

# Trade Policy Uncertainty and External Trade: Potential Gains of Ukraine Joining the CU vs. the Signing Free Trade Agreement with the EU

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*This policy brief summarizes the results of recent research which predicts gains in Ukrainian exports from signing a deep and comprehensive free trade agreement with EU, and compares these gains with predicted gains from joining the Customs Union of Belarus, Kazakhstan, and Russia. We argue that the gains would be mostly due to elimination of uncertainty in trade policy of Ukraine with the CU and the EU countries. We find that European integration brings higher potential for export growth, and that it also shifts the structure of Ukrainian exports towards capital goods, reducing the share of raw materials in total export.*

## Trade Policy Uncertainty and Export

Trade policy uncertainty (TPU) is a powerful negative factor that prevents economy from the realization of its export potential. In a recent paper, Handley and Limao (2012) argue that since the exporting decision involves substantial fixed costs, TPU significantly affects investment and entry decisions in international trade. In particular, they show that preferential trade agreements (PTAs) are important even when the pre-PTA tariff barriers are low. Comparing pre- and post-EU accession patterns of Portuguese exports, they find that Portuguese trade increased dramatically after 1985. The increase was the largest towards the EU partners, suggesting that it was caused by the accession. Export expanded through

considerable entry of Portuguese firms into EU markets, even in industries where applied tariffs did not change. Handley and Limao estimated that the tariff reduction, which averaged 0.66 percentage points, has been responsible for only 20 percent of the increase in exports to EU10 after the EU accession, while 80 percent of the increase was due to resolving TPU.

Handley and Limao further argue that the Portuguese example should be highly relevant for any small open economy, facing important trade policy choices. In this regard, Ukraine is facing a very hard choice of selecting its regional integration strategy – towards the EU or the Customs Union (CU) with Belarus, Kazakhstan and Russia, resulting in severe TPU. The options are mutually exclusive since the CU trade policy is not compatible with neither the WTO commitments of Ukraine, or with the parameters of the deep and

comprehensive free trade agreement (FTA) between Ukraine and the EU, finalized in 2012. Average tariff protection within the CU in 2012 was 10 percent (Shepotylo and Tarr, 2012), while the average WTO binding tariff rates in Ukraine were only 5 percent; the parameters of the FTA with the EU are even less protective, which would cause even stronger disagreements regarding the tariff schedules. Moreover, technical and phytosanitary standards in the EU and the CU are different; therefore, it would be extremely hard to harmonize the Ukrainian standards with both of them.

Despite low tariff protection, uncertainty on the parameters of the long run trade policy of Ukraine with the CU and EU countries is extremely high. It is crucial for both foreign and domestic investors to understand in what direction the regional integration will proceed before making decisions on investing or exporting, since these decisions can incur substantial sunk costs. Suppose that a large European multinational firm were interested in including Ukrainian companies in its production chains only if Ukraine signs the FTA with the EU (integrate vertically). If Ukraine instead joined the CU, this presumed European company would rather be interested in horizontal integration and invest by building a plant for final assembly of products to serve the Ukrainian and CIS markets. For Russian companies the situation would be the reversed. They would be interested to integrate vertically if Ukraine is a member of the CU and integrate horizontally if Ukraine signed FTA with EU. However, since vertical and horizontal integration are quite different strategies, neither European nor Russian companies invest in Ukraine before the uncertainty is resolved. The same holds true for domestic companies which would like to extend their export activities to new

markets. Since entrance to new markets is costly and requires some irreversible investment, it is optimal to wait until the policy uncertainty is resolved.

## Modeling Trade Policy Options of Ukraine

In Shepotylo (2013), we investigate which integration scenario is more preferable for Ukraine under the assumption that TPU is fully resolved and Ukraine trades up to its potential. Based on export data in 2001-2011, we estimate the gravity model by Helpman, Melitz, and Rubinstein (2008) method, adjusted for panel data case and endogeneity of a decision to sign a PTA. Using this model, we predict bilateral exports of Ukraine under three counterfactual scenarios: a) Ukraine joined the Customs Union in 2009 (CU); b) Ukraine signed the FTA with the EU in 2009 (EU FTA); c) Ukraine joined the EU in 2009 (EU). The model predictions take into account the level of economic development, geographical location, industrial structure, and quality of government and regulatory agencies. It also accounts for macro trends, including the global trade collapse of 2008-2009.

The results are not intended for a short-term forecast, but should be rather used as indicators of the long-run effects. Their interpretation is as follows. Suppose that Ukraine has signed the FTA with the EU in 2009. Taking into account all observable characteristics of Ukraine, what would be the level of Ukrainian export of product  $k$  to country  $j$ , if Ukraine, in all other respects, would behave as a typical country-member of the FTA EU? That would involve removal of the trade policy uncertainty, stronger integration of domestic companies into the global supply chains, and increase in foreign direct investments from the EU countries.

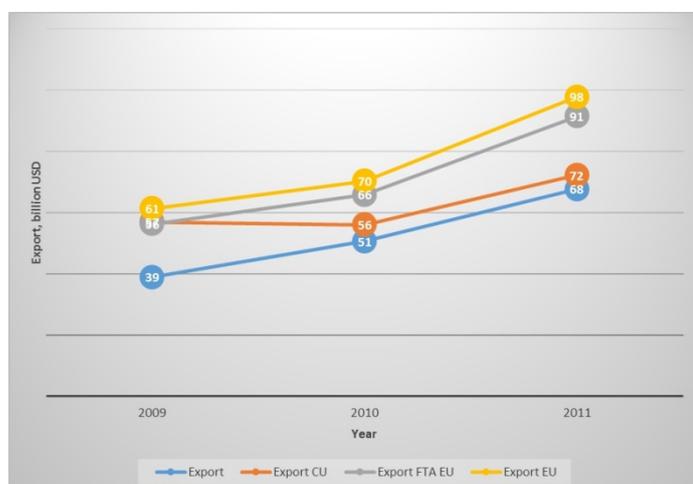
Unlike the studies based on the Computable General Equilibrium (CGE) method, which

assumes that the policy choice affects the economy only marginally through reduced tariff barriers, and that the underlying economic structure and expectations of the economic agents remain intact, the gravity model captures all changes that occur in the economy over the investigated period and extract the differences in export flows between any two counterfactual scenarios, given all background economic changes.

## Results

Our main results are as follows. First, the actual exports of Ukraine are far below their potential, compared with performance of both the CU countries and the FTA EU countries. The expected long run gains in Ukrainian exports to all countries under the CU scenario are equal to 17.9 percent above the export level in 2009-2011. The corresponding number for the FTA EU scenario is 36 percent, and for the full EU scenario, 46.1 percent. Based on 2011, the export of Ukraine would have been 98 billion US dollars under the EU scenario, 91 billion US dollars under the FTA EU scenario, and 72 billion US dollars under the CU scenario. All these numbers should be compared with the actual 68 billion US dollars of Ukrainian export in 2011.

*Figure 1. Ukrainian Export under the Different Scenarios*



Second, any scenario predicts that Ukraine severely underperforms in its trade with both CIS and EU countries, while its export to the rest of the world is in line with the predictions of the model. These results are consistent with the theory that unresolved TPU in relationships with the CIS and EU countries severely hurts the Ukrainian export potential to these countries.

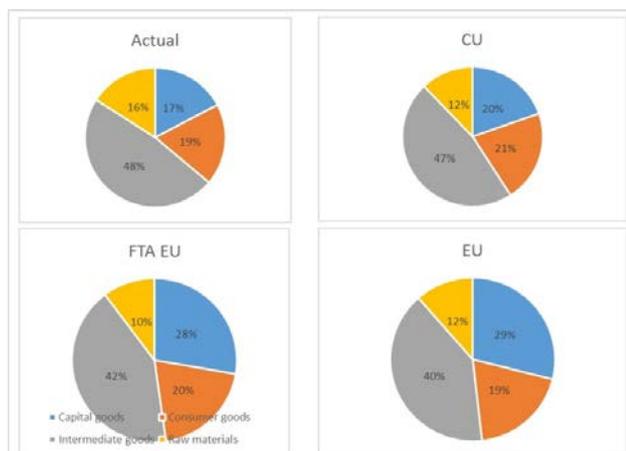
*Table 1. Ukrainian Export under the Different Scenarios*

Region/country	CU, % over actual exports	FTA, EU% over actual exports	EU, % over actual exports
CIS	40.9	79.4	89.5
EU12	31.7	45.5	62.1
EU15	19.2	26.9	43.7
RoW	-8.6	-5.9	0.3
<b>Total</b>	<b>17.9</b>	<b>36</b>	<b>46.1</b>

*Note:* CIS – Commonwealth of Independent States; EU12 – countries that joined EU after 2003; EU15 – countries that joined EU before 2004; RoW – rest of the World

Third, CU integration would be more beneficial for the Ukrainian agriculture and food industry, while FTA EU or full EU integration would be more beneficial for textiles, metals, machinery and electrical goods, and transportation. Conditional on not worsening its market access to Russia, Ukraine would expand its trade in these sectors to all countries, including Russia and other members of CU.

**Figure 2. Expected Increase of Ukrainian Export under the Different Scenarios**



Finally, the CU integration would lead to a small increase in the share of capital goods from 17 percent to 20 percent of total exports. FTA EU would increase the share of capital goods to 28 percent, while full EU integration would increase it to 29 percent. In all scenarios, the share of raw materials would decline from 16 percent to 10-12 percent. The share of intermediate goods would decline from 48 percent to around 40 percent under the two EU scenarios and would only marginally decrease under the CU scenario. The share of consumer goods would remain stable around 20 percent.

## Conclusions

Ukraine would be better off by signing a deep and comprehensive trade agreement with the EU and integrate into its production chains than joining the CU. Right now, Ukraine severely underperforms by exporting far below its potential. Evidence shows that high trade policy uncertainty plays a large role in Ukraine's poor performance, since the gap between actual and potential exports are mainly due to low levels of export to the EU and CIS countries. Moreover, Ukraine should be interested in moving the integration process even further, because EU accession would bring even better results.

## References

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