

Free trade with “East and West”: It can be done after all!

The recent public discussion has led to the impression that Ukraine could not, at the same time, have free trade with the EU and the Russian-led Customs Union. What is more, by offering Ukraine a free trade agreement (“DCFTA”), the EU has allegedly forced the country into an “either – or” decision, which contributed to the current crisis.

This impression is plainly wrong. Ukraine can very well conduct free trade with both sides through an optimal use of free trade agreements. Since such agreements concern only bilateral trade relations, they can be perfectly combined with existing and any future free trade agreements with third countries.

Indeed, Ukraine already has free trade agreements in place with the Customs Union’s member countries. Thus, once the DCFTA with the EU will be signed later this year, Ukraine would achieve such economically optimal combination of free trade arrangements with the “East and West”.

Clearly, a pre-condition for this optimal scenario to unfold is for Russia / the Customs Union to stick to its existing free trade agreement with Ukraine. Indeed, from an economic perspective there would be no reason for discontinuing the existing agreement. As such, both Ukraine and the EU should convince Russia of the mutual benefits of this optimal arrangement, so it can be realised as soon as possible.

Ukraine – a trading nation

With its economy featuring a high degree of openness, Ukraine can be rightly called a trading nation. Indeed, the sum of imports and exports was a remarkable 87% in 2012 – high in international comparison.

Exports, Imports and degree of openness, 2012

	Exports (% GDP)	Imports (% GDP)	Openness (% GDP)
Ukraine	39.0	48.0	87.0
Georgia	15.0	49.5	64.5
Moldova	29.8	71.9	101.7
Russia	25.8	15.6	41.4
Germany	41.3	34.2	75.5

Source: IMF, International Trade Centre

Not only does Ukraine trade intensively, the country’s regional trade structure is also rather diversified as the European Union, the Customs Union (consist-

ing of Belarus, Kazakhstan and the Russian Federation) as well as third countries all account for significant export market shares.

Ukraine’s regional export structure, 2013

	Share of total exports, in %
EU	26.5
Customs Union	30.3
of which Russia	23.8
Others	43.2

Source: State Statistics Service of Ukraine

Thus, Ukraine is an open economy with a diversified trade structure – two rather positive aspects of the country’s economy. It is important to note that this is the result of a – by and large – sensible trade policy. Ukraine joined the WTO in 2008 (four years earlier than Russia) and with an average of 2.7% its import tariffs are rather low (in comparison, Russia / Customs Union have an average import tariff of 9.4%).

Strategic goal of trade policy

The goal of Ukraine’s trade policy should be to maintain and extend the openness of the economy as well as a diversified trade structure – both of which have served the country well in the past. Specifically, Ukraine should aim to further intensify trade with its two main trading partners – the Customs Union and the EU.

How can this be done and is it at all feasible for Ukraine to intensify trade with both regional trading blocs? If the public discussion is anything to go by, the common answer to those questions should be ‘No’. Instead, so the discussion seems to suggest, Ukraine must decide for one side or the other – either more trade with the “East” or intensify trade with the “West”.

However, this common notion is wrong. Ukraine can very well intensify trade relations with both its main trading partners making use of the instrument of free trade agreements. Indeed, as free trade agreements are purely bilateral, they do not affect trade relations with third countries. Consider for example Chile: The country has signed altogether 17 free trade agreements without ever running into problems with existing partners. Such a use of free trade agreements should thus be the basis of Ukraine’s trade policy.

Perspective for implementation

A free trade agreement between Ukraine and the Customs Union’s countries is already in place as part

of a CIS multilateral agreement concluded in 2011. Thus, there already has been free trade in goods with one of Ukraine's two main trading blocs.

What is more, Ukraine has also initiated a free trade agreement with the EU (the so-called DCFTA), which is meant to be signed later this year. So once Ukraine signs this agreement, it will achieve an optimal combination of free trade agreements, which would ensure intensive economic relations with both partners.

The biggest challenge, however, for realising such a reasonable trade policy, would be a cancellation of the existing free trade agreement by Russia or the Customs Union. While there are no technical grounds for doing so - as both contracts would be fully compatible - Russia may still discontinue this agreement.

So what is next?

It would be in the very interest of Ukraine to continue its optimal trade policy of ensuring parallel free trade agreements with the Customs Union and the European Union. To do so it is necessary to seek a dialogue with Russia on how to avoid a discontinuation of the existing free trade agreement between Ukraine and the Customs Union's countries. The EU should support Ukraine in this important task.

Parallel membership in the Customs Union and DCFTA with the EU? Neither desirable nor legally possible

It makes no sense to search for a "magic formula" that creates "compatibility" between a membership of Ukraine in the Customs Union and the conclusion of a DCFTA with the EU. First, a hypothetical membership in the Customs Union is clearly not in the economic interest of Ukraine. Indeed, joining the Customs Union would mark the end of Ukraine's liberal trade policy and force it to adopt the protectionist stance of the Customs Union. This would see Ukraine's average import tariffs rising from currently 2.7% to the Customs Union's 9.4%. Ukraine would also have to cancel existing free trade agreements, renegotiate with WTO members and would not be able to conclude free trade agreements on its own anymore. Both the openness of the economy and its hitherto regionally diversified trade structure would come to an end - so would the positive economic benefits connected to those positive features.

Second, it is legally not possible to combine a membership in a Customs Union with own free trade agreements. Indeed, this is not just the case for Ukraine, but for all countries who are members in a customs union. Germany for example, as a member of the EU (which is also a customs union), cannot conclude any independent free trade agreement, say

with the US. Only the EU, but not its individual members, can conclude such an agreement.

Conclusions

Ukraine would be very well able to intensify economic relations with both trading blocs - EU and Customs Union - based on free trade agreements. Indeed, neither trade law would require any "either - or" decision, nor has the EU ever asked Ukraine to decide to intensify trade with one side or the other.

As such, the optimal use of parallel free trade agreements with the EU and the Customs Union should be the only declared goal of Ukraine's trade policy - especially in its dialogue with the Russian Federation. The EU should also unreservedly subscribe to this goal.

The search for a combination which would allow Ukraine to become a member of the Customs Union as well as concluding a DCFTA with the EU is a waste of time. Not only is such an exercise not in the economic interest of Ukraine, it also distracts attention from the important economic challenges that need be addressed right now.

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It can be downloaded at www.berlin-economics.com

German Advisory Group

The German Advisory Group on Economic Reforms, which is active in Ukraine since 1994, advises the Ukrainian Government on a wide range of economic policy issues and on financial sector development. The group is financed by the German Federal Ministry of Economics and Energy under the TRANSFORM programme and its successor.

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