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Between East and West: Regional Trade Policy for Ukraine

Elena Besedina and Oleksandr Shepotylo,
Kyiv Economics Institute (KEI)
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Given Ukraine's geographical location between Europe and Russia, the country often has to make difficult choices in its foreign policy. Trade policy is not an exception. In particular, Ukraine is currently negotiating a comprehensive free trade agreement with the EU, which is fostering hopes of joining it in the near future. However, at the same time, Russia is 'inviting' Ukraine to join the Customs Union it has created together with two other former Soviet Republics; Belarus and Kazakhstan. Since Ukraine cannot be part of both regional agreements simultaneously, it will again have to choose between the EU and Russia.

Over the last decade the European Union has become the most important trading partner of Ukraine. The share of Ukraine's exports of goods to the EU is now around 25-30 percent, while its share in Ukraine's exports of services has increased twofold from 17 percent in 1994 to 34 percent in 2008. The share of Ukraine's imports from the EU is even larger: around 35 percent in goods and more than 50 percent in services. This growth in trade shares has occurred despite the fact that there are still substantial barriers, both tariff and non-tariff, to free trade between Ukraine and the EU. The Free Trade Agreement (FTA) which Ukraine and the EU are currently negotiating is intended to remove many of these barriers.

The EU-Ukraine FTA is part of the so-called New Enhanced Agreement between the EU and Ukraine and consists of a set of provisions stipulating the liberalization of trade in goods and services, capital movement and payments, and government procurement.

A big part of the agreement is devoted to the trade in goods. This is perhaps not surprisingly so given that trade in goods accounts for 80 percent of the their total bilateral trade in goods and services. Tariffs that Ukraine currently applies to the EU non-agricultural imports vary from 0 to around 20 percent. Under the new agreement, the tariffs on many of these goods will be reduced.

Apart from tariffs, the agreement stipulates an elimination of many non-tariff barriers to trade. This will be achieved by harmonization and simplification of the procedures related to customs and licensing, capital movement, government procurement, and intellectual property rights (IPR) protection, as well as competition policy, energy security and others. Ukrainian legislation must be standardized to conform to the respective European laws, with some procedures becoming more transparent (tenders), while others becoming more stringent (IPR). For example, Ukrainian producers will have to abide by the legislation on trademarks and geographical names. According to the Ukrainian deputy minister of Economy, the EU has offered a grace period of 5-10 years to Ukrainian producers to re-brand their products.

The FTA negotiation process between the EU and Ukraine started on February 18, 2008.

Since then, more than fifteen rounds have taken place. Initially, there were hopes that the agreement would be signed before the end of 2010. However, in the fall of 2010, it became clear that this was not going to happen. Currently, the more pessimistic experts expect the agreement to be signed only in 2013.

In parallel with the EU integration processes, Russia, Belarus and Kazakhstan have created a customs union and are actively trying to involve Ukraine in their union. On the one hand, the Customs Union is attractive for Ukraine since it offers free trade with Russia, which is still one of Ukraine's biggest trading partners, both in terms of imports and exports.

This union promises access to cheaper energy resources, which would be beneficial for Ukraine given its high energy dependence, especially in the exporting sectors like metals and chemicals. However, joining this Customs Union would jeopardize the FTA negotiations with the EU and would even endanger the WTO membership of Ukraine.

So far, the Ukrainian government has not taken a clear stance on whether Ukraine is going to become a full member of the Customs Union. Instead, it has cautiously offered a "3+1" arrangement.

In the light of the above discussion, the natural question to ask is then: what integration strategy would Ukraine benefit the most from?

Regional Trade Agreements

The idea that regional trade agreements (RTA) are beneficial to a country is best supported by the fact that such agreements have become increasingly popular over the last twenty years. As of July 31, 2010, there were around 400 RTAs reported to the WTO with 193 being in force. According to the World Bank, on average, a WTO member has regional agreements with more than 15 partner countries.[1] RTAs exist predominantly as free trade agreements (FTA) and customs unions (CU). The former removes barriers to trade in goods and services among member countries but allows individual members to set their own tariffs against third parties. The latter type is a stricter arrangement since customs unions act as a single agent in the world markets and has a unified external tariff regime.

The analysis of RTAs and customs unions in particular, dates back to Viner in 1950 who introduced the terms *trade creation* versus *trade diversion*.[2] Trade creation refers to a situation where member countries begin to trade goods and services with each other after the creation of an RTA, whereas previously they produced them domestically. Trade diversion, on the other hand, occurs when member countries shift their imports from outside partners to inside partners. Obviously, while trade creation is viewed as a good consequence of a RTA, trade diversion is undesirable. This, since the lower tariffs make member countries shift away from the most efficient outside producer to an RTA partner.

There are two approaches in the literature to evaluate the impact of the RTAs: gravity models and general equilibrium (GE) models. Gravity models are estimated on the actual trade data while GE models are used for simulations. The typical findings on the effect of RTA's are that: (*a*) excluded countries almost always lose, (*b*) there is a trade creation effect but it is rather small, and (*c*) the effect of the RTAs differs across their members, in particular, smaller countries tend to experience a larger increase in their exports (World Bank, 2005; Berthelon, 2004).

In addition, the so-called "South-North" RTAs (agreements between developed and developing countries), are found to be more beneficial for the latter than "South-South"

[1] "Regional Trade Agreements", World Bank Policy Research Working Paper No5314
[2] The Customs Union Issue, New York: The Carnegie Endowment for International Peace, 1950.

agreements. Finally, the literature shows that on average FTAs are associated with lower levels of tariffs compared to customs unions.

Ukraine's Choice of Trade Policy

The above presented empirical findings on existing RTAs, can offer guidance in which of the regional agreements Ukraine would benefit the most from. First, on the one hand, both of the the FTA with the EU and the Customs Union with Russia are likely to lead to higher trade volumes (trade creation). On the other hand, the FTA with the EU can be regarded as a *South-North* agreement and could therefore be expected to have larger benefits for Ukraine than the Customs Union with Russia. Another argument in favor of the EU-FTA, is that Ukraine's other trading partners are likely to face higher tariffs if Ukraine became a member of the Customs Union, than if she signed an FTA with the EU.

A recent study by Shepotylo (2010) addresses this issue and can be used as a benchmark for the analysis. Shepotylo uses a gravity model to compare potential export gains from deeper integration with the CIS countries to those from integration with the EU. Shepotylo's analysis evaluates whether integration would be trade creating or not, leaving aside the issue of trade diversion.

Based on past experiences of Eastern European and CIS countries, Shepotylo builds two thought experiments. The first one is based on the scenario in which Ukraine would have become more deeply integrated into the CIS structure. That is, the experiment allows us to see what would have happened to Ukrainian foreign trade over the period 2004-2007 if Ukraine had developed closer ties with the CIS countries. The second experiment envisages what would have happened if Ukraine would have joined the EU in 2004.

According to the results, Ukraine would have benefited under both integration scenarios relative to the current situation of no integration. However, the benefits would have been twice as high under the EU integration strategy. Shepotylo's results suggest that the EU integration could have increased Ukrainian exports in 2004-2007 by 10 percent, while the deeper CIS integration would only have increased exports by about 4 percent.

The highest expected benefits of Ukraine's integration into the EU would have come from a substantial increase in export of various types of machinery and equipment, road vehicles and transport equipment, as well as apparel and closing accessories. These gains would have been virtually uniformly positive and economically large across all groups of countries regardless of the membership in EU. For example, export of road vehicles to the CIS countries would have been 88 percent higher under the EU integration scenario than under the CIS integration scenario, while their exports to the Western Europe would have been 82 percent higher. The export of raw materials, on the other hand, would have either declined (nonferrous metals), or remained relatively stable (iron and steel).

More importantly, gains under the EU scenario would also have come from a more diversified trade structure. A higher export diversification would be achieved because of the rapid expansion of manufactured exports, the share of which in total export would have been 26 percent under the EU scenario and only 16 percent under the CIS scenario.

In our view, a diversification of trade flows is very important since a more diversified export structure with a high share of manufactured products can better protect a country from negative terms-of-trade shocks. For example, export diversification reduces the effect of idiosyncratic shocks. This was found by Koren and Tenreyro (2007). According to their findings, low-income countries which specialize in fewer and more volatile sectors, experience higher aggregate volatility in terms of GDP growth rates and trade volumes, etc.

Another reason to why a more diversified trade flow (i.e. moving away from exports of primary goods to exports of manufactured products) is desirable, is the general trend of declining prices of primary commodities relative to the prices of manufactured goods. Also, a diversified export structure with a higher share of technologically advanced products has been found to be conducive for higher economic growth (Hausmann et al., 2007).

Conclusion

The above analysis suggests that signing a deep FTA with the EU would benefit Ukraine the most. This, given that it is likely to lead to a substantial increase in total exports and a favorable change in export composition towards a more diversified structure with a higher share of technologically advanced goods. These developments could in turn lower macroeconomic volatility and boost economic growth. Also, the EU integration scenario considered by Shepotylo (2010) did not allow for a substantial liberalization of trade in agriculture – an area where the large EU market is most protected. If the Ukrainian government manages to negotiate more open trade in agriculture, Ukraine may potentially gain much more than predicted in Shepotylo's experiment.

On the other hand, joining the Customs Union with Russia would enhance the trade with its members and secure a lower price for energy resources. However, the benefits are likely to be outweighed by the potential losses of other markets and complications with the WTO due to the increased level of protectionism – an inevitable consequence of joining the Customs Union. In addition, the Ukrainian trade structure would become even more concentrated and skewed towards primary commodities, making the country even more vulnerable to shocks and slowing down its economic development.

Recommended Further Reading

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Elena Besedina

Kyiv Economics Institute (KEI)

lbesed@eerc.liev.ua

www.kei.org.ua/en

Elena Besedina is a Senior Economist at the Kyiv Economics Institute and an Assistant Professor at Kyiv School of Economics.. Besedina holds a Ph.D. in Economics from Bocconi University.

Her main research areas are international trade, political economics and development economics.

Oleksandr Shepotylo

Kyiv Economics Institute (KEI)

oshepotylo@kse.org.ua

www.kei.org.ua/en

Oleksandr Shepotylo is a Senior Economist at the Kyiv Economics Institute (KEI) and an Assistant Professor at Kyiv School of Economics. Shepotylo holds a Ph.D. in Economics from University of Maryland, College Park.

Shepotylo joined KEI in September 2006 as a Senior Economist. He has previously worked as a consultant at The World Bank's Development Research Group (DECRG) in 2003-2006.

His main research areas are econometrics, institutional economics, international macroeconomics, and international trade.