

Trade policy issues in the wider Europe – that led to war and not yet to peace

Michael Emerson

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Abstract

This paper looks at the trade policy landscape of the EU and the wider Europe, with a focus on issues arising from the signature on 27 June 2014 of Deep and Comprehensive Free Trade Agreements (DCFTAs) between the EU and three East European countries (Georgia, Moldova and Ukraine), and actual or prospective issues relating to the customs union of Belarus, Russia and Kazakhstan (BRK), and the Eurasian Economic Union whose founding treaty was signed on 29 May 2014. While the contrived collision between these projects has tragically induced Russia to break all the established international security norms by waging war against Ukraine, the present paper deals essentially with trade policy issues. The huge expansion of intercontinental free trade area negotiations currently underway, in which the EU is an active participant alongside much of the Americas and Asia, stands in contrast with Russia's choice to restrict itself to the Eurasian Economic Union, which is only a marginal extension of its own economy. Alone among the major economies in the world, Russia does not seek to integrate economically with any major economic bloc, which should be a matter of serious concern for Moscow. Within the wider Europe, the EU's DCFTAs with Ukraine, Moldova and Georgia are a major new development, but Russia now threatens trade sanctions against Ukraine in particular, the economic case for which seems unfounded and whose unilateral application would also impair the customs union. The Belarus-Russia-Kazakhstan customs union itself poses several issues of compatibility with the rules of the WTO, which in turn are viewed by the EU as an impediment to discussing possible free trade scenarios with the customs union, although currently there are far more fundamental political impediments to any consideration of such ideas. Nonetheless this paper looks at various long-term scenarios, if only as a reminder that there could be much better alternatives to the present context of conflict around Ukraine.

Michael Emerson is Associate Senior Research Fellow at the Centre for European Policy Studies. This is a revised version of a paper presented to a conference on trade policy regimes of the IIASA project, "Challenges and Opportunities of Economic Integration within the Wider European and Eurasian Space", Vienna, 8-9 July 2014. The author is grateful to Roderick Abbott for advice on WTO-related points, Veronika Movchan on CIS/FTA-related points, and Guillaume Van der Loo on legal aspects.

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Trade policy issues in the wider Europe may sound like a safely technocratic matter, but in the last six months the signing of a free trade agreement between the EU and Ukraine became the proximate cause of the gravest conflict Europe has seen in the post-Soviet period. This paper lays out the economic issues as they now stand, above all as between the EU, Ukraine and Russia. The agreement between the EU and Ukraine was signed in June. But the conflict waged by Russia continues, at the expense of any real prospect for the objectively desirable integration of the entire wider Europe – from Lisbon to Vladivostok – from which Russia would be the biggest beneficiary.

1. Models of trade and integration relationships viewed from Brussels

The EU is currently engaged in a huge expansion of the share of the world with which it has, or is currently negotiating, preferential trade agreements. This is illustrated in the map below, where the white spaces are the exceptions to this pattern, and from which it is evident that Russia is the only major economy in the world that has no preferential agreements with the EU (either already or in the course of negotiation), or in fact with any other major trading bloc.¹ China and the EU are subject currently only negotiating an investment agreement, but with some understanding that a free trade agreement (FTA) might be negotiated in a next stage after this.

EU trade policy in the world



Source: European Commission, DG Trade.

¹ Australia, which occupies a large white space on the map, has just concluded an FTA with China, and has other FTAs with East and South-East Asian states.

The driving forces behind this huge trade policy development, as announced by the Commission in its 2006 Global Europe Strategy,² are twofold. One is the failure of the Doha Round after over a decade of negotiation to reach substantial agreement at the global level. A second is the concern of the EU to sustain its position as a competitive economy in the fast-changing world with the rising force of much of Asia as trading economies. As its huge trade volumes and actual surplus on current account show, the EU economy is, broadly speaking, quite competitive in global markets, with many industrial and service sectors performing at world-class level. However, the extraordinary advances in much of Asia and the continuing leadership of the US in IT-related sectors mean that the EU cannot afford to take risks of slipping backwards in its global competitiveness. Expansion and deepening of its trade agreements with virtually the whole of the rest of the technologically advanced world are therefore deemed to be part of the prescription for keeping up with global trends.

But this leads immediately to a point for Russia. This huge expansion of preferential trading agreements is a global phenomenon, not just a European one. The Americas and Asia are doing the same. Only Russia stands alone among the world's major economies in not integrating with any major global trading bloc; the Eurasian Economic Union is not in this category. We return to the risks inherent in this situation at the end of this paper.

The contents of new agreements recently concluded or under negotiation are much deeper than some of the earlier agreements entered into by the EU, or seen in many other FTAs in the world. A certain hierarchy of types of agreement, by depth of content, can be observed.

Model 1 sees a simple 'classical' FTA, with suppression of tariffs and quantitative restrictions. There is a reliance on WTO principles concerning industrial standards, and sanitary and phytosanitary (SPS) regulations for agri-food products, which are based on the application without discrimination of national standards to imports from partner states. Interestingly, the EFTA countries have recently made an agreement with Ukraine that falls into this same category.

Model 2 goes further in reducing technical barriers to trade, such as in the case of the recent EU-Korea FTA for key industrial sectors (electrical, cars, pharmaceuticals, etc.), with increased reliance on international standards which are often the same as European standards,³ simplified conformity procedures and other WTO+ arrangements for government procurement and intellectual property rights. This model is feasible between economies that share high technical standards and mutual trust over a reliable rule of law.

*Model 3 goes further still, with negotiation over convergence of regulatory standards, for service sectors as well as for the elimination of non-tariff barriers for trade in goods. This model is now being explored in the Transatlantic Trade and Investment Partnership (TTIP) between the EU and US. The range of techniques may include some harmonisation, but more often the possible agreements are likely to rely on the mutual recognition or equivalence of technical standards. A further key feature of this negotiation is its *symmetrical* nature between two major global trading powers, with regulatory systems that are often similar in broad intent but quite divergent in practice. The outcome of these negotiations to reduce these divergences is still very much an unknown quantity, and notably therefore on how deep the possible FTA will be (and indeed whether it would qualify as a case distinctly*

² http://trade.ec.europa.eu/doclib/docs/2006/october/tradoc_130376.pdf

³ More precisely, these standards are established by the Economic Commission for Europe (ECE) and the International Standards Organisation (ISO) and then are often used as EU standards, and EU Regulations and those of member states are usually aligned on international standards where they exist.

deeper than model 2). However, given the huge share of world trade still occupied by the trans-Atlantic pair, whatever regulatory convergence is achieved would most likely have global significance. Indeed other main trading partners of either or both the EU and US, such as Mexico, Brazil, Canada and Turkey, are already anxiously following these negotiations in order to work out how they might avoid being hit by a new relative competitive disadvantage.

Model 4 opens up the several categories of asymmetrical agreements between the EU and its much smaller neighbours.

Model 4.1 is the customs union, such as the one between the EU and Turkey, whose functioning however is paralleled by a considerable amount of convergence by Turkey on EU regulatory standards, stimulated by the ongoing accession process. Even if the prospect of EU accession is currently stalled, Turkey has already developed a substantial extent of compliance with EU legislation. The Turkish-EU experience of the customs union is broadly successful, but still throws up problems of coping with divergent interests of types that the Eurasian Economic Union is, or will be, confronted with.

Model 4.2 is the European Economic Area (EEA), bringing together Norway, Iceland and Liechtenstein with the EU, and in which the non-EU partner states have accepted to adopt the entirety of EU single market law as the condition for being treated ‘as if’ full member states in terms of guaranteed full access to the EU single market. This is a highly developed system, with specific institutional arrangements including a special court of justice for disputes, consultation procedures over new EU laws, and their ‘dynamic’ application (which means that, subject to some safeguard provisions, all new EU market laws have automatically to be accepted by the non-EU partner states to prevent obsolescence of the agreement). It should be noted, however, that the EEA is not a customs union, which leaves the partner states individually or as a group in EFTA free to make their own FTAs separately from the EU (as in the case of the EFTA-Ukraine FTA mentioned under model 1).

The Swiss case is sometimes regarded as a further model, but it is really only a messier derivative of the EEA model, with problems that both parties would like to do without.

Model 4.3 is now that of the new Deep and Comprehensive Free Trade Agreements (DCFTAs), signed by Georgia, Moldova and Ukraine on 27 June 2014. The content of these agreements can be described as a process of evolving gradually but incompletely over quite a long transition period towards the EEA model. These agreements thus go way beyond the simple ‘classical’ FTA model, and take on board a large but incomplete number of EU single market laws. The basic pattern is one of gradual convergence on EU standards, but with a spectrum of variations as regards the degree of strictness of the obligations and length of transition periods. On the one hand, there are many EU directives and regulations that the partner states ‘will’ within a certain time scale adopt (transpose) into their own domestic legislation. On the other hand, there are some areas where the partner state can request a lengthening of the implementation delays in the event of need, or some other areas that see far looser language about the partner state pledging “best endeavours” for “gradually moving towards compliance with EU standards”. This means a considerable range in the degree to which some of the provisions are legally binding. In particular, the dispute settlement procedures in the event of non-observance of the commitments are more rigorous for core features of the DCFTA than for various other sectors of cooperation.⁴ The political

⁴ In formal legal terms, Title 4 of the Association Agreement is the DCFTA – whose core features include tariff and non-tariff barriers, services, public procurement, intellectual property rights and competition policy – whereas Title 5 concerns cooperation in sectors such as environment, transport, company law, consumer protection and labour market policies.

idea is that whereas the core DCFTA content is more of a traditional trade policy bargain with reciprocal obligations, for other areas of cooperation the partner states are choosing which parts of the corpus of EU law they deem to be useful for their economic policy reforms and economic governance.

It remains to be discussed what kind of model from the above menu, or other variants, might best suit a hypothetical agreement between the EU and the Eurasian Economic Union, and this issue is taken up later.

2. More on the Deep and Comprehensive Free Trade Agreements

As is well known, the DCFTAs and Association Agreements (of which they form a part) contain no promises of future EU membership, despite the fact that all three states concerned declare full membership as their long-term objective, including now in the case of Ukraine the clear mention made by President Petro Poroshenko in his recent inaugural address. But neither is future membership excluded, since it is actually a legal right according to Article 49 of the Treaty of Lisbon that any European democracy may apply for full membership.

Whether in this case, i.e. in the absence of a clear membership perspective, the DCFTAs are overloaded in commitments taken on by the partner states, either politically or as a matter of economic policy, has certainly been a contested question. The reader of these 900-page texts, with a further thousand pages of annexes, can observe that between 300 and 400 EU directives and regulations are to be adopted.⁵ These range across a vast landscape of both external and internal policies. The rationale for accepting this mass of obligations has been both political and economic. The political case is that this is only consistent with the ultimate objective of EU membership, signalling to the EU that the partner states are serious in this regard. The economic case is both about opening the economy as well as, and maybe even more importantly, about improving the quality of economic governance at home. All three partner states have had, and still have big challenges in completing the transition from the communist regimes into modern market economies. The predominant experience in the post-Soviet states, as well as post-Yugoslav states, has been to get 'stuck in transition' with economies that have been largely privatised but afflicted with deep systemic disorder regarding the rule of law, corruption and 'state capture' (i.e. where political leadership groups appropriate national economic assets for their private benefit). The case of Ukraine under Yanukovich became an egregious example of these disorders, while Georgia has made big progress in escaping from this condition, with Moldova somewhere in between. On the question of how to design and execute a real reform programme, one argument that is used to justify the DCFTA package is that this puts the process of reform on 'automatic pilot', thus helping to circumvent the hazards mentioned.

This links to more mundane technical and economic arguments. All three partner states agree, to take one example, to transpose into their national laws the EU directive on the safety of toys. The directive in question, alongside hundreds of others, has been painstakingly worked out over years of expert consultations and negotiations into a text of 180 pages. While within the EU itself there is lively debate over the risks of over-regulation, broadly speaking independent stakeholders report that for this kind of market regulation the EU has got the balance roughly right.⁶ For the DCFTA partner state that wonders whether it

⁵ Although to ease implementation burdens, some of these laws are subject to the exclusion of certain provisions, or only partly to be adopted.

⁶ The evidence for this is seen in the Balance of Competences Review currently being undertaken by the British government in the context of the argument underway that various powers of the EU

is a good idea to adopt the EU directive, the following questions have to be confronted. Do you want your toys to be more safe, or maybe to be less safe than EU toys? Then do you want your toy industry to have a chance of competing in international markets? Of course there is the outright protectionist argument that ‘we want our own regulations to be different’, and therefore to assure a protected but uncompetitive future. While these arguments may continue, it is clear what the DCFTA partner states have judged best, namely to set aside progressively their own national (or inherited GOST) standards, and to aim at an open and competitive economy.

3. Implications of the DCFTAs for the Russian economy

A next question is whether or how the DCFTAs of Georgia, Moldova and Ukraine may affect their other trading relationships, and notably with the countries of the Eurasian Economic Union, and also the economic interests of these third countries. These questions deserve clear consideration, given that they have been contested arguments about the costs and benefits of joining the BRK customs union instead of the DCFTAs. Indeed Armenia switched its position on precisely this question in September 2013.

The EU and Russia agreed already in June 2013 before the current Ukraine crisis to engage in a consultation on whether the new DCFTAs, and especially that of Ukraine, give any legitimate cause for concern for Russia.

It has been publicly argued several times by President Putin that Russia risked being “flooded with goods from the EU”. This argument ignores the ‘rules of origin’ generally applied by WTO members, which include Russia, Ukraine and of course the EU. Goods exported to Ukraine from the EU tariff-free by virtue of the DCFTA, and which then might be sold on into the Russian market, would still be treated as ‘made in the EU’ and therefore subject to Russia’s import tariffs that apply to the EU (currently its WTO-bound MFN tariffs). The only exception to this would be if the goods were intermediate products, which might then be substantially transformed in Ukraine into different final products, with a significant Ukrainian value-added. In this case the products would have become ‘made in Ukraine’, and could benefit from the Russia-Ukraine free trade agreement (although Russia talks now of possibly cancelling the existing free trade provisions). The rules determining whether the goods shift from ‘made in the EU’ into ‘made in Ukraine’ are very precise and subject to dispute procedures that allow for the preferences to be suspended in the event of fraud. It should be added that the nature of EU exports to Russia, with a high proportion of advanced ‘branded’ products, makes the likelihood of such frauds rather implausible.

A second argument relates to the fact that under the DCFTA Ukraine will progressively adopt EU technical product standards as its own national standards. The suggestion has been made that this would mean that Ukrainian enterprises exporting to Russia would be obliged to make these goods according to EU standards, and that this would hinder these traditional trade flows where Russia applies different standards. This argument is incorrect, since Ukrainian enterprises would only have to apply these standards to sales on their domestic market or to the EU, but they would remain entirely free to produce for export to Russia according to Russian standards, or to China in accordance with Chinese standards, etc. This is standard practice among WTO member states.

In practice the DCFTA with Ukraine only specifies 27 product directives for adoption under Ukrainian law within fixed time schedules, generally of three to five years after entry into

should be ‘repatriated’ to the national level. In fact the evidence in support of repatriation turns out to be negligible.

force, although many of these seem to have been transposed into Ukrainian law already ahead of schedule.

On the other hand, Russia itself is taking steps to reduce its reliance on supplies from Ukraine. For the railway sector Russia has set targets for import substitution away from Ukrainian supplies, and Dmitri Rogozin, responsible for the Russian industrial-military complex, has announced the aim of moving rapidly to lessen reliance on supplies from Ukraine. These are clearly autonomous policy decisions being taken by the Russian side.

A more subtle economic argument is that the DCFTA would mean an erosion of Russia's relative competitiveness for exports to Ukraine, since the EU will, after the transition periods for Ukraine's tariff cuts have elapsed, enjoy free access to this market which it did not have before. However this argument is not a strong one for three reasons. First from the legal standpoint, the making of free trade agreements between WTO member states is regulated by WTO rules, and the DCFTAs will be in conformity with these rules. Secondly, Russia is doing the same thing in effect with Kazakhstan's joining the BRK customs union and thereby applying a higher external tariff than before, and thus creating a trade preference for Russian producers relative to EU exporters. Thirdly, Russia's exports to Ukraine are hardly competing with EU exports, given that gas is the predominant product, followed by supplies for Ukraine's Soviet-era nuclear facilities. So this line of argument lacks force in economic terms. In terms of WTO jurisprudence, the argument has absolutely no standing, since otherwise any regular WTO-compatible free trade agreement could be contested for damages.

All in all, this thorough review of the conceivable arguments of possible concern to Russia reaches the conclusion that it is basically a non-story.⁷ But since the political context is so sensitive, with Moscow currently warning that if its economic interests are harmed it will retaliate, it is just as well to put unjustified fears and suspicions to rest.

In fact, Putin has warned that Russia could cancel the tariff preferences accorded to Ukraine under the CIS (Commonwealth of Independent States) free trade agreement of 2011. This agreement states in Annex 6 that if the Customs Union is subject to damage or threat of damage from imports from another CIS state that belongs also to another regional trade agreement, then the members of the Customs Union may impose MFN tariff rates, cancelling the tariff-free preference.⁸ From the text it is to be noted that the 'members of the Customs Union' are referred to in the plural, which is only logical for a customs union, whose technical integrity would be impaired if individual member states adopted different tariff regimes.

However, this constraint on individual action by Russia, in the event that Belarus and Kazakhstan fail to agree on the 'punishment', led to the adoption of a Decision (No. 48) by the Supreme Eurasian Economic Council on 24 October 2014, to enable individual member states to act in the specific case that Ukraine signed the Association Agreement with the EU.

⁷ The arguments presented here largely agree with those coincidentally published at almost the same time by Sergei Alexashenko in "European Choice: Crime and Punishment", *Gazeta.ru*, 06.07.2014 (http://www.gazeta.ru/comments/2014/07/05_a_6098741.shtml).

⁸ Annex 6 states: "In case participation of the [signatory] Party in the agreement specified in Paragraph 1 of Article 18 [that is, in another regional trade agreement] leads to an increase in imports from such Party in such quantities as to cause damage or threaten to damage the industry of the Customs Union, the countries-members of the Customs Union, without prejudice to the application of Articles 8 and 9 this Agreement [these articles relate to application of antidumping, safeguard and countervailing measures] and after appropriate consultations, reserve the right to impose duties on importing the goods from such first Party in the amount of MFN rates".

The Eurasian Economic Commission's minister for trade, Andrei Slepney, commented on 4 July 2014:

Russia had earlier obtained the right to introduce unilaterally, without participation of other countries of the [Eurasian Economic Union], measures aimed at protecting its market in case the situation on this market deteriorates as a result of the signature by Ukraine of the Association Agreement with the European Union.⁹

So here Russia is signalling its 'right' to override the preferences of Belarus and Kazakhstan, even if such unilateral action will be manifestly incompatible with the basic principles of any serious customs union. The timing of this Decision, one month before the EU's Vilnius summit, was obviously part of Russia's pressuring of President Yanukovich to renege on signing at Vilnius, which he duly did.

In practice, Russia has more recently asked both Belarus and Kazakhstan whether they would be willing to join in activating these punitive measures against Ukraine. Both Minsk and Astana said they would *not* support such an action, which returns to Moscow the question whether Russia alone would implement this suspension of tariff preferences. If it did so, this would be in flagrant breach of the basic rules of the customs union, using the Decision of 24 October 2014, as the contrived legal basis, and would for enforcement require customs controls at the Belarus-Russia border to prevent circumvention. Quite apart for these legal aspects, the economic case for claiming damage by Ukraine neither exists nor threatens to materialise. One can add that this possible unilateral action would be not only technically inconsistent with the customs union but also politically inconsistent with any talk about 'Lisbon to Vladivostok'.

4. Questions about the BRK customs union and WTO rules

From the perspective of the EU, the ongoing and future trading relationships in the wider European space should be compliant with WTO rules, and this should also be the case for Russia as a WTO member. In this context, a number of issues arise regarding the current evolution of the BRK customs union, its enlargement and possible FTAs between it and other economies. The practical issues concern the non-membership of WTO by Belarus and Kazakhstan, and the planned enlargement of the BRK customs union to other states that are already WTO members, notably Armenia and Kyrgyzstan, and the implications for hypothetical negotiations over an FTA with the EU. The box below extracts the most relevant provisions from the GATT/WTO texts.

Selected GATT/WTO rules

Article I: General Most-Favoured-Nation Treatment

With respect to customs duties ... (etc.), any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

Article XXIV on Customs Union and Free Trade Agreements

Article XXIV.4. The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or of a

⁹ See BELTA, Belarus News (http://www.belta.by/ru/all_news/economics/EEK-ne-iskljuchaet-primenenija-zaschitnyx-mer-na-rynke-vsego-TS-v-svjazi-s-assotsiatsiej-Ukrainy-i-ES_i_674248.html).

free-trade area should be to facilitate trade between the constituent territories *and not to raise barriers to the trade of other contracting parties with such territories.* (Emphasis added)

Article XXIV.5. Accordingly, the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or a free trade area or the adoption of an interim agreement necessary for the formation of a customs union or a free-trade area.

Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 (extracts from Articles 4 and 5).

4. Paragraph 6 of Article XXIV establishes *the procedure to be followed when a Member forming a customs union proposes to increase a bound rate of duty.* In this regard Members reaffirm that the procedure set forth in Article XXVIII, as elaborated in the guidelines adopted on 10 November 1980 (BISD 27S/26-28) and in the Understanding on the Interpretation of Article XXVIII of GATT 1994, must be commenced before tariff concessions are modified or withdrawn upon the formation of a customs union or an interim agreement leading to the formation of a customs union. (Emphasis added)

5. These negotiations will be entered into in good faith with a view to achieving mutually satisfactory *compensatory adjustment.* In such negotiations, as required by paragraph 6 of Article XXIV, due account shall be taken of reductions of duties on the same tariff line made by other constituents of the customs union upon its formation. Should such reductions not be sufficient to provide the necessary compensatory adjustment, *the customs union would offer compensation, which may take the form of reductions of duties on other tariff lines.* (Emphasis added)

GATT/WTO law is a complex matter with many grey areas concerning its interpretation and implementation. Some basic rules are clear, however. GATT Article XXIV provides for the creation of regional trade agreements such as customs unions and free trade areas between members, however with the proviso in Article XXIV.4 that the purpose should be to facilitate trade between its members and not to raise barriers to the trade of other WTO members. Moreover, if it is proposed to include a non-WTO member in such an agreement, Article I, which sets out the core MFN principle, provides that any advantage (e.g. preferences) granted to “any other country” shall be immediately extended to all other member states. Here there is a problem, since neither Belarus nor Kazakhstan is yet a WTO member state, and the BRK customs union has of course not extended its preferences to the rest of the WTO.

This is why the EU has consistently responded to references in Russian speeches about a conceivable ‘Lisbon to Vladivostok’ agreement between the EU and the BRK customs union, by saying that all members of the customs union should first join the WTO and the agreement itself should become WTO-compliant. This could be done with completion of the accession to the WTO of Belarus and Kazakhstan, but this has not yet happened.¹⁰ There is consistency here with the position of EFTA, which has had five negotiating rounds (currently suspended) over a possible FTA with the customs union, but states that it is assuming that Belarus and Kazakhstan would accede to the WTO before signing the agreement.

The terms of Kazakhstan’s participation in the customs union has been subject to requests for 1,000 tariff lines to be treated in a special manner. It is understood that 200 of these lines will be subject to exemptions from the common external tariff, and 800 to transition periods. Presumably these requests have been running parallel to or connect with Kazakhstan’s negotiations to join the WTO.

The planned accession of Armenia and Kyrgyzstan, which are already WTO members, to the BRK customs union would fall under the disciplines of Article XXIV.6 and the ‘1994

¹⁰ Kazakhstan’s application for WTO membership has reached an advanced stage, but it is not yet concluded. Belarus seems to be in no hurry to move towards WTO membership.

Understanding', which provides for negotiations where the acceding country has to raise its tariff levels in order to be compliant with the common external tariff of the customs union. Here the rules say that the customs union should offer compensation to other WTO members, which may be by reducing its common external tariffs by agreed amounts. The current status of the negotiations within the customs union and with the acceding countries is not wholly transparent to the present author. However, some key points are known. The Armenian government has submitted a list of 900 tariff lines for which it requests special treatment in relation to the common external tariff, because otherwise accession would increase Armenia's tariff levels significantly. It is understood that these requests will be met by a transition period. In the case of Kyrgyzstan also, accession would mean raising its external tariffs, and here the increase in tariffs on imports from China would be notably damaging.

In the cases of both Armenia and Kyrgyzstan, the raising of their WTO-bound tariffs to the higher levels of the common external tariff of the customs union would present the case for other WTO members to demand compensation through proportionate reductions in the common external tariff. Since the final decisions on the terms of Armenia and Kyrgyz accession to the customs union have not yet been communicated to the WTO, demands for compensation have not yet been formulated, but can be anticipated.

5. What model for the common neighbours of the EU and Eurasian Economic Union?

It does not take an econometric genius to work out that the best economic regime for the countries lying between the EU and the Eurasian Economic Union would be open and reliable trade and investment relations with both. On the EU side, the basic choice of the DCFTA, rather than a customs union, means that Moldova and Ukraine remain free to continue their participation in the CIS Free Trade Agreement of 2011, which covers also the three countries of the Eurasian Economic Union, plus Armenia, Kyrgyzstan, Tajikistan and (joining subsequently) Uzbekistan. This would pose no problems of compatibility of tariff regimes. Improving the quality of the CIS-FTA remains an issue, both to reduce or eliminate the present exemptions from the free trade principle, and to respect a strictly technical application of industrial standards and SPS regulations, avoiding their politicisation.

As already pointed out, the European system of industrial standards remains voluntary in the sense that the DCFTA states can produce according to the standards of the Eurasian Economic Union for their exports to these countries. There remains the question what technical standards are to be adopted by the BRK customs union. Various official documents of the Eurasian Economic Union speak of 7,000 standards, of which 51% would be GOST standards.¹¹ At the same time, speeches are heard to the effect that the industrial standards of the customs union will largely converge on European and international standards. These are of course very different systems, and pose a rather fundamental issue for the future of the economic system between the BRK customs union and both the DCFTA countries and the EU.

It also remains to be seen what kind of trading regime the Eurasian Economic Union will want to have with non-member states in their neighbourhood, and in particular whether they will want to differentiate between the DCFTA states and the non-DCFTA states. One

¹¹ «Система технического регулирования в рамках Таможенного союза и Единого экономического пространства», Евразийская экономическая комиссия, 2014, "The system of technical regulation in the framework of the Customs Union and the Single Economic Space", working notes of the Eurasian Economic Commission, 2014.

can expect that Russia will on present form wish to carry on having leverage over the DCFTA states, while seeking to get the non-DCFTA states into the customs union. On the other hand, Belarus and Kazakhstan want to keep open trading relationships with Ukraine especially. Ukraine proposes to negotiate an FTA with the customs union in 2013, but Russia declined to pursue this 3+1 deal.

Are there better alternatives to be considered for the cases where Russia presses accession to the customs union upon CIS states that want to keep the freedom to determine their own external trade policies? One idea could be to draw on the EU-EEA model, where the non-EU states join fully in the single market, but not the customs union. This model could be especially relevant for Armenia, which in any case has no common frontier with the customs union, and also negotiated a DCFTA with the EU in accordance with its prime interest in developing an open competitive economy; and also Kyrgyzstan and Tajikistan that have frontiers and major trading relationships with China. An arrangement of this kind need not undermine the depth of these countries' integration into the single economic space of the Eurasian Economic Union (like Norway in the EEA), but would make allowances for the understandable special concerns of these small and geographically peripheral economies. This links on to the broader question of how to optimise the trading regime for the common neighbours of the EU and Russia, to which we now turn.

6. What model for an agreement between the EU and the Eurasian Economic Union?

While the current political context makes this question of no immediate relevance, it is possible for independent analysts to discuss some scenarios as academic hypotheses.

There are two distinct but inter-related issues here: 1) What economic interests would the two parties share to induce them to make a basic or deeper FTA? 2) What kind of agreement can be envisaged, keeping in mind the various models already discussed?

A prevalent argument on the Russian side is that an FTA with the EU would risk being too asymmetric in the sense that the EU's imports from Russia (and Kazakhstan) are already virtually tariff-free because of their mainly raw commodity composition, whereas Russia would be dismantling significant tariffs on its imports of manufactured goods. While this is factually correct, it does not necessarily mean that the benefits are equally asymmetric. This depends crucially on the nature of the benefits in question, which leads into two debates. The first is about the distribution of benefits from tariff cuts between consumers, producers and government. The second is about strategies for achieving the modernisation and international competitiveness of the industrial and service sectors.

For a commodity-rich economy, whose wealth is heavily dependent on its commodity exports, there is necessarily a counterpart in terms of imports of consumer and investment goods. For consumers, the reduction of import tariffs and enhancement of competition in domestic markets are the surest routes for harvesting welfare gains. This may mean tougher times for producers who see their profit margins squeezed in the short run, and a loss of tariff revenues for the state budget, which however has ample revenue sources from the profits of commodity exporters. In addition, the lower cost of investment goods helps the competitiveness of industry. These potential welfare gains for the Russian or Kazakh consumer will be incomparably higher than any gains of this kind for the EU; so here the asymmetry is turned around 180 degrees.

On the modernisation question, it is pertinent for Russia in particular to evaluate its options between economic integration with Europe, or, as is topically discussed, with Asia and China

in particular, or to keep to the status quo (integration with no other major trading power). The recent agreement between Russia and China to invest in a major gas pipeline is going to make Russian trade structures with the EU and China more similar in their commodity export/manufactures import structures. But this does not answer the vital question for Russia as to how it could best modernise its industrial and service sector economy, with increased integration of corporate relationships more with the EU or with China. Despite the interest of geopolitical commentators in the so-called ‘pivot to Asia’ by Russia, the economics of this question point in favour of European solutions. This is based not only on the obvious matter of geographical and cultural proximity with Europe, but also on the view that major European enterprises are much more likely to be the kind of partner that Russian enterprises need with regard to technology transfer and supply-chain linkages.¹² In this respect, too, the potential gains for the Russian economy appear to be potentially more important than for the European economy. By contrast, the status quo, with no radical opening by Russia to any major trading bloc, looks like a recipe for a continuation of the economic stagnation in which it has been mired since the end of the recent commodity price boom.

Debate over the nature of the contemporary modernisation challenges, and the risks in not facing up to them, are heightened by the profound transformations going on now in the global economy. In short, the ‘digital revolution’, currently racing ahead in the advanced economies of the world, is having the effect of breaking up traditional production-line and supply-chain structures. The digital economy sees both an increasing share of IT-related services built into the value-added structure of both goods and services, and an extraordinary dispersion or fragmentation of the geographical location of many components of the supply chains.¹³ To simplify, all manner of inputs can be sourced anywhere, as long as of course they are competitive in price and quality. Russia has, for example, impressive strengths in IT-related sciences and skills, but for these to flourish to the extent of generating macroeconomic gains they have to be fully integrated into global markets and production structures. The key to achieving this full integration is the electronic connectivity of people, as is manifestly appreciated by younger generations everywhere. This leads back to the main issues for trade policy negotiators, where the need for compatible technical standards is a *sine qua non* of success in the global economy, as is also the service-sector liberalisation agenda (for rules of establishment, the cross-border supply of services, and rules for key personnel and professional standards).

Noting these arguments why Russia might evaluate more positively the prospect of an FTA with the EU than is the current conventional view, we may be encouraged to go on to consider the form such an agreement might take. The DCFTA model can surely be set aside, since it would imply an unacceptable amount of compliance with EU internal market law. Russia does not want to join the EU. The EEA model would be even less acceptable.

An interesting thought experiment might to consider the case for the EU and the Eurasian Economic Union to merge their customs unions. The economic case for this could be made, but it would mean such a cession of economic policy sovereignty by Russia to a preponderant EU that we set this aside too.

Much less implausible would be a moderately deep free trade agreement between the EU and the Eurasian Economic Union. What would ‘moderately deep’ mean in concrete terms? It would mean more than the simple ‘classical’ FTA (e.g. cutting out tariffs, but with

¹² The present author heard this argument clearly made by a former Russian minister, now an academic economist, at a recent conference.

¹³ See for example, Alfredo Valladao, “Masters of the Algorithms – The Geopolitics of the New Digital Economy from Food to Google”, German Marshall Fund of the United States, 2014.

retention of WTO-based rules for national treatment on non-tariff barriers). The Russian side would surely want a richer agreement to enhance its 'modernising' impact. It could resemble the EU-Korea FTA with serious content on industrial and agri-food standards, financial services, government procurement and intellectual property rights. But it would exclude bringing in as much EU internal market legislation as in the case of the DCFTAs. A crucial issue would be (as already discussed above) how far Russia and the Eurasian Economic Union are willing to embrace European technical standards for industrial products, especially to the extent that these are also international standards.

A further option for enhancing this hypothetical EU-Eurasian Economic Union agreement would be to transform it into a Pan-European Free Trade Area (PEFTA), including also the EFTA and DCFTA economies. Apart from being a first-best economic system, its implications for peace and harmonious integration across the wider Europe would be a political achievement of the highest value, standing in vivid contrast to the dreadful present.

7. Conclusions

The EU is greatly expanding its preferential trade relationships with all major trading blocs in the world, as is also the trend in the Americas and Asia. On the other hand, by contrast, Russia is alone in not integrating with any trading bloc of global significance, with serious implications for its economic modernisation and competitiveness. The BRK customs union and Eurasian Economic Union are and will surely remain only a marginal extension of Russia's own economy, notably because the accession of Ukraine is now out of the question,

The EU's DCFTAs with Georgia, Moldova and Ukraine are a new model trade agreement, with very comprehensive content but variable degrees of flexibility over implementation.

Fears expressed by Russian leaders that its economic interests would be harmed by the DCFTAs seem unfounded. Nonetheless Russia has pushed ahead with initiatives intended to provide a legal basis for punitive action against Ukraine. But since Belarus and Kazakhstan do not agree to such measures, unilateral action by Russia would impair the integrity of the customs union, and in addition would be quite inconsistent with any proposals for a common European economic space, such as the 'Lisbon to Vladivostok' idea promoted by President Putin.

There are issues raised by the BRK customs union that for the outsider could benefit from clarification, first some WTO-related issues (Kazakhstan's accession to the WTO, and the planned accession of Armenia and Kyrgyzstan to the customs union, which could give rise to claims by other WTO members for compensation); secondly, the compatibility of the technical standards being adopted with international and European standards; and third, how the current CIS free trade area will be adapted in relations between the members and non-members of the customs union, including the DCFTA states (this is a more general question going beyond the current threat by Russia to punish Ukraine unilaterally).

Various hypotheses for an agreement between the EU and the Eurasian Economic Union are discussed, including the optimal case of a pan-European free trade area (PEFTA), to include also DCFTA and EFTA states. Arguments frequently heard in Russia that such arrangements would disproportionately benefit the EU are contested, on grounds that while it is true that the EU faces lower tariffs on its mainly commodity imports from Russia than vice versa, the relative importance of the benefits of an EU-Russia FTA turn this argument around 180 degrees. Liberalisation through an EU-Russia agreement could be of strategic significance for the modernisation of the Russian economy, whereas for the EU it would be a matter of useful but still marginal benefit. Sadly, these ideas can only be academic hypotheses at the present time.