Ukraine between two regional integration blocks

Analysis and Recommendations

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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

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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

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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

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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 issued 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

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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

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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

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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

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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

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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

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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 constrains on reaching intermediate goals with other means

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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

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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

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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.

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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

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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?

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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

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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

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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

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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

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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

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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

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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

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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

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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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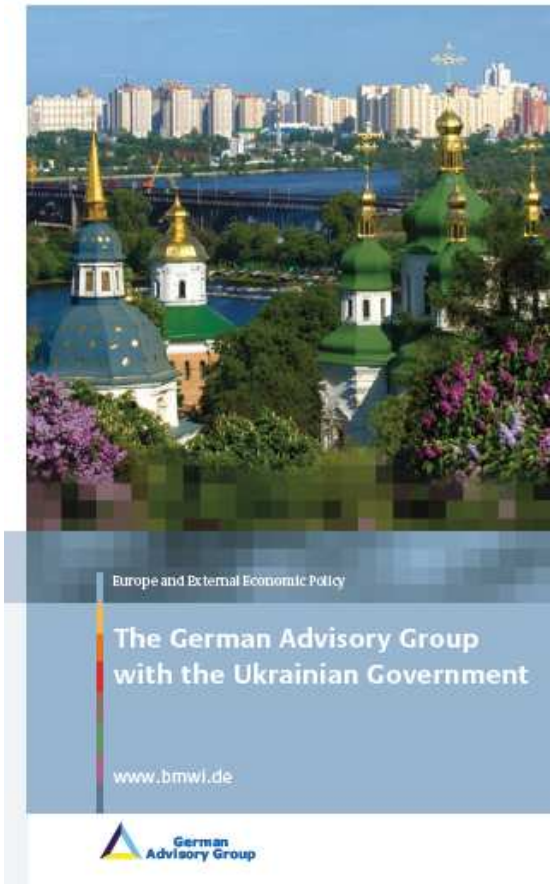
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