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Thinking ahead for Europe

2016 already puts its mark on the economic map of Europe

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Abstract. *The start of the year brought highly symbolic changes to the trade policy map of Europe between the EU- and Russian-led blocs, as the EU's Deep and Comprehensive Free Trade Area (DCFTA) with Ukraine entered into force provisionally, while Russia moved in precisely the opposite direction by scrapping its free trade agreement with Ukraine. However the ongoing changes go far wider and deeper. The energy sector and major industries see disengagement between Ukraine and Russia, and Russia's share in Ukrainian trade is falling substantially. New transport corridors with China may offer synergies with trade opportunities for all three DCFTA states, with Georgia first in line. Visa liberalisation for the entire DCFTA space is now firmly in prospect. Divergent macroeconomic trends between a recovering eurozone and recession in Russia will accentuate the changes in trade structures. A better organisation of the pan-European economic space is surely desirable, but prospects for links between the EU and the Eurasian Economic Union remain problematic.*

As the bells chimed in the New Year, from Big Ben to the Kremlin, an important but little-reported change was taking place in the economic map of Europe. At exactly midnight on 31December 2015, the customs services of the 28 member states of the EU all switched into free-trade mode with Ukraine, suppressing virtually all tariffs in accordance with the Deep and Comprehensive Free Trade Area (DCFTA) signed in 2014. At the same time, the customs service of Russia took precisely the opposite action in cancelling its free-trade regime with Ukraine in retaliation, which Ukraine has reciprocated as for its imports from Russia. Further Russia has banned agri-food imports from Ukraine as of 1 January, which between fellow WTO members is presumably illegal under WTO law, which Ukraine intends to reciprocate as of 10 January. The new economic map of Europe crystallises more clearly than ever the breakdown between the EU-led and the Russian-led blocs, with little left 'in between'.

While these moves on 1 January 2016 resonate deeply because of their political symbolism, much had already been happening, and many more developments lie in prospect.

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A year ago, the EU removed most of its tariffs towards Ukraine unilaterally, but the full (provisional) introduction of free trade was postponed at the request of Russia pending trilateral consultations (EU-Ukraine-Russia). But these talks broke down shortly before the end of the year, with Russia still demanding further postponements, but this was rejected by the EU and Ukraine (on which more below). Meanwhile the DCFTAs between the EU and Georgia and Moldova had already seen their provisional entry into force on 1 September 2014. However, on 1 January 2016, there was a significant extra move regarding Moldova, with agreement made for the basic preferential conditions of the DCFTA to be applied to the "entire territory of Moldova", which is diplomatic language for saying that it applies explicitly also to the separatist region of Transnistria.[1]

Just before the end of the year, on December 18th, the European Commission finally concluded lengthy sets of negotiations over the conditions for visa-free travel with Ukraine and Georgia, proposing to the Council and Parliament that short-term, 3-month visas for the Schengen area be scrapped. These proposals are expected to enter into force in 2016, adding to the case of Moldova which had already become similarly visa-free in 2014. Therefore, 2016 will see the DCFTA space also become a visa-free space, assuming that the Commission recommendations are implemented, while Russia threatens to introduce visas for Ukraine.

The economic structures of interdependence are being broken down between Ukraine and Russia, independently of the formal trade policy measures. Ukraine has drastically reduced its energy dependence on Russia, with the aid of reverse-flow pumping capacities added to its existing pipeline linkages to the EU. For example, Norwegian gas now flows into Ukraine, making it generally more connected to EU gas networks. Ukraine has stopped importing electricity from Russia and has come close to stopping its former electricity exports to Crimea, while Russia is installing new undersea power lines to Crimea at the Kersch strait. Russia is also taking explicit steps towards import substitution away from traditional Ukrainian suppliers, both for civil railway wagons and the industrial-military complex, and Ukraine reciprocates. Similarly, a civil aviation ban was introduced by Ukraine towards Russia in 2015, and Russia reciprocated. A further Russian measure taken on 1 January 2016 was a decree requiring Ukrainian trade with Kazakhstan that would transit through Russia to first enter the Eurasian customs union space through Belarus, thus imposing extra logistic costs and border controls. Such a measure will presumably increase interest in developing the alternative route across the Black Sea-Georgia-Azerbaijan-Caspian Sea, further confirming the changing map.

Trade between the three DCFTA countries and Russia is declining. In the year from mid-2014 to mid-2015, Russia's share in Ukraine's exports fell from 21% to 15%, for Moldova it fell from 21% to 13%; Russia's shares in Ukraine's imports declined from 24% to 17%, for Moldova from 21% to 13%. For Georgia, the corresponding figures are more stable, hovering at a low level around 8% for both imports and exports. These trends are likely to continue as the DCFTA measures are progressively implemented, alongside divergent macroeconomic trends between the EU and Russia. The counterpart to Russia's declining market shares are taken up by both the EU and other world markets.

Overall the market of the de facto wider European free trade area, including Norway, Switzerland, the Balkans, Turkey and the three new DCFTA states of Eastern Europe amounts

[1] Decision No 1/2015 0f the EU-Moldova Association Council of 18 December 2016, O.J. L336/93, 23.1.2015.

now to 650 million consumers, 500 million for the EU plus another 150 million for the neighbours.

Important changes are also in prospect for the transport corridors between Europe and Asia, given China's ambitious investment plans for the New Silk Road (or One Belt, One Road), which point to further changes in the economic map that links up with the three DCFTAs. The new land routes from China will pass through Kazakhstan and then branch out into various routes to the EU market. One of these will go across the Caspian and South Caucasus, allowing Georgia – if it plays its cards well – to also obtain synergies with its free trade agreement and territorial contiguity with Turkey, which is also part of the EU's customs union. But Ukraine and Moldova can also look for analogous benefits, not only as potential locations for manufacturing investments from the EU and the rest of the world, but also in agriculture. Ukraine is already hugely expanding its farm exports to China, and its adoption of EU technical standards for agri-food products will mean a positive international branding of its products all the way across Asia.

These changes will be compounded by divergent macroeconomic trends.

The EU economy may grow modestly but usefully by around 2% in 2016. The extent of the eurozone crisis is gradually receding, with Spain returning to robust growth and Ireland seeing boom times once again. The eurozone's growth prospects, albeit still modest in amplitude, are underwritten by the European Central Bank's relentless commitment to monetary easing, combined with the competitive advantage of a weak euro exchange rate, plus the low oil price. For all of the talk about Europe's multiple crises, the actual economic outlook is not that bad at all.

As for the Russian economy, it is being hit by the multiple ingredients of its 'perfect storm', with the collapse of the oil price, sanctions from the West and a major exchange-rate devaluation, all leading into a 9% drop in real wages in the last year and a serious recession in 2015 that is now expected to continue in 2016. On top of all this, Russia is turning in on itself, cutting off food imports from the EU, to which is now added its scrapping of free trade with Ukraine and cutting multiple ties with Turkey (trade, tourism, investment projects). The Russian middle class, which until recently was enjoying fast-rising incomes, is experiencing both the loss of real income and access to favourite mass-tourist destinations in Turkey and Egypt. The economic costs of Russia's voluntary military and geo-political adventures in Eastern Europe and the Middle East are mounting up alongside the inescapable costs of the oil price collapse. Russia has managed to make itself an adversary of the EU, Ukraine and Turkey all at the same time.

In all of this Russia's trade policy has been problematic, first of all by pursuing a customs union format for its Eurasian Union. Russia could have offered deep and comprehensive free trade to its Eurasian Union partners, which would have avoided pushing them into the straight jacket of Russia's preferred external tariff, and allowed them to negotiate individual free trade deals with the EU. The problems caused by this seemingly rather secondary technical choice of customs union *versus* free trade are becoming clearer. Russia's pressuring of Viktor Yanukovich in 2013-14 to dump the DCFTA with the EU and join the Eurasian customs union instead was at the heart of the conflict that followed, even if the prime driver was geo-political. In addition it is well known that Kazakhstan, Armenia and Kyrgyzstan would prefer a lower external tariff. All three are now WTO members (with Kazakhstan's accession in December 2015), and are facing problems of having to raise their WTO-bound tariff schedules to the Russian/Eurasian levels. This dilemma means that there is not yet a real common external tariff, while there are unresolved issues of compensation due to third countries according to WTO law. More problematic still for the functionality of the customs union, Russia's partners have been unwilling politically to follow Russia in its sanctions against the EU, Ukraine and Turkey, which gives further reasons for customs controls to remain at the Eurasian Union's internal borders. More strategically, this constellation of factors damages the possible attractiveness of the Eurasian Union as an international investment location. Russia is heading towards economic autarky and pulling its partners along with it.

Finally, there is the issue of the triangulation of trade relations between the three parties: EU, Ukraine and Russia/Eurasian Union. A trilateral working group of trade ministers and senior officials of the EU, Ukraine and Russia has attempted over the last two years to find solutions to alleged problems for Russia posed by the EU-Ukraine DCFTA. These trilateral meetings ended without agreement in December 2015, with Russia then carrying out on 1 January 2016 its threat to sanction Ukraine if no agreement could be reached.

The full story of this failed trilateral exercise remains to be told, since full information on the positions adopted by the three sides has not yet been made public. Around a year ago, Russia requested drastic changes to the EU-Ukraine DCFTA treaty, which would have effectively demolished it. Not surprisingly, this was rejected by the EU side. More recently, there have been signs of possible compromise arrangements on technical barriers to trade. Indeed, it could in principle have been possible to agree that Ukraine would retain the possibility to import Russian goods conforming with Russian GOCT standards, while Ukraine would still adopt European standards. Since the European standards are voluntary, Ukrainian producers could produce for the Russian market in accordance with GOCT standards. It seems that something like that was offered by the EU and Ukrainian side at the negotiating table at the last trilateral meeting in December, but no agreement was reached.

The underlying economic issues for such triangular relationships are familiar nowadays with the huge proliferation of free trade areas, given the impossibility to agree major liberalisation initiatives at the global/WTO level. Some are pure bilateral agreements such as CETA between the EU and Canada, whereas others are inter-continental such as the TPP across the Pacific and the TTIP across the Atlantic. The compatibility of these proliferating initiatives raises complex technical issues, with inevitable collateral impacts on third parties. But some ground rules are clear: free-trade areas between WTO member states can be consistent with WTO law as long as they are comprehensive in coverage, and the negotiation of new free trade deals between WTO member states do not give the right for third parties to claim compensation. All free trade deals necessarily change comparative advantages between the insiders and the outsiders.

For a comparative perspective, take the example of the EU's recent free trade agreement with Canada, which already shares free trade with the US through NAFTA. The EU's new deal with Canada changes the comparative advantage scales somewhat against the US on the Canadian market. But the US will not sanction Canada or break up NAFTA because of this change. On the contrary, the EU and the US are following through with their bilateral TTIP negotiations, which if successful will surely raise issues for consideration on the other two sides of this triangle.

To bring the comparison back to Europe, a model scenario would see the EU follow on from its DCFTAs with negotiations with Russia (or the Eurasian Union) for a comprehensive trade and cooperation agreement. Indeed, there must be better ways to organise the pan-European economic space than what is currently emerging. However the political context for this objectively desirable scenario would be immeasurably more favourable if Russia were to resume a cooperative free-trade relationship with Ukraine, and to credibly demonstrate an interest in trade liberalisation that is so far absent. Geopolitics have been the lead driver so far, and the economic map follows.

How long must we wait before economic rationality becomes the driver? Longer than 2016 it seems...