Between East and West: Regional Trade Policy for Ukraine

Elena Besedina and Oleksandr Shepotylo,
Kyiv Economics Institute of Economics (KEI)
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Given her geographical location, Ukraine often has to make difficult choices in its foreign policy. Currently Ukraine is negotiating a comprehensive free trade agreement with the EU fostering hopes of joining the Union in not very distant future. At the same time, Russia has been making a lot of attempts to move Ukraine back by 'inviting' to join the Customs Union created together with two other former Soviet Republics, Belarus and Kazakhstan. Ukraine cannot join both regional agreements so it will have to make a difficult choice again.

To date, Ukraine has free trade agreements in force with 14 countries, primarily former Soviet Union countries and is negotiating several others, including a deep and comprehensive FTA with the European Union.

Over the last years European Union became the most important trading partner of Ukraine. The share of EU in Ukrainian exports of goods fluctuated around 25-30 per cent, while share in exports of services increased twofold from 17% in 1994 to 34% in 2008. The share of EU imports in total imports is even larger: around 35% for goods and more than 50% in services. Despite growing trade volumes there are still different tariff and non-tariff barriers to free trade between Ukraine and the EU. The FTA with the EU is intended to remove many of these barriers.

The EU-Ukraine FTA is a part of the New Enhanced Agreement between EU and Ukraine and consists of a set of provisions stipulating liberalization in such areas as trade in goods and services, capital movement and payments, government procurement. Not surprisingly, a very big part of the agreement is devoted to the trade in goods which accounts for 80 per cent of total bilateral trade in goods and services between EU and Ukraine. Tariffs that Ukraine currently applies to the EU imports vary from 0 to around 20 per cent for non-agricultural imports. Under the new agreement the tariffs on many categories of these goods are expected to be reduced.

Apart from tariffs, Ukraine and EU are negotiating to eliminate non-tariff barriers to trade in the form of harmonization of the customs and licensing procedures toward their simplification and improvement. Other areas include capital movement, government procurement, intellectual property rights (IPR), competition, energy security and others. Ukraine has to harmonize its legislation in the above areas to adhere to the respective European laws, in some cases make procedures more transparent (tenders) or more stringent (IPR). For example, Ukrainian producers will need to follow legislation on trademarks and geographical names. According to the deputy minister of Economy, the EU has offered a grace period of 5-10 years for Ukrainian producers to re-brand their products to stop using trademarks and geographical names such as Champagne.

The FTA negotiation process between the EU and Ukraine started on February 18th 2008. Since then more than fifteen rounds occurred. There were hopes that the agreement will be signed before the end of 2010. However, it became clear at the beginning of the fall of 2010 that it was not going to happen. Current voices talk about the end of 2011, which at this stage seems again to be unrealistic and the most pessimistic expect the agreement to be signed in 2013 only.

In parallel with the EU integration processes, Russia, Belarus and Kazakhstan are creating a customs union and are actively trying to involve Ukraine in the union. On the one hand, the Customs Union may be attractive for Ukraine since it offers free trade within the union and Russia is still one of the biggest trading partners for Ukraine both in terms of imports and exports. It also provides access to cheaper energy resources, which could be also beneficial for Ukraine given its high energy dependence, especially in the exporting sectors like metals and chemicals. However, due to more protectionist policies of this union, joining the Customs Union would jeopardize the FTA negotiations with the EU and put a question mark on the WTO membership of Ukraine, in general. So far, Ukrainian government has not taken a clear stance on whether Ukraine is going to become a full member of the Union but rather the government cautiously counteroffers a "3+1" arrangement. In the light of the above discussion, the natural question to ask will be what integration strategy would benefit Ukraine more?

First, we discuss the regional trade agreements in general and then focus our attention on Ukraine's choice between the two specific agreements.

Regional Trade Agreements

Regional trade agreements (RTA) have become increasingly popular over the last twenty years. As of July 31 2010, there were around 400 RTAs notified to the WTO (both on goods and services), out of these agreements 193 were in force. According to the World Bank, on average a WTO member has regional agreements with more than 15 partner countries.[1] RTAs come predominantly as free trade agreements (FTA) and customs unions (CU). The former type removes trade barriers to goods and services but allows individual members to set their own tariffs against third parties. The latter type stipulates for more bounded arrangements since customs unions act as a single agent in the world markets, hence it has unified tariffs regime for non-members.

The analysis of customs unions dates back to Viner in 1950 who introduced the terms "trade creation" versus "trade diversion." [2] ***Trade creation*** refers to a situation where two countries within the customs union begin to trade with each other, whereas formerly they produced the good in question for themselves. ***Trade diversion***, on the other hand, occurs when two countries begin to trade within the union, but one of these countries had formerly imported the good from *outside* the union. Obviously, while trade creation is viewed as a good consequence of the RTA, trade diversion creates inefficiency since country shifts away from the most efficient producer to an RTA partner.

There are primarily two approaches used in the literature to evaluate the impact of the RTAs: gravity model and simulations of the general equilibrium models. Research on the effect of RTA's find that (a) excluded countries almost always lose, (b) trade creation effect is present but small, and (c) the effect of the RTAs differ across their members: smaller countries seem to experience increase in exports to a larger extent (World Bank, 2005; Berthelon, 2004). The above results are connected to another

[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.

finding that regional trade agreements between developed and developing countries (South-North) are found to be more beneficial for developing countries than South-South agreements. The impact of RTAs on the level of tariff varies across agreements: on average FTAs are associated with lower levels of tariffs compared to the customs unions.

Ukraine's Choice of Trade Policy

Gravity model is widely used for trade policy analysis and it is applicable in this case. In a recent study Shepotylo (2010) compares potential export gains from deeper integration with the CIS countries to the potential export gains from the EU integration. Shepotylo's analysis evaluates whether Ukraine's integration will be trade creating or not without considering the issue of the trade diversion. Based on the experience of the CIS and Eastern European countries, he builds two thought experiments. The first experiment considers a scenario, in which Ukraine would have been more deeply integrated into the CIS structures. 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 considers a scenario, in which Ukraine had 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 higher under the EU integration strategy. The benefits of the EU integration relative to the CIS integration are twofold. First, the EU integration would have increased exports in 2004-2007 by 10 percent, while the deeper CIS integration would have increased exports by 4 percent. More importantly, gains under the EU scenario would have come from more diversified trade structure. The higher export diversification is achieved because of the rapid expansion of manufactured exports – the share of manufactured goods in total exports would have been 26 percent under the EU scenario and only 16 percent under the CIS scenario.

The highest expected benefits of the Ukraine integrating into the EU would have come from a substantial increase in exports of various types of machinery and equipment, road vehicles and transport equipment, and apparel and closing accessories. These gains would have been virtually uniformly positive and economically large across all groups of countries. As an example, exports 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 exports to the Western Europe would have been 82 percent higher. The export of raw materials, on the other hand, would have either declined as, for example, export of nonferrous metals or remained relatively stable as export of iron and steel. This would help to make Ukrainian exports more diversified.

In general, a country with more diversified exports with high share of manufactured products is better protected from negative terms of trade shocks. Koren and Tenreyro (2007) find that low-income countries specialize in fewer and more volatile sectors, which in turn leads to higher aggregate volatility. There are several mechanisms in play. First, export diversification reduces the effect of an idiosyncratic shock for purely statistical reason. Collapse in the world price of metals in the second half of 2008, would not have been so disastrous for the Ukrainian economy, if its export had not been dominated by metal products. Second, moving away from exporting primary commodities towards exporting manufactured products is desirable because of a general trend towards a decline in prices for primary commodities relative to prices of the manufactured goods. Third, Hausmann et al. (2007) link a higher share of high-quality exports with higher future growth.

Conclusion

The above analysis suggests that signing of the deep FTA though not quite the same as joining the EU would benefit Ukraine by changing exports composition towards more diversified structure with higher share of the technologically advanced goods.

The EU integration scenario considered by Shepotylo (2010) does not allow for substantial liberalization of trade in agriculture -- an area where the large EU markets are the most protected even against the new EU members. If Ukrainian government manages to negotiate more open trade in agriculture relative to the EU integration scenario, Ukraine may potentially gain much more than predicted in the experiment.

On the other hand, joining the Customs Union would boost the trade with the Union members and secure lower price for energy resources. However, the benefits will 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 the joining the Union. In addition the Ukrainian trade structure will become even more concentrated and skewed towards of low value added exports.

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Recommended Further Reading

Berthelon, Matias (2004) "Growth Effects of Regional Integration Agreements", Working Papers Central Bank of Chile No 278.

Freund, Caroline and Emanuel Ornelas (2010) "Regional Trade Agreements", *World Bank Policy Research Working Paper No. 5314.*

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Hausmann, Ricardo, Hwang, Jason, Rodrik, Dani (2007) "What You Export Matters", *Journal of Economic Growth* 12, No. 1, 1-25.

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