



Trading with Moscow: the law, the politics and the economics

by Iana Dreyer and Nicu Popescu

On 12 September, a purportedly technical meeting between Ukrainian, EU and Russian trade officials produced an outcome which took many by surprise: a delay in the application of the free trade provisions of the Association Agreement until 1 January 2016.

In the run-up to the meeting, organised to address Russian commercial concerns over the Deep and Comprehensive Free Trade Area (DCFTA) between the EU and Ukraine, Russia's demands were leaked. Moscow was demanding that around 2300 tariff lines in the DCFTA be exempted from customs duty elimination. These lines covered a wide range of goods, but the main focus was on agricultural and industrial products, textiles, and machine tools.

Russia also sought to ensure that the DCFTA's stipulation that Soviet-era technical standards (GOST) be phased out would not be implemented and that both EU and GOST standards would coexist in Ukraine. Finally, Moscow insisted Ukrainian institutions do not become members of EU standardisation bodies, and that Ukraine abandon the plan to align its sanitary and phytosanitary standards (SPS) to those of the EU.

But hopes that the decision taken on 12 September would appease Russia and leave time to discuss

concrete trade issues – the official rationale for the move – were quickly dashed. As soon as the agreement on the postponement of DCFTA was reached, Russia pressed further, demanding a wholesale renegotiation of DCFTA provisions, and then the postponement of the entire Association Agreement.

President Putin sent a letter to then European Commission President Barroso on 17 September 2014 asking for 'systemic adjustments of the Association Agreement, which take into account the full range of risks to Russian-Ukrainian economic ties and to the entire Russian economy arising from implementation of the agreement'.

The Russian president also hinted that the provisions of the DCFTA stipulating that Ukraine would introduce EU technical and sanitary standards is in breach of Russia's own free trade agreement (FTA) with the country. A week later, Putin warned Ukraine's President Petro Poroshenko that Kiev was expected not to apply lower tariffs for EU goods and not to implement any EU legislation as foreseen by the Association Agreement. Failure to comply would have led Russia to suspend its trade preferences with Ukraine.

Yet, while many in Europe bought the Russian argument that it has legitimate concerns over the



deal, the figures do not substantiate the claim that DCFTA would have a significant impact on Russia's economic interests.

Deconstructing the arguments

Since the onset of the current crisis, Russia has repeatedly suggested that the EU-Ukraine Association Agreement will negatively affect its economy. It argued that, as a result of the association, European goods could be relabelled as Ukrainian and then re-exported to the Russian market under the FTA of the Commonwealth of Independent States (CIS).

This argument does not hold up under scrutiny. All FTAs, including those of the CIS, include so-called 'rules of origin'. These aim to avoid precisely what Moscow fears, namely trade deflection, or re-export. They also fix a minimum share of national production for a product to qualify for duty-free treatment under an FTA, and exporters from a signatory country must prove the origin of the product at customs.

The risk of potential re-export of EU goods to Russia via Ukraine should normally be policed according to international trade norms. Currently, Belarus – a country with which the EU has no Association Agreement – is believed to re-export European goods to Russia. However, this is only possible because Russia tolerates it, not because anyone thinks Norwegian salmon or Belgian muskels are really 'made in Belarus'.

Russia also claims that if Ukraine implements EU standards in accordance with the DCFTA, Russian goods would face new barriers when being exported to Ukraine. This argument has some merit, but needs to be analysed in greater detail. The EU's DCFTA stipulates that Ukraine is to progressively introduce EU technical regulations and to phase out the uncompetitive GOST standards, although it only specifies 27 EU product directives which need to be integrated into Ukrainian law within a fixed timeframe of three to five years.

Over time, presumably, Russian industrial products could not be sold on the Ukrainian domestic market if they fail to comply with the new EU-inspired standards. Nothing, however, would forbid

Ukrainian industry from continuing to produce for the Russian market according to Russian (and partly GOST) standards – nor would the implementation of EU standards by Ukraine prevent it from importing the relevant industrial inputs from Russia. This point is important as Russia and Ukraine – at least until the recent trade spats – have maintained integrated industrial supply chains in the aircraft, armaments and railway sectors. Similar arguments can be made about the DCFTA requirement that Ukraine incrementally apply the EU's SPS.

Will Russia suffer a major hit if Ukraine adopts EU standards? Not likely. While Ukraine is not an insignificant market for Russia – absorbing around 5% of its total exports – there is an important twist. Russia's entire exports to Ukraine in 2013 amounted to \$23 billion, two-thirds of which were energy resources (among them, gas worth \$10.8 billion, petroleum oils worth \$1.9 billion, and coal worth \$1.3 billion) and nuclear equipment (\$604 million). All these goods are largely unaffected by the DCFTA, as the EU-Ukraine agreement contains no barriers related to the importing of fossil fuels, nor are nuclear equipment standards specified in the deal.

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A further Russian claim is that the CIS FTA and the DCFTA are legally incompatible. This is simply false. FTAs leave contracting parties the freedom to shape trade relations with their other partners as they see fit, given that 'rules of origin' for imports are

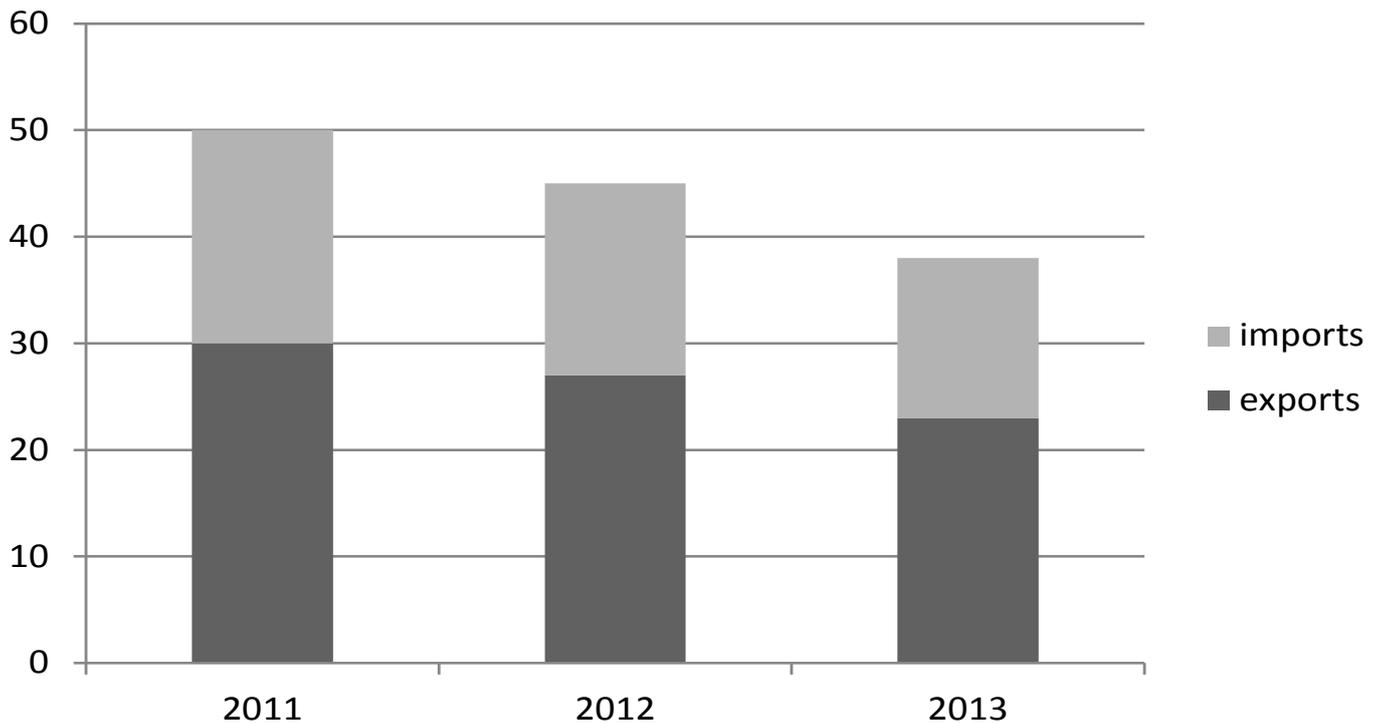
notably designed to avoid trade deflection. This is why many – if not most – countries in the world have multiple FTAs.

There are no legal provisions in the CIS FTA that prevent Ukraine from creating other free trade areas, including one with the EU. Article 18 §1 of the 2011 CIS FTA explicitly states that 'the current treaty does not preclude participating states from taking part in customs unions, free trade or arrangements for frontier traffic that correspond to WTO rules'.

For its part, Article 39 of the EU-Ukraine Association Agreement stipulates that 'this agreement shall not preclude the maintenance or establishment of customs unions, free trade areas or arrangements for frontier traffic except insofar as they conflict with trade arrangements provided for in this agreement.'



Russian imports/exports to Ukraine (\$ billion)



Source: Statistical department of the Eurasian Economic Commission

What is incompatible with other national trade arrangements, however, is the Eurasian Customs Union. Membership in a customs union – which is what Russia originally demanded from Ukraine – makes it technically impossible for any one of its members to enter into autonomous trade deals with third countries. But Ukraine is not a member of the Eurasian Customs Union, and even under pro-Russian President Yanukovich it systematically refused invitations to join the grouping.

Who's to blame?

Last but not least, Russian complaints that the DCFTA would damage Russian-Ukrainian economic relations ignores the fact that bilateral trade has been in free fall since well before Autumn 2013, when the EU-Ukraine Association Agreement was supposed to be signed. This drop in trade was mostly due to Moscow's own policy choices and the bleak economic outlooks for both countries.

Since 2011, the entering into force of the Eurasian Customs Union between Russia, Belarus and Kazakhstan has meant tighter customs controls with neighbouring CIS countries that did not sign up. In 2012, data from Russia's statistical agency (Rosstat) shows that Russian imports from Ukraine decreased by 10.7%, a reduction that is clearly attributable to these restrictions and *not* to other

factors like the economic growth cycle (which was positive that year).

In the summer of 2013, Russia orchestrated a full-blown trade blockade on Ukrainian exports – a clear violation of CIS FTA rules and of international norms of behaviour related to international trade – in a move aimed at deterring Kiev from signing the association deal with the EU.

This year, Russia introduced import bans on Ukrainian dairy products and potatoes, and then began restricting imports of Ukrainian railway equipment. Russia has also reneged on an international treaty ensuring free transit of goods, the so-called TIR convention, despite the fact that this constitutes a key principle of the CIS FTA it signed with Ukraine.

Moscow's actions have had a clear negative impact on trade across the long border between the countries. The numbers are clear: Russian trade volumes with Ukraine have fallen from \$50 billion to \$38 billion in just two years (2011-2013) – and 2014 is likely to witness an even more dramatic fall.

From Association postponement...

The problem with a one-year postponement of the Association Agreement does not lie with the delay



as such. The DCFTA's implementation process is designed to last for several years, with its terms leaving Ukraine time and leeway to adopt the selection of rules it prescribes. Meanwhile, the EU has *unilaterally* applied its own tariff concessions as enshrined in the DCFTA since March this year, and will continue to do so until late December 2015. With Kiev being given this breathing space to protect its weaker industries, its exports to the EU have already surged, increasing by 25% in May-June this year.

The fundamental concern is that one year can easily turn into two, or perhaps more. As long as the agreement is not unequivocally applied, there is a risk of creating incentives for Russia – as well as for Ukrainian protectionist interests – to continue efforts to disrupt the process and, possibly, undermine the outcome.

What is more, the deal's greatest economic benefits will not stem from Europe's elimination of tariffs, but rather from Ukraine's own tariff cuts, and in particular from the economic reforms agreed in the text. Only Ukraine's domestic initiatives – as stipulated in the DCFTA – will start the much-needed modernisation process of the country's economy and attract the investment required to cater for European and global industrial value chains and consumer markets.

Still, the postponement is to be understood as a quintessentially political move aimed at trying to stabilise Ukraine. The year prior to the planned application of the Association Agreement, however, could be put to wiser use than for the ping-pong-like exchange of arguments and jibes over trade that has emerged lately in the 'trialogue' between Moscow, Brussels and Kiev.

...to extended dialogue

The EU Association Agreements with Ukraine, Georgia and Moldova are not the only initiatives which will change regional economic realities. The Eurasian Economic Union – the Moscow-sponsored economic integration project building on the current customs union with Kazakhstan and Belarus – will do so, too. Provisions of the Eurasian Economic Union treaty signed in May 2014 will no doubt impact European (and other) businesses operating in the signatory member states.

What is more, Armenia, and Kyrgyzstan – two WTO members currently in line to join the Eurasian Union – would need to raise tariffs as a result of their inclusion. Discussions have already begun

at the WTO over the possibility of third parties – including the EU – seeking compensation for any tariff increases affecting their exports, part of a standard procedure foreseen by the laws of the world trade body. It would therefore be prudent for the EU to assess its own position regarding the economic impact of the Eurasian Union and conduct negotiations as part of the same 'package' as those concerning its Association Agreement with Ukraine. The same applies for Ukraine, Moldova and Georgia.

If Russia has objections and the EU listens, it is only logical for Russia also to listen to concerns expressed by the EU. Thus, the current trilateral EU-Russia-Ukraine format might well be turned into a slightly wider one in which the EU, Ukraine, Georgia, Moldova, as well as the members of the Eurasian Union can all discuss each other's economic concerns, as well as ways to avoid new trade barriers from being erected across the Eurasian landmass.

These broader talks could form the basis of attempts to limit and mitigate potential trade disruptions which result from the two sets of arrangements. In the meantime, the Association Agreements and the Eurasian Economic Union could proceed as planned – and perhaps be reviewed at a later stage as part of a grand (trade) bargain.

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