



Ukraine's Choice: European Association Agreement or Eurasian Union?

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Since gaining independence in December 1991, Ukraine has vacillated between the European Union and Russia for economic and political cooperation. Until recently neither had offered Ukraine much, but in the last few months, things have heated up. Ukraine's intention to sign an Association Agreement for political association and economic integration with the European Union has raised a furor in the Kremlin, which is now trying to block Ukraine from aligning itself with the European Union. Moscow has imposed trade sanctions in clear violation of its obligations in the World Trade Organization (WTO) and is pursuing an intense confrontation.

Ukraine concluded negotiations on a deep and comprehensive free trade area (DCFTA) with the European Union in late 2011 and the Association Agreement in March 2012. The Association Agreement consists of over 1,200 pages, of which DCFTA forms the bulk with some 1,000 pages. The agreement is comprehensive covering all areas of interest. It offers enhanced cooperation in 28 key policy areas, including political cooperation, foreign and security policy, justice, and freedom. It aims to accelerate the deepening of political and economic relations between Ukraine and the European Union and gradually integrate Ukraine into the EU internal market. The Association Agreement thus provides for significant legal, regulatory, and political convergence with the European Union, for which the European Union offers considerable assistance. Yet it stops short of granting EU membership.

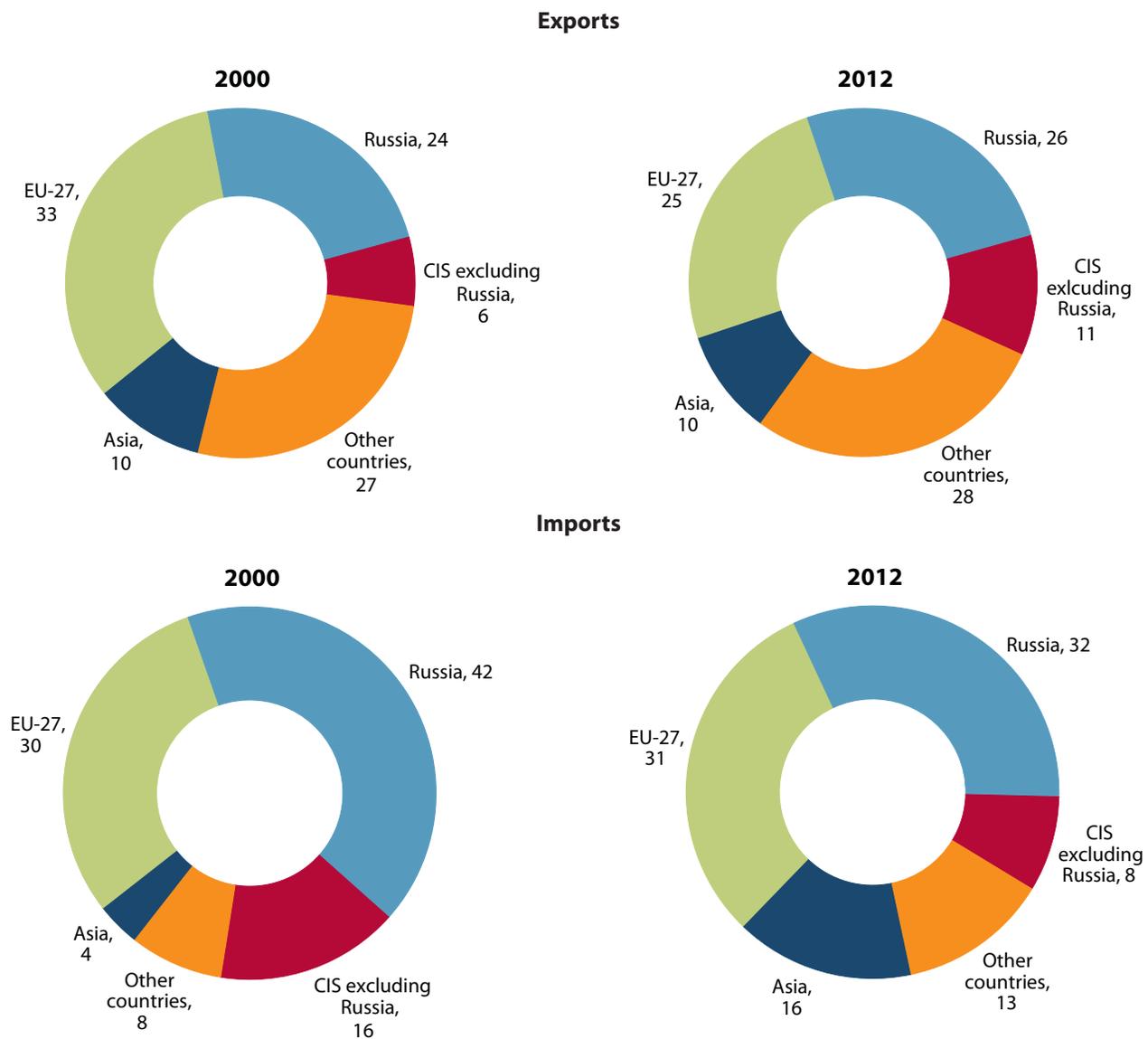
Ukraine should improve its macroeconomic policies to reduce its vulnerability and qualify for IMF funding. It should also comply with all the EU demands, including releasing Yulia Tymoshenko.

In the last two years, however, EU officials have balked at the Ukrainian government's flagrant violations of human rights and rule of law but hope that Ukraine will make amends so that it can sign this agreement at its Eastern Partnership summit in Lithuania's capital, Vilnius, on November 28–29.

Unwilling to "lose" Ukraine to the European Union, Russia launched substantial trade sanctions against Ukraine in July and August 2013. Russia wants Ukraine to reject the European bid and join its Customs Union with Belarus and Kazakhstan. President Vladimir Putin's adviser, Sergey Glazyev, puts it candidly, "We are preparing to tighten customs procedures if Ukraine makes the suicidal step to sign the association agreement with the EU."¹ This impasse may have major

1. Filipp Sterkin, Maksim Tovkailo, and Maksim Glikin, "Prichina tomozhennoi voiny s Ukrainoi—bol'shaya politika" ["The Reason for the Customs War with Ukraine—Big Politics"], *Vedomosti*, August 19, 2013.

Figure 1 Ukraine’s foreign trade, by region, 2000 and 2012 (percent of total)



CIS = Commonwealth of Independent States

Source: UN Comtrade data from <http://wits.worldbank.org/wits> (accessed on August 26, 2013).

consequences for the Ukrainian economy because both the European Union and Russia are equally important as export markets. In 2012, each purchased one-quarter of Ukraine’s exports, and each accounted for about 30 percent of Ukraine’s imports (figure 1).

In this Policy Brief I argue that Europe, Ukraine, and Russia all share the blame for creating the current conflict but also that it’s in their interest to defuse tensions and seek a way out before it threatens the well-being of all involved. To resolve this problem, Europe, Russia, and Ukraine must alter

their policies. For Ukraine, this means putting its own house in order. In the political sphere, Ukraine must reform its justice system, stop suppressing political dissent, and end the selective prosecution of opposition leaders, notably former Prime Minister Yulia Tymoshenko. In the economic sphere, Ukraine needs to reduce its budget expenditures, liberalize regulations, let its exchange rate float, and raise energy prices. It should enlist the help of the WTO to block Russia’s trade sanctions. The European Union, meanwhile, should welcome Ukraine and intensify its interaction with Ukraine but also demand

that it implement political and economic reforms. The United States can back Ukraine and the European Union in these efforts and organize a top-level visit to Kiev before the Vilnius summit. Russia should reconsider its economic warfare ploy, observe its obligations to the WTO, and recognize Ukraine's right to independence.

TWO BUMPY DECADES WITH LIMITED ECONOMIC INTEGRATION

Economic cooperation among the former Soviet republics has been a process of trial and error. After Ukraine voted for independence with a 90 percent majority on December 1, 1991, Russian President Boris Yeltsin decided to dissolve the Soviet Union.² He did so swiftly and presented it as a positive choice: "I was convinced that Russia needed to rid itself of its imperial mission" (Yeltsin 1994, 115).

As a replacement for the USSR, 11 former Soviet republics formed the loose Commonwealth of Independent States (CIS), a minimal organization without supranational power. Georgia and the already-independent Baltic states stayed outside. While Yeltsin wanted the CIS to be like the British Commonwealth, the dominant Russian view was that the Soviet demise was a tragedy and that the CIS should become like the European Union. Russia aspired to closer cooperation than any other state desired. Together with Belarus and Kazakhstan, Russia's closest partners, Russia attempted a customs union in 1995, which was revived in 2009. Ukraine, by contrast, kept Russia at a distance.

In April 1994, all the CIS countries except Turkmenistan signed a multilateral free trade agreement (FTA). But it was of low quality and never came into force because even Russia did not ratify it. Instead most CIS countries went on to conclude similar bilateral FTAs. Russia and Ukraine concluded one in 1993, which came into force in 1994 and has been the legal basis for their trading relationship. Yet, both countries frequently resorted to protectionist measures. Sudden quotas, tariffs, or outright prohibitions often disrupted Russian-Ukrainian trade. Since neither was a member of the WTO until 2008, when Ukraine joined, they had no recourse to any rules-based arbitration or penalty mechanisms.

In 2003, President Putin tried to integrate Ukraine into a new Single Economic Space (SES) with Russia, Belarus, and Kazakhstan. It was supposed to start as a free trade area, become a customs union, and eventually a currency union, modeled after the European Union. It was an evident attempt to tie Ukraine closer to Russia before the presidential elections

in late 2004, but no Ukrainian government has accepted more than a free trade area. During the 2004 presidential campaign, Putin went to Ukraine twice to campaign for his preferred candidate, Viktor Yanukovich, although he did not think much of him. During the Orange Revolution in November–December 2004, hundreds of thousands of Ukrainians protested against the rigged election of Yanukovich, who lost the following repeated run-off vote to Viktor Yushchenko. As a result, the SES fell by the wayside.

All along, Putin had expressed nostalgia about the Soviet Union, but after the Orange Revolution he stated: "the collapse of the Soviet Union was the biggest geopolitical disaster of the century."³ To him, the key element of a minimal restoration of the Russian empire has been the inclusion of Ukraine.

The European Union should support Ukraine but also maintain its standards to make sure that Ukraine complies with its conditions so that both parties can sign the European Association Agreement in Vilnius in November.

The main conflict between Russia and Ukraine has been their dispute over the price of natural gas for Ukraine and over transit of natural gas to Europe. In January 2006 and January 2009, Putin cut Russian gas deliveries to Ukraine and a large part of Europe, prompting Ukraine to reduce its purchases of Russian gas. Russia has clearly given up on Ukraine for gas transit and is building pipelines around Ukraine to eliminate any gas or oil transit through Ukraine in the future.

EUROPEAN ASSOCIATION AGREEMENT

Ukraine has been asking for EU membership since 1995, but for years the European Union was too occupied with incorporating the 10 Central and East European countries, which was completed in 2004 and 2007, respectively.⁴

In 2003, the European Union looked farther and launched a European Neighborhood Policy (ENP), designed for North African and Middle Eastern countries and the western CIS countries (Russia, Belarus, Ukraine, and Moldova). It attempted

2. I discuss this in detail in Åslund (2007).

3. Vladimir Putin, "Annual Address to the Federal Assembly of the Russian Federation," April 25, 2005, www.kremlin.ru.

4. This section draws on Åslund (2009).

to standardize the EU approach to friendly neighbors, offering them more market access and interaction. Ukraine seized this opportunity, while Russia excluded itself. Instead, Armenia, Azerbaijan, and Georgia asked to be included in the ENP and the European Union accepted.

The Orange Revolution brought about the democratization that the European Union demanded for closer cooperation with Ukraine, and the ENP was a convenient instrument for closer cooperation. In February 2005, Ukraine concluded a substantial initial action plan with the European Union. Most of the action items were reforms that Ukraine committed itself to carrying out with plenty of EU assistance. The Orange government also accelerated Ukraine's accession to the WTO, which was completed in 2008. Immediately afterwards, the European Union initiated negotiations with Ukraine on a DCFTA. In May 2009, the European Union launched an Eastern Partnership with the six ENP countries, declaring: "The main goal of the Eastern Partnership is to create the necessary conditions to accelerate political association and further economic integration between the European Union and interested partner countries" (Council of European Union 2009). In addition to FTAs, the European Union now offered broader Association Agreements, which also involved political and legal aspects, but EU membership remained out of reach.

In February 2010, Yanukovich won with a slight margin over Prime Minister Yulia Tymoshenko in a reasonably free and fair presidential election. He continued negotiations with the European Union on the DCFTA, which were successfully concluded in late 2011. Yet, the European Union held up the signing because of new concerns about violations of human rights and rule of law in Ukraine. On July 19, 2012, the DCFTA was initialed, not signed. In the summer of 2013, Moldova, Armenia, and Georgia also concluded DCFTAs with the European Union.

The DCFTA is a substantial FTA. It abolishes mutual customs tariffs, although the current average EU tariff on manufactures is only 1.19 percent and 2.45 percent in Ukraine, so the impact will be limited. The effect will be more significant for agricultural goods, for which the average EU tariff is 7.42 percent versus 6.41 percent in Ukraine, and agricultural goods will compose about one-third of Ukraine's exports in 2013. The DCFTA also covers regulatory convergence in competition policy, state aid, property rights, and energy policy (Giucci 2013).

CUSTOMS UNION

In June 2009, Prime Minister Putin surprised everybody by stating that Russia, Belarus, and Kazakhstan would enter the WTO as a customs union. These three countries agreed to unify their customs tariffs. In 2010, the Customs Union came into

existence, with the implementation of a common customs tariff and joint Customs Code. In January 2012, border controls were abolished. A joint secretariat, the Eurasian Economic Commission, was set up in Moscow with a staff of more than 1,000 people. The Eurasian Development Bank in Almaty, Kazakhstan, and an arbitration court in Minsk were also established (Movchan and Giucci 2011).

Putin's aim is to transform the Customs Union into a Eurasian Union by 2015—a political counterpart to the European Union—but Belarus and Kazakhstan resist closer integration. In Russia the Customs Union and the Eurasian Union are used nearly synonymously. The difference is best understood thus: "The ostensible purpose of [the Eurasian Union] is economic. Its primary objectives, however, are geopolitical, and these are to be achieved in large part by economic means" (Adomeit 2012). Russia has pressured all former Soviet republics to join. Kyrgyzstan has signed a letter of intent and Tajikistan may do so as well, but Putin's real goal is to integrate Ukraine.

From an economic standpoint, the Customs Union is problematic because the economic interests and structures of Russia, Kazakhstan, and Belarus vary greatly. Kazakhstan is largely a raw material exporter, and Belarus is an exporter of Soviet-style manufactured goods. Russia is a comparatively protectionist post-Soviet country. The Customs Union also complicates relations with third parties, notably the WTO. As Russia joined the WTO as a member of the Customs Union in August 2012, Kazakhstan realized that it could not enter the WTO as intended because Russia had forced it to raise its import tariffs. Belarus and Kazakhstan complain that Russia's WTO obligations apply to them, although they did not participate in those negotiations. These three countries already had tariff-free trade among them before the Customs Union; the only big Customs Union advantage is that border controls between them have been taken down (Carneiro 2013).

In effect, Russia is being forced to pay Belarus and Kazakhstan for the sacrifices they made to join the Customs Union. Every year Belarus receives implicit oil and gas subsidies of 15 to 18 percent of its GDP from Russia. When Belarus' irresponsible economic policies brought about a severe payments crisis in 2011, Russia offered a large bailout package of \$20 billion for three years. Even so, the relationship between the two countries is very bad, and Belarus is on the verge of a new financial crisis (Garbert 2013).

Russia's relationship with Kazakhstan is better, but the Kazakhs are not enthusiastic about the Customs Union. For Kazakhstan, the Customs Union is straightforward trade diversion. It forced Kazakhstan to raise its average custom tariffs from 6.7 to 11.1 percent on an unweighted basis and from 5.3 to 9.5 percent on a trade-weighted basis. The World Bank (2012)

assessed the cost to Kazakhstan of joining the Customs Union in its baseline scenario at 0.2 percent of GDP (Carneiro 2013).

Despite the Customs Union being Russia's dominant priority, the CIS countries concluded a new multilateral FTA in October 2011. Only eight countries signed it, and Russia, Belarus, and Ukraine have ratified it. This FTA has replaced the bilateral FTA of 1993 as the basis of trade between Russia and Ukraine. It introduced two major novelties, namely that WTO rules and procedures should apply to CIS members belonging to the WTO and that a customs union could be a party to the FTA. The agreement exempts almost all goods from customs tariffs, with sugar being the exception. However, Russia's export

Russia should obey the rules of the WTO and the CIS Free Trade Agreement and end its trade sanctions against Ukraine. It should realize that it is not in its national interest to force countries to join its Customs Union.

taxes on commodities, such as gas and oil, still apply to Ukraine, and Russia imposes quotas for certain sensitive products such as steel pipes. Russia also continues to block imports of agricultural products, dairy, and meats on alleged sanitary grounds (Giucci 2013). Thus, in a trade conflict between Russia and Ukraine, the WTO should take precedence, but the role of the Customs Union is confusing, since neither Belarus nor Kazakhstan belongs to it.

QUANTITATIVE ASSESSMENT

Many institutions—mainly Polish and Ukrainian institutes, the World Bank, and the Eurasian Development Bank⁵—have made quantitative assessments of the effects on the Ukrainian economy of Ukraine's accession to the Customs Union versus implementation of the DCFTA. Using standard gravity and computable general equilibrium models, all but the Eurasian Development Bank have obtained very similar results.

5. Recent relevant studies are Dabrowski and Taran (2012a, 2012b), Eurasian Development Bank (2012), Giucci (2013), Ivanter et al. (2012), Maliszewska, Orlova, and Taran (2009), Movchan (2011), Movchan and Giucci (2011), Movchan, Giucci, and Kutsenko (2010), Movchan and Shportyuk (2012), Shepotylo (2010, 2013), Tarr (2012), and von Cramon-Taubadel, Hess, and Breummer (2010).

Movchan and Giucci (2011, 11) provide the most complete recent mainstream study of the effects on Ukraine of both the DCFTA and the Customs Union. They conclude that in the long term, the DCFTA would add 11.8 percent to Ukraine's GDP, while the Customs Union would reduce it by 3.7 percent. The DCFTA would substantially increase trade (both exports and imports), whereas the Customs Union would reduce trade. Other studies offer similar numbers.

The biggest impact comes from exports. Shepotylo (2013, 21) has estimated that the "expected long run gains in Ukrainian exports to all countries under the CU scenario are equal to 17.9 percent,... and under the EU scenario 46.1 percent. Surprisingly, the highest unrealized potential is in exports to CIS countries," notably to Russia.

The DCFTA will decrease or eliminate existing trade barriers between Ukraine and the European Union, leading to increased mutual trade. The main advantages for Ukraine will be better access to the vast EU market; increased inflow of foreign direct investment, which will modernize the Ukrainian economy, restructure enterprises, and create jobs; and harmonization of regulatory and institutional standards, which will improve the business environment and rule of law in Ukraine (Dabrowski and Taran 2012b, 23–24). All these effects should be substantial and positive. Conversely, the Customs Union market is smaller, technologically backward, less competitive, and does not offer Ukraine significant institutional benefits.

A counter study by a group of economists affiliated with the Eurasian Development Bank (Ivanter et al. 2012) presents analysis that is not based on any calculations but on scenarios and peculiar assumptions.

Ukraine's joining the EU FTA would worsen the terms of trade in the post-Soviet area. In this case the SES countries can mitigate the negative consequences of such a move by Ukraine by raising the median customs tariffs. Because of a reduction in exports to the SES countries and an increase in imports from the EU.... Ukraine in this scenario can lose up to 1.5% of its baseline GDP (Ivanter et al. 2012, 40).

Apparently, the authors mean that the Customs Union countries would impose trade sanctions against Ukraine. However, if Ukraine joined the Customs Union, then "Over the period of 2011-2030, the total cumulative effect of the creation of the SES and Ukraine joining it on the four countries can reach \$1.1 trillion in 2010 prices..." (Ivanter et al. 2012, 41). This study presents numbers that contradict all other mainstream Ukrainian and Western studies without revealing the authors' methodology or calculations. It appears more like propaganda than research. Their message is political: It is good

for Ukraine to join the Customs Union but had to adopt the DCFTA. Another Eurasian Development Bank study (2012, 29) comes to a similar conclusion:

Ukraine's non-participation in the integration processes currently underway throughout the post-Soviet area leads to the continuation of the sectoral breakdown of its economy and as a result, to a potential slowdown in its economic growth rate....

But if Ukraine embraced the Customs Union, then

Under technological integration and the fostering of cooperation ties, assessment of the economic effect could be boosted to 6-7% of total GDP volume by 2030 (Eurasian Development Bank 2012, 29).

Putin's adviser, Sergey Glazyev, has stated that Ukraine would gain \$9 billion a year if it joined the Customs Union, because he suggests that Ukraine would be allowed to buy Russian oil and gas at the same low prices as Belarus does (Moshes 2013).

Since these counter assessments appear insubstantial, we have every reason to rely on the many quantitative studies with revealed methodology that Ukraine can benefit substantially from the DCFTA with the European Union but would suffer considerable harm if it joined the protectionist, small, less developed, and less competitive Customs Union.

THE KREMLIN'S POLITICAL TRADE POLICY

The only way to make sense of the Kremlin's trade policy is to see it as politics mixed with old Soviet economic thinking. Glazyev, a former minister for external economic relations, became Putin's personal adviser on Eurasian integration in July 2012. He advocates state capitalism, and aside from Putin, is the main advocate of the Eurasian Union (Åslund forthcoming). Their thinking runs counter to modern trade theory.

First, while modern economics favors intensive competition, Customs Union advocates want to reduce competition so that countries lagging technologically, such as Russia and Ukraine, can produce and export more without technological change. Another Kremlin misperception is that only a customs union, and not an FTA, can lead to free trade. Third, the Kremlin does not understand that a country can have FTAs with many countries. Russia has FTAs only with former Soviet countries, so it has little practice. Clearly, they do not comprehend the concept of rules of origin. Russia's First Deputy Prime Minister Igor Shuvalov has stated that if Ukraine signs the DCFTA "there are serious worries that some groups of goods

will enter the Customs Union without control."⁶ Presumably, he refers to Russia being unable to control the Belarusian border with Ukraine, but that is an internal Customs Union problem. Fourth, as a new member of the WTO, Russia has not been able to internalize the WTO rules. Even after one year of membership it has not set up a permanent mission to the WTO. Finally, the Kremlin appears to look at trade policy primarily as a foreign policy weapon.

Putin is the greatest enthusiast of Eurasian integration, often citing dubious numbers on the benefits of the Customs Union. In December 2012, he praised the Customs Union:

Trade with these countries grew by 10 percent [in 2012]—that is not bad at all. Most importantly, ...we have a very good structure of trade with the Customs Union countries. Machinery and equipment make up 20 percent of [Russian exports]. That is very good, because machinery and equipment make up only 2 percent in our [exports to] the rest of the world....⁷

In other words, Belarus and Kazakhstan were forced to raise their import tariffs for cars from 5 to 15 percent and thus bought more cars produced in Russia than before. Similarly, in his talks with Ukrainian President Viktor Yanukovich in March 2013, Putin made the implausible claim that Ukraine would gain 1.5 to 6.5 percent in additional GDP growth (depending on the depth of integration) if it joined the Customs Union.⁸

UKRAINE'S ECONOMIC VULNERABILITY

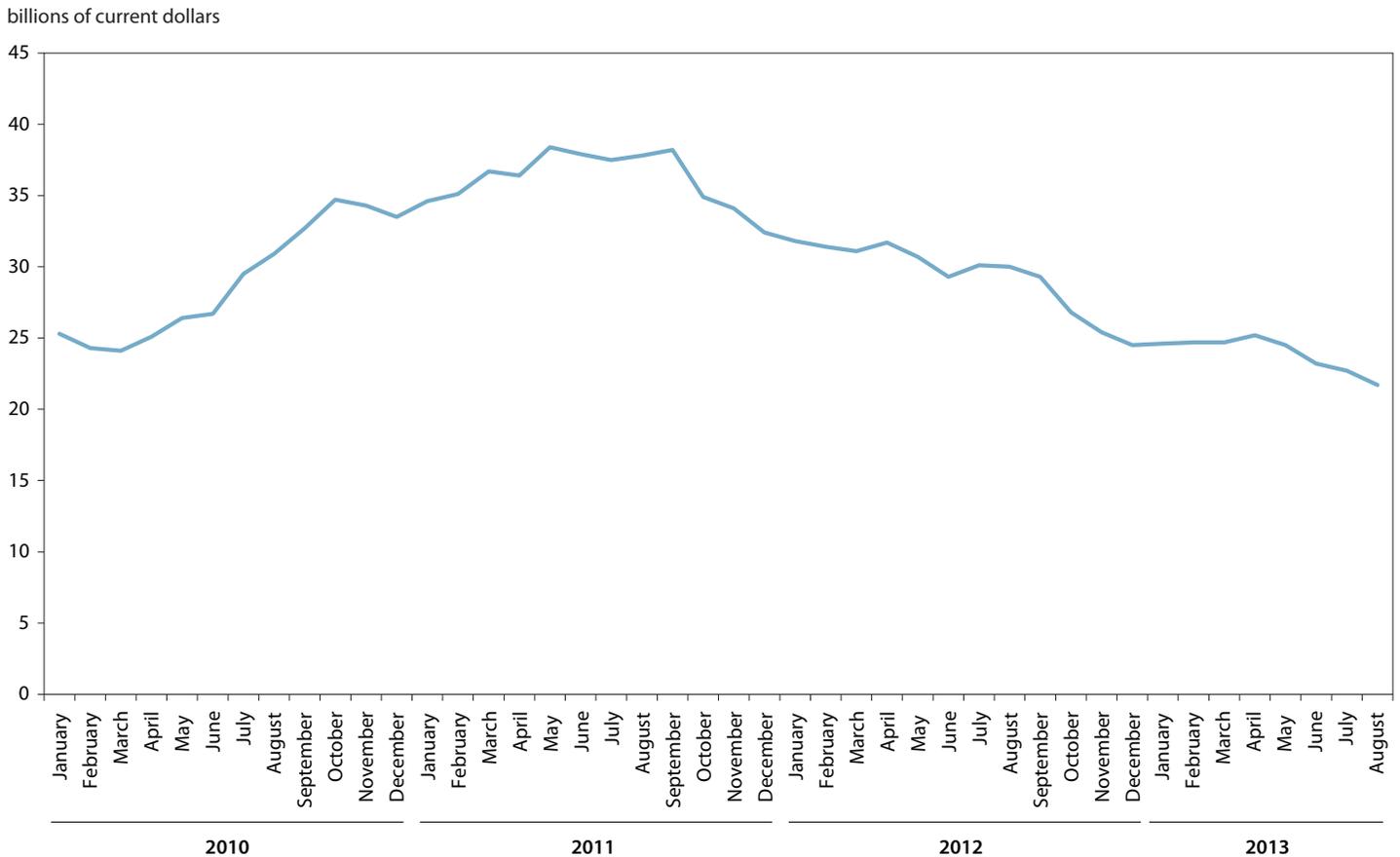
Since independence, Ukraine's economy has persistently underperformed other economies in the neighborhood, such as Russia, Poland, and Turkey. After Yanukovich was inaugurated as president, he controlled both government and parliament. Initially, he focused on three goals: a favorable gas deal with Russia (see next section), an economic reform program, and a new International Monetary Fund (IMF) program.

An extensive reform program was quickly adopted in June 2010. On its basis, Ukraine concluded a new Stand-By Arrangement with the IMF in July 2010. It was supposed to

6. Mari Mesponyan, "Shuvalov nazval bessmyslenym dal'neishie peregovory ob integratsii Ukrainy s ES i TS" ["Shuvalov Called Further Negotiations about the Integration of Ukraine into the EU and the CU Meaningless"], *Vedomosti*, August 26, 2013.

7. News Conference of Vladimir Putin, President of Russia, December 20, 2012, www.kremlin.ru (accessed on March 7, 2013).

8. Vladimir Putin, Meeting with President of Ukraine Viktor Yanukovich, March 4, 2013, www.kremlin.ru (accessed on March 6, 2013).

Figure 2 Ukraine's total international reserves, 2010 to August 2013

Source: International Monetary Fund, *International Financial Statistics*, August 2013 (accessed on September 16, 2013).

last for two and a half years with a total disbursement of \$15 billion, and Ukraine received two disbursements in the fall of 2010.

By November 2010, however, economic reforms and the IMF program went off the rails. The IMF posed four major demands to the Ukrainian government: reduce the budget deficit, raise the very low subsidized gas prices for consumers and utilities, deregulate the exchange rate market to render the exchange rate flexible, and carry out a major pension reform (IMF 2011). Eventually, the government carried out only the pension reform. Because of low global interest rates, the government could finance its substantial budget deficit with eurobonds.

Ukraine's economic outlook is precarious. The economy contracted by an annualized 1 to 2.5 percent in the last four quarters. The consolidated budget deficit was 6.3 percent of GDP in 2012 and is likely to be 5 percent of GDP in 2013. The public debt is \$69 billion or 38 percent of expected GDP.

The main concern is foreign imbalances. The current account deficit was 8.4 percent of GDP in 2012 and it is heading toward 6 percent of GDP in 2013. For no good economic reason, Ukraine maintains a dollar peg at an overvalued exchange rate. After global bond yields started rising in May 2013, the Ukrainian 10-year bond yields rose to 10 percent, precluding most international borrowing. To defend it, the National Bank of Ukraine pursued ever stricter currency regulations and high interest rates, which have killed investment and economic growth but brought inflation to zero.

Ukraine's critical weakness is its international reserves, which are declining quickly, having fallen from a peak of \$38 billion two years ago to \$21.7 billion in August 2013, covering only 2.7 months of imports (figure 2). Ukraine faces the risk of a run both on bank deposits and on foreign currency exchange in the country. The government's foolhardy economic policy has left the country vulnerable to external shocks, and Russia appears intent on exploiting that vulnerability.

THE EVER-DETERIORATING RUSSIAN-UKRAINIAN RELATIONSHIP

After Yanukovich's election victory in February 2010, both Putin and Yanukovich thought they had a wonderful opportunity to improve relations between the two countries, but they had different aims. Yanukovich wanted a favorable gas price agreement with Russia, while Putin wanted Ukraine to join the Customs Union.

In April 2010, the two countries concluded an agreement in Kharkiv. In exchange for a purported discount on the gas price of 30 percent, or \$100 per one thousand cubic meters, Yanukovich extended the Russian lease of Sevastopol, the naval base of Russia's Black Sea fleet by 25 years until 2042. Most Ukrainians thought this was a bad deal, and sure enough the gas price Ukraine paid did not fall. After the Kharkiv agreement, Putin and Yanukovich could not agree on anything and their personal relations deteriorated.

The United States and the European Union should defend Ukraine against Russian economic aggression in the WTO and through vocal and economic support.

Yanukovich has persistently opposed Customs Union membership because it would make him and Ukraine too dependent on the Kremlin. The Customs Union would harm the Ukrainian economy, violate Ukraine's membership in the WTO, make it impossible for Ukraine to conclude any bilateral FTA, and most importantly make Yanukovich's reelection in 2015 impossible. Instead, Yanukovich has opted for the European Association Agreement. He has a steady majority behind him. According to an independent poll in August 2013, 42 percent of the respondents supported Ukraine's integration into the European Union, while 31 percent preferred the Customs Union. While Yanukovich wants to align himself and Ukraine with the European Union, he has a problem with observing European norms.

The European Union has protested persistently against 11 of Yanukovich's malpractices. On dubious legal grounds, he imprisoned several opposition leaders (notably, former Prime Minister Yulia Tymoshenko). He also violated the rules for free and fair elections and imposed his control over courts, law enforcement, and media. Specifically, five people had been elected to parliament, but courts had disqualified them and the European Union demanded new elections be held. The European Union has also

objected to the deteriorating business and investment climate, as well as Ukraine introducing protectionist recycling fees for imported cars in violation of WTO rules.

In February 2013, Putin started his offensive for the Customs Union by claiming the inevitability of "the integration processes in the post-Soviet sphere," stating that "[t]ight integration is an objective global process. No rude shouting or screaming can stop it on our territories."⁹ Glazyev insisted that Ukraine choose between the European Union and the Customs Union.¹⁰

As a goodwill gesture to Russia, Yanukovich agreed that Ukraine would become an observer to the Customs Union. On May 29, 2013, the Customs Union countries and Ukraine signed a Memorandum on the Deepening of the Interaction between the Eurasian Economic Commission and Ukraine. This document is as brief as it is empty: "Ukraine declares its intention to observe the principles...of the agreed legal framework of the Customs Union..." but the final article states that "[t]he present Memorandum is not an international agreement and does not cause rights or obligations regulated by international law."¹¹ Ukraine's status as an observer to the Customs Union was explicitly approved by EU Commissioner for Enlargement Stefan Füle, who clarified that the Association Agreement "does not prevent Ukraine from developing a constructive relationship with the Eurasian Customs Union as long as this is based on the respect of WTO rules and does not contradict the DCFTA."¹²

Meanwhile, Ukraine has reduced its vulnerability to Russian sanctions by minimizing its gas purchases from Russia, which it plans to cease completely in a few years, violating the nation's January 2009 agreement with Gazprom. The country is cutting gas consumption and trying to develop multiple alternative sources of gas, including exploiting shale gas and importing gas from Europe. The government has just adopted an energy strategy aimed at making Ukraine self-sufficient in gas by 2030.

9. Vladimir Putin, "Zasedanie Kollegii Federal'noi sluzhby bezopasnosti" ["Meeting with the Collegium of the Federal Security Service"], February 14, 2013, www.kremlin.ru (accessed on February 14, 2013).

10. See, for example, "Soglashenie s Yevrosoyuzom navsegda zakryvaet dlya Ukrainy dveri v TS—sovetnik Puina" ["Putin Adviser: An Agreement with the European Union Closes the Door for Ukraine to the Customs Union Forever"], *Ukrainskaya pravda*, April 27, 2013.

11. "Memorandum ob uglublenii vzaimodeistviya mezhdru Evraziiskoi ekonomicheskoi kommissiei i Ukrainoi" ["Memorandum on the Deepening of the Inter action between the Eurasian Economic Commission and Ukraine"], Astana, May 29, 2013, mimeo.

12. European Commission, "EU-Ukraine: Statement by Commissioner Stefan Füle Following the Meeting with Andriy Klyuyev about the Road to Signing the Association Agreement," August 28, 2013, http://ec.europa.eu/index_en.htm.

It appears that in June 2013 the Kremlin realized that the European Union really will sign the Association Agreement with Ukraine in November 2013.¹³ Russia has pulled out all the stops to block Ukraine from signing its Association Agreement and Moldova and Armenia from initialing their DCFTAs in November. Many observers draw parallels with 2008, when Russia tried to block Ukraine and Georgia from concluding Membership Action Plans with the North Atlantic Treaty Organization at its summit in Bucharest in April 2008. Then Russia succeeded in blocking that form of Western integration of these two states, but even so war erupted between Russia and Georgia in August 2008.

In July 2013, Russia started a trade war against Ukraine. The eminent independent weekly, *Zerkalo nedeli*, published a leaked Russian memorandum, allegedly coauthored by Glazyev.¹⁴ It aims to block Ukraine from signing the EU Association Agreement and force it into the Customs Union. It lists a large number of economic and political subversive measures that Russia could undertake, such as select trade sanctions against specific businessmen.

In keeping with their plan, on July 16, the Russian government pulled important export quotas from two big Ukrainian steel pipe producers, Interpipe and the Industrial Union of Donbass. On July 24–25, the Russian Customs Committee labeled 40 large Ukrainian companies as “risky,” subjecting them to minute checks.¹⁵ On July 27–28, Putin went to Ukraine to celebrate the 1025th anniversary of the christening of Kievan Rus and refused to talk to Yanukovich, even while standing beside him. On July 29, the Russian food inspector banned imports of chocolates from the biggest Ukrainian producer, Roshen.¹⁶ On August 14, Russian customs authorities classed all Ukrainian producers as “high risk,” which subjected all their deliveries to onerous checks, thus barring most Ukrainian imports from Russia.¹⁷ Customs claimed that they eased their sanctions on August 20, but troubles persist. Ukraine has not retaliated with sanctions against Russia.

Russian leaders have also gone on a public offensive against Ukraine joining the DCFTA, making ever more shrill statements. As usual, Glazyev has taken the lead:

By signing an association agreement with the European Union, Ukraine would be depriving itself of its sovereign right on all issues of trade policy that we have handed over to the Customs Union. For us, Ukraine would stop being a strategic partner, because it would be disappearing as an international partner, as an entity under international law, because it will have to agree all its actions on trade with the European Union.¹⁸

On August 22, Putin warned that if Ukraine concluded the Association Agreement with the European Union, “the Customs Union countries must think about safeguards.”¹⁹ Russia’s First Deputy Prime Minister Igor Shuvalov told Ukraine’s Prime Minister Mykola Azarov while visiting Moscow that if Ukraine opened its border to the European Union, Russia would be forced to limit its imports from Ukraine to defend its domestic production.²⁰ Trade between Russia and Ukraine is likely to be sharply reduced as has previously happened between Russia and the three Baltic countries, Georgia, and Moldova.

The heavy-handed Russian intimidation had a direct impact on Yanukovich. Rather than giving in to the Russians, he altered his policy line in a pro-European direction in two big speeches, on Ukraine’s Independence Day on August 24²¹ and at the opening of the parliamentary session on September 3.²² In these speeches, Yanukovich not only reconfirmed his pro-European position but also fully embraced the European Union and laid out his legislative agenda for EU integration: “For Ukraine, association with the European Union must become an important stimulus for forming a modern European state. At the same time, we must preserve and continue deep-

13. Yuliya Mostovaya and Tatyana Silina, “Russkii plan, osmyslennyi i bespochadnyi” [“The Russian Plan, Thought Through and Ruthless”], *Zerkalo nedeli*, August 16, 2013.

14. “O komplekse mer po povlecheniyu Ukrainy v evraziiskii integratsionnii protsess” [“On Measures to Draw in Ukraine into the Process of Eurasian Integration”], *Zerkalo nedeli*, August 16, 2013.

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22. Viktor Yanukovich, “Vystuplenie Prezidenta vo vremya otkrytiya tret’ei sessii Verkhovnoi Rady sed’mogo sozyva” [“Speech by the President at the Opening of the Third Session of the Seventh Supreme Council”], September 3, 2013, www.president.gov.ua.

ening our relations and processes of integration with Russia, countries of the Eurasian community....”²³

In early September, Yanukovich made an agreement with the opposition and currently the parliament is swiftly adopting one law after the other demanded by the European Union. Because of the agreement with the opposition, all laws are adopted by more than two-thirds majority. These laws will bring domestic customs regulation in line with WTO standards and improve the enforcement of court rulings, the electoral law, media access for the opposition, the business environment, and conditions for prisoners. They will also reform the prosecutor’s office, the judiciary, and the police and organize repeat elections in five constituencies where elected opposition deputies were deprived of their mandates. The Constitutional Court and the judicial system are being thoroughly reformed through a constitutional amendment.

One reason for Yanukovich’s quick and forceful pro-European action was that his political advisers thought that he had no chance of being reelected in 2015 unless he signed the EU Association Agreement. An additional reason was that on September 3 Putin had forced the president of Armenia, Serzh Sargsyan, to join the Customs Union and scrap the concluded DCFTA. Moldova has also come under heavy Russian pressure, but so far has resisted it.

The most significant EU condition that remains is the release of Tymoshenko. Yanukovich has an obvious choice. If he frees Tymoshenko from prison, the European Union will in all probability sign the important Association Agreement in Vilnius in late November, which would offer Ukraine major benefits. Otherwise, it may refuse, which would leave Yanukovich vulnerable to Kremlin harassment.

In a speech to the European Parliament on September 11, EU Commissioner Füle came out with strong support for Ukraine, objecting to Russian intimidation: “Any threats from Russia linked to the possible signing of agreements with the European Union are unacceptable.” He referred specifically to “the possible misuse of energy pricing; artificial trade obstacles such as import bans of dubious WTO compatibility and cumbersome customs procedures; military cooperation and security guarantees.”²⁴

Füle has also refuted the Russian concern about rules-of-origin problems within the context of the CIS FTA: “EU goods exported to Ukraine through the future DCFTA will not qualify for preferential treatment when exported from Ukraine to Russia. Therefore, the signature of a free trade agreement

with a third party, meaning us, may not be used as a justification for the tightening of customs procedures.”²⁵

As Moscow has emphasized, the chips are down. Putin’s actions suggest that he is intent on forcing Yanukovich down on his knees, but he offers no carrots, only sticks. His prime aim does not appear to be geopolitical but to arouse Russian nationalism. On September 4, he insulted Ukrainians by saying that “we are one people” and “we have a common language.”²⁶

All observers agree that this is not an economic but a political conflict. The question is whether it primarily concerns domestic politics or geopolitics. Eminent Ukrainian journalists Yuliya Mostovaya and Tatyana Silina note that “Yanukovich does not recognize that the main threat to his power and wealth is not Tymoshenko but Russia.”²⁷ According to Russia’s prominent foreign policy specialist Fyodor Lukyanov, “the customs war was just a rehearsal for Ukraine’s European choice. Moscow has clearly signaled how it will conduct relations with Kiev if the agreement with the EU goes forward.... Obviously, any discussion of Ukraine in Russia is largely geopolitical in nature.”²⁸ German economists Ricardo Giucci and Robert Kirchner (2013) observe that “Russia has not succeeded to convince Ukraine to join the Customs Union voluntarily. Now it is trying to force it to accede.”

Putin is likely to isolate Russia and force Ukraine into the European community. Hardball is a game that Yanukovich understands very well. Both the European Union and the United States have protested the Russian trade sanctions against Ukraine, and the Ukrainian opposition is supporting their president against Russian pressure.

POLICY RECOMMENDATIONS

The analysis in this Policy Brief leads to numerous policy recommendations for the Ukrainian government, the European Union, the United States, and Russia.

1. The Ukrainian government should
 - establish elementary macroeconomic order to reduce its vulnerability. It should
 - reduce the budget deficit to a tenable level,

25. Yuliya Mostovaya and Tatyana Silina, “Russkii plan, osmyslennyi i besposhchadnyi” [“The Russian Plan, Thought Through and Ruthless”], *Zerkalo nedeli*, August 16, 2013.

26. Vladimir Putin, interview to Channel One and Associated Press News Agency, September 4, 2013, www.kremlin.ru (accessed on September 4, 2013).

27. Mostovaya and Silina, “Russkii plan.”

28. Fyodor Lukyanov, “Russia and Ukraine on the Verge of a Decisive Choice,” *RIA Novosti*, August 22, 2013.

23. “Ukraine Defiant in Face of Russian Pressure over EU Path,” *Moscow Times*, August 26, 2013.

24. Stefan Füle, “Statement on the Pressure Exercised by Russia on countries of the Eastern Partnership,” Strasbourg, September 11, 2013, http://ec.europa.eu/index_en.htm.

- liberalize currency controls to render the exchange rate flexible,
 - raise the very low gas prices gradually to a market level for domestic production, consumers, and utilities, and
 - meet IMF demands and become eligible for IMF funding.
 - comply with EU demands to receive its signature on the Association Agreement:
 - free Tymoshenko,
 - reform the judicial system and law enforcement so that rule of law can develop, and
 - allow more independent media.
 - seek resolution of conflicts with Russia:
 - notify the WTO about the Russian trade sanctions and proceed with its conflict resolution, and
 - take Russia to CIS arbitration in St. Petersburg for violating the CIS FTA.
2. The European Union should
- make sure that Ukraine complies with its conditions so that they can sign the Association Agreement in Vilnius in November. The European Union could sign the agreement conditionally, demanding concrete prior actions before it comes into force,
- protest Russian trade sanctions against Ukraine that violate WTO rules, and
 - intensify top-level political exchanges ahead of the Vilnius summit.
3. The United States has considerable influence on Ukraine. It should
- support both the Ukrainian government and the European Union so that the Association Agreement can be signed in Vilnius in November,
 - protest Russian trade sanctions against Ukraine that violate WTO rules, and
 - organize a top-level visit to Kiev before the Vilnius summit.
4. The Kremlin is not acting in Russia's national interest and is increasing budget costs, distorting the Russian economy, and undermining Russia's international standing. It should:
- obey the rules of the WTO and the CIS FTA and end its trade sanctions against Ukraine,
 - recognize Ukraine's right to conclude FTAs and learn about rules of origin, and
 - reconsider the Customs Union, as it is harmful to Russia's national interests.

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