ANALYSIS

ISPI

Analysis No. 241, April 2014

THE EASTERN PARTNERSHIP AND THE CUSTOMS UNION: A CRITICAL ASSESSMENT

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The countries of the Eastern Partnership, including Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine, can get significant economic gains from international cooperation, either in the form of the EU's Association Agreements, or the Russia-led Customs Union. But since the terms and conditions of the EU Agreements and the Customs Union are not compatible, there could be no gains from joining either alliance without some imminent losses. Moreover, solutions, which work for one country, may not work for others, as their preconditions vary. Economic effects from joining either union matter for the Eastern Partnership countries not less than any mere political reasons. While choosing a side, each country has to take into account a bunch of domestic factors and anticipate all potential consequences, concerning international trade, foreign investment, and energy policy.

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The problem is, however, that the terms and conditions of the EU Agreements and the EurAsEC Customs Union are not compatible; hence, there could be no gains from joining any alliance without some imminent losses. Yet, the incapacity to make a decision soon and to spur on economic recovery can be even more dangerous for any country in question. It is no longer possible for the Eastern European and South Caucasian countries to have a foot in both camps; nor is it possible for them to hold off choosing a side.

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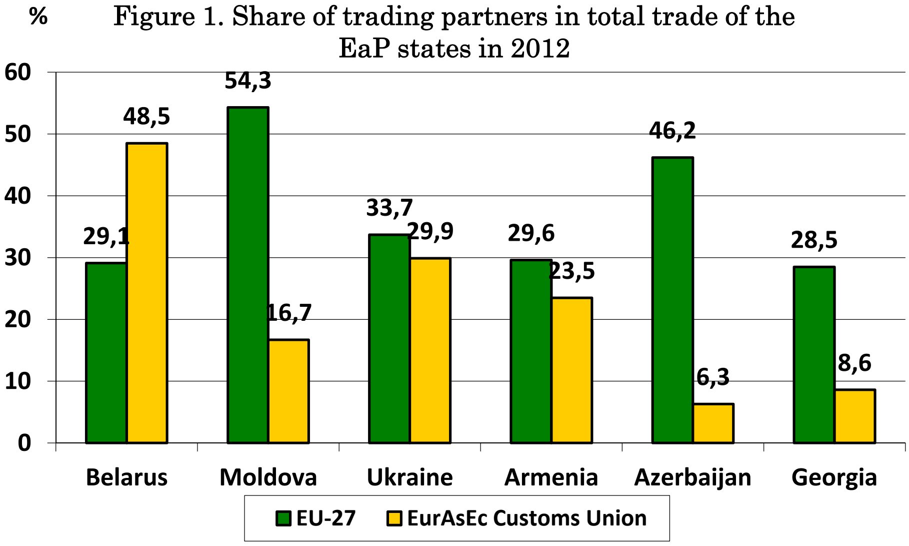
Certainly, such a choice has never been easy, especially from the economic point of view. This assessment focuses on some of the issues, concerning trade in goods and services, foreign investment, and energy, that matter for each of the countries.

International trade

The EU is the main trading partner for all countries of the Eastern Partnership, except Belarus (see Fig.1). During the whole period 2000–2012, trade with the EU represented more than 50% of total trade flows for Moldova and 25% for Georgia[1]; both countries have kept working on closer economic ties with the EU over the past few years and have initialized the Association Agreements in November 2013.

Figure 1. Share of trading partners in total trade of the EaP states in 2012



Source of data: Eurostat (2013)

[1] P. MESSERLIN, M. EMERSON, G. JANDIERI and A. LE VERNOY, *An Appraisal of the EU's Trade Policy Towards its Eastern Neighbours: The Case of Georgia*, Joint GEM-SciencesPo/CEPS Policy Study; ÅSLUND, A. (2013). *Ukraine's Choice: European Association Agreement or Eurasian Union?* Peterson Institute for International Economics, Policy Brief no. 13-26, 2011.

The initialling of the Association Agreements should be followed by a signature and implementation of the Deep and Comprehensive Free Trade Area (DCFTA) parts of those Agreements, expected already in 2014. The DCFTAs are intended not only for providing a simplified mutual market access for goods and services between the EU and its eastern neighbours, but also for ensuring a stable and predictable legal environment. Georgia and Moldova are committed to bring their regulatory policies closer to those of the EU, including rules for food safety, management of customs, intellectual property rights, public procurement, and many others, – up to 400 required changes of legislation in total. Conceivable long-term effects from implementing the DCFTAs in both countries depend mainly on two factors: a) the structure of their trade flows; b) promptness and sustainability of their regulatory policies.

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Georgia's main imports from the EU consist of mineral fuels, chemicals, machinery, and transport equipment. A trade sustainability impact assessment by Ecorys-CASE predicted that the DCFTA would increase the total volume of the Georgian import by 7.5% in the long run[2]. The exports from Georgia, which include primarily raw materials, mining products, and fertilisers, are calculated to increase by 9 and 12% in the short and long run respectively. Although the DCFTA is expected to improve the trade balance for Georgia in relative terms, the trade deficit may still increase in absolute terms, given that imports currently exceed exports. Another significant effect for the Georgian economy is that the agricultural sector (livestock, sugar, and beverages production) will come under pressure due to increased competition from abroad; however, some subsectors (such as vegetable oils, fruits, and animal products) are still expected to expand due to the DCFTA. The Agreement is expected to lead to an overall increase in national income for Georgia by €114 million (1.7% of GDP) in the short run and €292 million (4.3% of GDP) in the long run.

For *Moldova*, the same impact assessment estimated an increase in national income due to the DCFTA implementation by €75 million (3.2% of GDP) in the short run and €142 million (5.4% of GDP) in the long run, while the country's total exports and imports are expected to grow up in the long run by 16.2% and 7.7% respectively. As in the case of Georgia, Moldova's imports from the EU are dominated by machinery, transport equipment, chemicals, and mining products. It should be noted here that the Moldova's exports are already liberalised to a large extent under the EU Autonomous Trade Preferences, which grant Moldova unlimited and duty free access to the EU market for all products originating in Moldova,

[2] ECORYS-CASE, *Trade Sustainability Impact Assessment in support of negotiations of a Deep and Comprehensive Free Trade Area (DCFTA) between the EU and respectively Georgia and Moldova*. Rotterdam: Ecorys Netherland and Center for Social and Economic Research, 2012.

except for certain agricultural products (for which tariff rate quotas are defined). Taking this into account and given that Moldova mainly exports to the EU agricultural products (up to 30% of the total export), clothing, and textiles, some assessments produce more conservative estimates, concluding that the overall effects from the DCFTA for Moldova's trade might be marginal[3]. The main positive impact of the DCFTA would be thus from the improved economic regulations and standardization of the safety and customs procedures in line with the EU norms, which would increase both quality and competitiveness of the Moldovan goods and services.

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The cases of Georgia and Moldova might have served as an example to follow for *Ukraine*. The EU and Ukraine concluded the negotiations for a DCFTA in 2011 and were prepared to sign the EU-Ukraine Association Agreement, including its trade part, in November 2013. Though Ukraine has provisionally suspended the preparations for signing the Agreement, the EU offer is still valid. However, the actions of Russia are currently holding Ukraine off from continuing with its initial objectives.

In August 2013, Russia temporarily tightened its customs rules on selected Ukrainian goods. Ukraine's total exports then dropped by $1.4 billion in 2013, showing a 10% year-on-year decline for the 10-month period[4]. The Russian officials warned that, if Kyiv had signed the EU Agreement, further trade sanctions would have followed. Once Russia had restored its former liberal import regulations later in October 2013, the Ukrainian officials calculated that this would save Ukraine about $1.5 billion (roughly €1.1 billion) in 2014 only. For comparison, the DCFTA, as outlined by the European Commission, was expected to save Ukraine about €487million annually[5], which could have been a significant amount, had Russia not threatened Ukrainian exporters.

While considering its options, Ukraine also pays attention to the structure of trade with Russia and the EU. Ukraine exports to the EU primarily raw materials, mineral products, and vegetables. At the same time, Ukrainian exports to the Customs Union countries (Russia, Kazakhstan, and Belarus) consist mainly of machinery and transport equipment, such as diesel locomotives and aircrafts hardware. Since Ukraine's long run objectives include modernization of economy and development of its

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[3] V. BEZRUTCHENKO, *Eastern Partnership: Pro et Contra*, AVA.md, February 6, 2014, Retrieved from http://ava.md/projects/es/023425-vostochnoe-partnerstvo-za-i-protiv.html on February 10, 2014.
[4] INTERFAX-UA. *Eased Russian customs rules to save Ukraine $1.5 bln in 2014, says minister*. Interfax, December 18, 2013. Retrieved from http://en.interfax.com.ua/news/economic/182691.html on February 10, 2014.
[5] P. MANOLI, "Political Economy aspects of Deep and Comprehensive Free Trade Agreements", *Eastern Journal of European Studies*, vol. 4, no. 2, 2013, pp. 51-73.

manufacturing sector, the country can't allow itself loosing international markets for automotive and aerospace industries, which would also mean threatening domestic employment and investment.

All the above mentioned factors made the government of Ukraine to adopt a Program of Cooperation with the Member States of the Customs Union until 2020 on January 15, 2014[6]. According to the official estimates, total trade between Ukraine and the Customs Union countries will increase by 10-15% due to such cooperation, with the maximum up to $12 billion (€8.8 billion) annually in the long run. Yet, the Program of Cooperation remains mainly a declarative document, restating the intentions of both sides to continue "working on joint ventures, improving protection of investors, and exploiting export potential", while lacking any detailed calculations as to what would bring about the estimated increase in trade flows. Moreover, the Program of Cooperation does not oppose association with the EU, since all the norms and procedures proposed by the Customs Union to Ukraine should be also compliant with the EU regulations. The Ukrainian government thus stated that it kept preparing to sign the Association Agreement with the EU in the nearest future. Several studies assessed the potential gains from the Ukraine-EU DCFTA as the reduction of capital costs by 4-5% and the increase in the country's GDP by 11.8%[7]. In the long run, these gains could be even doubled[8]. It is worth reminding, however, that these estimations assess net economic benefits for the Ukraine-EU association under the assumption that all other things remain stable and, hence, underestimate those potential losses for Ukraine's exports, which Russia has demonstrated in 2013 in such an assuring manner.

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[6] Official press-release of the Ministry of Economic Development and Trade of Ukraine on January 15, 2014. Retrieved from http://www.kmu.gov.ua/control/publish/article?art_id=246978824 on February 10, 2014.
[7] For more details, see O. SHUMYLO-TAPIOLA, *Ukraine at the Crossroads: Between the EU DCFTA & Customs Union*. Institut français des relations internationales, Russie.Nei.Reports No. 11, 2012; V. MOVCHAN and R. GIUCCI, *Quantitative Assessment of Ukraine's Regional Integration Options: DCFTA with European Union vs. Customs Union with Russia, Belarus and Kazakhstan*. Institute for Economic Research and Policy Consulting, Policy Paper PP/05/2011, 2011.
[8] M. FREY and Z. OLEKSEYUK, *The EU-Ukraine trade liberalization: How much do the costs of tariff elimination matter?* Kompetenzzentrums Forschungsschwerpunkt Internationale Wirtschaft, FIW Working Paper No. 103, 2013; Institute for Economic Research and Policy Consulting, *Costs and benefits of FTA between Ukraine and the European Union*, 2010.

Both *Azerbaijan* and *Armenia* currently benefit from the EU's Generalised Scheme of Preferences (GSP). Azerbaijan's share in total EU trade is high due to imports of energy products, at 0.8%. Since the WTO membership is one of the criteria for the negotiation of a free trade agreement with the EU, Azerbaijan is excluded from DCFTA discussions for now. Besides, under the reformed GSP scheme, as of February 2014 preferences for Azerbaijan are deferred and the country reverts to the standard "Most Favoured Nation" treatment. However, with a view to supporting Azerbaijan's future WTO membership and a subsequent eventual bilateral FTA, negotiations on upgrading the existing trade related provisions of the Partnership and Cooperation Agreement were launched in 2010. Azerbaijan's objectives include signing an Association Agreement with the EU as soon as possible, in order to secure and expand its export of oil and gas to the European markets.

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Armenia announced its decision to join the Customs Union of Russia, Belarus, and Kazakhstan in September 2013. Although negotiations and discussions are still on-going, there is little doubt that the process will be finalized soon, as early as in May 2014. The main reason for Armenia to join the Customs Union is Russia's promise to abolish tariffs on exports of natural diamonds, oil, and gas from Russia to Armenia. Due to the high trade deficit, dependence on the Russian energy sources and military presence, as well as dependence on the capital transfers from abroad, Armenia is genuinely interested in receiving preferential treatment from Russia, even though the current volumes of trade flows of Armenia with the EU are higher than those with Russia. According to some estimates, if Armenia implemented a DCFTA, it would have increased the country's exports to the EU by 15%, its imports from the EU by 8%, and GDP by 2.3%[9]. After the announcement of the Armenian decision, the EU does no longer pursue the steps required for the Association Agreement with this country to become effective.

Belarus formed the Customs Union with Russia and Kazakhstan in 2010. Although a part of the EU Eastern Partnership, the country has not been considered for negotiations on a DCFTA for a number of political reasons, including the country's authoritarian regime and reported violation of human rights.

Foreign investment

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[9] C.VUTZ, *Prospects for an upgrade in trade relations with Eastern Partnership countries*. Library Briefing, Library of the European Parliament, 2013.

any of the countries to sign a DCFTA with the EU would be attracting European investment. Current level of foreign investment in most of these countries is quite low (see table 1), and, except for some energy exporters, they generally have low levels of capital accumulation[10].

Table 1 - Foreign direct investment (FDI) in the Eastern Partnership countries

	FDI inflows from EU-27, mln. euro					FDI inflows from Russia, mln. euro				
Country/Year	2008	2009	2010	2011	2012	2008	2009	2010	2011	2012
Belarus	277	164	242	154	93	472	459	509	1938	53
Moldova	0	0	0	0	0	0	1	0	0	0
Ukraine	5847	1032	8190	1045	7	6	18	160	16	29
Armenia	0	0	0	0	0	310	34	0	0	1
Azerbaijan	0	0	0	0	0	0	8	1	7	2
Georgia	0	0	0	0	0	0	0	12	21	0

Source of data: Eurostat (2013); Rosstat (2013)

In Belarus and the South Caucasus countries, Russian investment exceeds European FDI due to a large number of joint ventures and industrial ties, some of which exist since the Soviet era, mainly in mining industry, energy production, and agricultural sector. In Moldova, however, investors from the European Union created almost 60% of the total Moldovan FDI in 2000–2012, even though the yearly FDI inflows were still under €1 million[11]. Some of the largest investment positions in Moldova originate in the Netherlands (such companies as Danube Logistics, operating a harbour and trading oil and petroleum products), France (Orange being a prominent telecommunication provider and Lafarge as a building materials producer), Romania, and Spain.

Several issues are still holding back investment into the Moldovan economy. The most important of them is a need to revise current legislation, starting with the ban of land purchasing for foreign investors, out-dated labour laws (especially regarding professional trainings and social benefits), weak protection of know-how transfers, and many others. Secondly, many business executives name a complicated state-business relationship as one of the major barriers for FDI and claim that the risks of investing in Moldova are quite high due to somewhat arbitrary implementation of legislation by the authorities. A third, equally

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[10] I. DREYER, *Trade Policy in the EU's Neighbourhood Ways Forward for the Deep and Comprehensive Free Trade Agreements*. Notre Europe, Studies and Research Series, 2012.

[11] A. POPA, *Foreign Direct Investments in Economy of Republic of Moldova and Perspectives for their Growth in the Framework of Neighboring with the EU*. Chisinau: Expert-Grup Research Paper, 2007; R. GIUCCI and J. RADEKE, *FDI Attraction to Moldova: Facts, Potential and Recommendations*. German Economic Team Moldova, Policy Paper PP/02/2012, 2012.

important issue is the current "personalised approach" of policy-makers in attracting investment, when a few companies get favoured over the others, leaving open a range of possibilities for corruption and paternalism.

Similar institutional problems exist in Ukraine, though the volumes of FDI in Ukraine are much higher than those in Moldova. Still, over the years, Ukraine has been repeatedly assessed as one of the most underinvested countries in Central and Eastern Europe, based on the ratio of investment potential to the actual FDI inflows. According to Ernst&Young[12], Ukraine ranked 10th both in the total number of investment projects (178) and the number of jobs created (7487). Around 80% of the cumulative FDI inflows in Ukraine originated in the European Union, with Cyprus and Germany being among the top EU sources. One should keep in mind that, although Cyprus on average accounts for 22% of the total FDI inflows, it is quite likely that most of this investment is of a Ukrainian and Russian origin, going through Cyprus as an offshore zone. Yet, Germany (16% of total FDI) and the Netherlands (7%) are sources for some of the biggest investment projects in the country[13].

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An important difference between the EU and Russian investors in Ukraine lies in their sector preferences. Russian enterprises' affiliates are concentrated in oil and gas refining, aluminium production, financial sector, telecommunication, and mass media. Out of six oil refineries in Ukraine, the three largest ones are Russian-owned, one is a Ukrainian-Russian joint venture, and only two small refineries belong to Ukrainian companies. The EU investment, on the other hand, goes primarily in the banking sector, metal production, and manufacturing. Alas, Russian investment in some "sensitive" sectors of the Ukrainian economy becomes a constant source of national security concerns. Besides, there were attempts by some Russian financial groups over the past few years to use their investment as a political or economic leverage, which led to increased tension between them and their Ukrainian counterparts.

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Constantly changing, complicated and inconsistent legislation, as well as corruption risks and weak protection of intellectual and property rights, are some of the major factors, supressing foreign investment in all countries of the Eastern Partnership. In 2010, when the Ukrainian authorities attempted to invalidate privatization agreements of Kryvorizhstal by Arcelor Mittal, a French company and the biggest foreign investor in Ukraine, it took the president of France's personal

[12] ERNST & YOUNG, *Ukraine Foreign Direct Investment (FDI) report*. Kiev: Ernst & Young, 2011.
[13] O. KONONOV, *Ukraine's inward FDI and its policy context*. Columbia FDI Profiles, 2012.

intervention to resolve the issue[14]. Such cases discourage further investment until the time when legal and institutional framework in Ukraine, Moldova, and other countries will be improved. The agreement with the EU would have helped all the countries to become a far more appealing investment destination for both domestic and foreign investors. Unification of regulatory policies, reduction of administrative burdens, development of infrastructure and services, and protection of investment rights are all expected results of the DCFTAs, which can serve as a good environment for flows of investment, goods, and labour, can strengthen the countries' energy independence, and lead to a higher economic growth in the main industries, as well as in their economies as a whole.

Energy policy

There is no doubt that uninterrupted transit and pricing of energy goods are of great importance for all parts involved, – for the EU as a consumer, Russia as the main supplier, and for the Eastern Partnership countries both in terms of supplying energy resources to the EU and consuming them. The proposed Ukraine-EU DCFTA was the first agreement, which had included specific provisions on trade-related energy issues. It also took into account Ukraine's membership in the Energy Community Treaty, which imposed an obligation to implement the most relevant EU energy *acquis* on electricity and gas.

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Among the Eastern Partnership countries, only Azerbaijan and Georgia don't depend on the Russian gas supplies. Russia's export tariff on gas is currently 30% of the price for any country outside of the Customs Union. It is therefore unsurprising that the price and export tariffs on oil and gas have become a major leverage in Russia's negotiations with Ukraine and Armenia about joining the Customs Union[15]. The case of Belarus was used to demonstrate potential gains: besides benefitting from the lowest price of gas among the Eastern European countries (see fig.2), Belarus as a member of the Customs Union saves almost $550 million per year due to zero export tariff on gas used for domestic consumption[16]. It is also discussed that, once the Eurasian Economic Union becomes a reality in 2015, Belarus might keep the revenues from tariffs on gas exported to the EU, which would be equivalent to another $4 billion per year.

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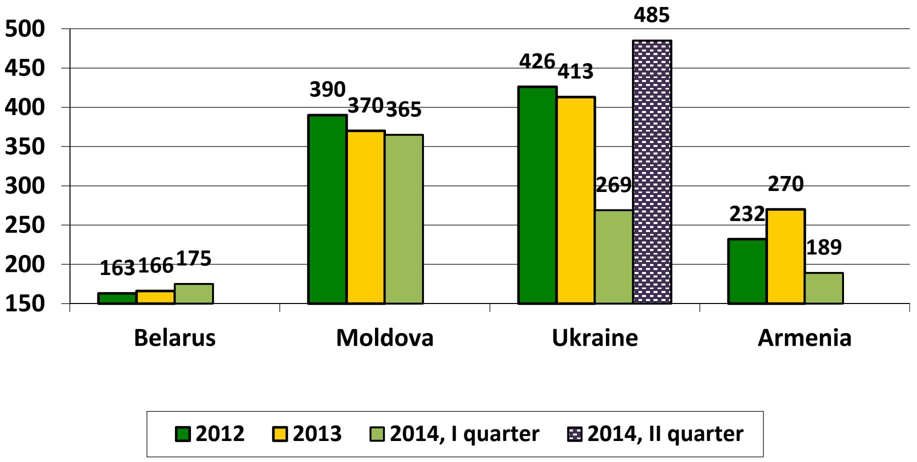
[14] O. KONONOV, *Foreign Direct Investment Regulation: The German Model and Bulgarian Reforms Approach as Patterns for Ukraine*. Berlin: European University Press, 2011, pp. 303-304.
[15] T. PENKOVA, *EU or Russia? Ukraine's recurrent (non)integration dilemma*. Istituto per gli studi di politica internazionale, ISPI Policy Brief No. 150, 2013.
[16] A. KNOBEL, *The Price of the Customs Union*. Vedomosti, January 13, 2014, http://www.vedomosti.ru/opinion/news/21197171/cena-tamozhennogo-soyuza on February 10, 2014.

Figure 2. Average annual price of gas, exported from Russia ($/1000 m³)



Source of data: Author's compilation from various public sources

When Ukraine has shown the will to cooperate with the Customs Union in 2013, Russian holding Gazprom agreed to reduce the price of gas for Ukraine down to $268.5 per 1000 m3 in 2014. According to some calculations at the time, an additional agreement on abolishment of export tariff on gas for domestic consumption would have allowed Ukraine to save up to $6 billion annually. However, after the power change in Ukraine, Gazprom cancelled all types of discounts—those from December 2013 and those from 2010. A new price of gas for Ukraine set at $485 will be effective as of the second quarter 2014[17].

For Armenia, economic gains from eliminated export gas tariffs after joining the Customs Union will amount up to $140 million per year, according to an impact assessment by the Centre for Integration Studies of the Eurasian Development Bank[18]. This economic effect translates into approximately 4% of additional growth of Armenia's GDP.

Among the countries depending on the Russian gas supplies, only Moldova has no perspectives of reduced gas prices or eliminated tariffs, so the country plans to diversify its gas import through the Ungheni-Iaşi pipeline, which will connect Moldova directly to the EU gas market.

[17] REUTERS, *UPDATE 3-Russia raises gas prices for Ukraine by 80 percent*. Retrieved from http://www.reuters.com/article/2014/04/03/ukraine-crisis-gas-idUSL5N0MV2WL20140403 on April 3, 2014.

[18] Eurasian Development Bank, *Armenia and the Customs Union: impact of economic integration*. St. Petersburg: EDB Centre for Integration Studies, 2013.

Azerbaijan is a major supplier of oil and gas to the EU, as recognized in the EU-Azerbaijan memorandum of understanding on energy concluded in 2006. Georgia not only participates in the oil and gas transit from the Caspian Sea to the EU, but also imports energy goods from Azerbaijan for domestic consumption. Both countries intend to develop closer ties with the EU and increase the volumes of gas supply to the European market.

Conclusion

Economic effects from joining either union matter for each country of the Eastern Partnership not less than any mere political reasons. Moreover, solutions, which work for one country, may not work for others, since their economic preconditions vary. While Belarus and Armenia both aim to stay as close to Russia as possible, the factors behind their decisions are quite different: trade and investment for Belarus, oil and gas supplies for Armenia. Georgia and Azerbaijan have little to offer to the EU in terms of trade or investment opportunities but they are important European partners on energy security. Moldova and Ukraine are genuinely interested in increasing trade with the EU, as well as in attracting European FDI, but Ukraine currently has no internal resources to compensate for imminent losses, should Russia decide to tighten its custom regulations or to use the gas supply leverage.

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