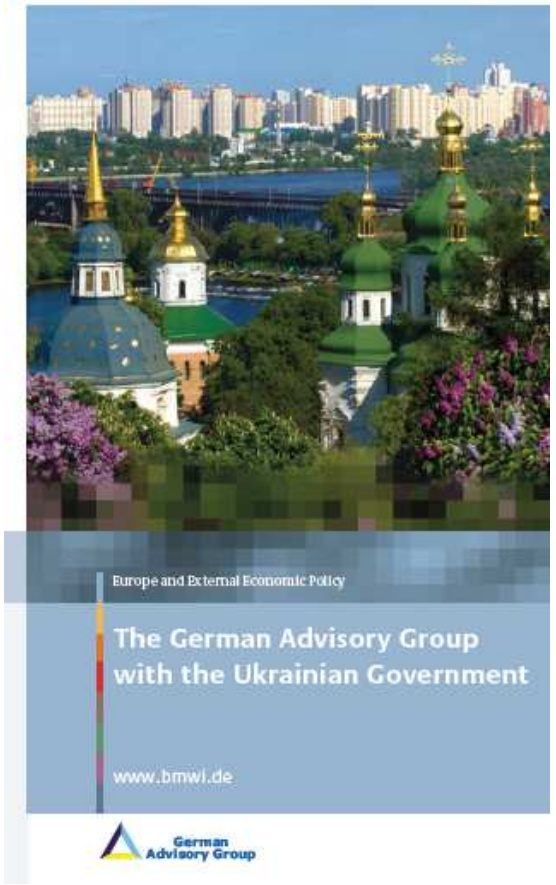
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