

## EU-Ukraine: what Russia does next

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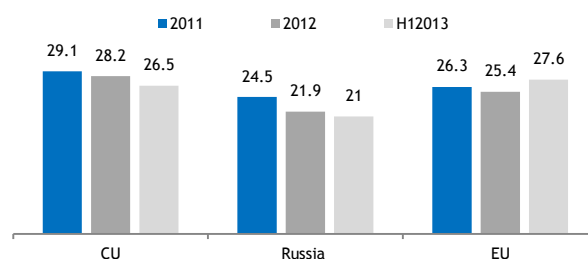
### Summary

Last Wednesday Ukraine reached a major political milestone in its relations with the EU when the Ukrainian government gave the green light to the signing of an Association Agreement between the two in Vilnius in November this year. After ten years of hesitation, Ukraine is choosing between two distinct and probably incompatible economic and geo-political alignments. Moreover, by rejecting Vladimir Putin's Eurasian Economic Union in favour of closer economic integration with the EU, Kiev is making a choice that is likely to provoke Russian resentment and retaliation. This is far from a definitive statement of Ukraine's European orientation: public attitudes are still ambivalent and Moscow remains a constant source of pressure. But it is a significant geopolitical setback for Vladimir Putin's regional agenda. What he does next will matter for business.

Last Wednesday Ukraine reached a major political milestone in its relations with the EU when the Ukrainian government gave the green light to the signing of an Association Agreement between the two (pending Brussels' approval) in Vilnius in November this year. This would update the current framework for relations between the EU and Ukraine from the current 1994 Partnership and Cooperation Agreement to a much deeper level of economic integration and political alignment. This includes a free trade agreement that will eliminate all tariffs between the two markets and the implicit promise of increasingly close integration between the two economies.

This sounds unexceptional, but the journey has been a long one and the geopolitical stakes are comparatively high. Ukraine is choosing between two distinct regional alignments. Brussels has been explicit in its requirement that the Association Agreement cement a westward pivot that precludes membership of Vladimir Putin's Eurasian Economic Union of Russia, Kazakhstan and Belarus. Russia has done the same - Prime Minister Dmitry Medvedev said the EEU Customs Union would be closed to Kiev if it chose closer partnership with the EU. There is a lot of politics in this positioning, but also a substantial element of trade reality. The EU would not offer the kind of deep FTA embedded in the Association

Agreement to a country that was part of a customs union with others on much weaker terms.



**Fig 1: Share of total Ukrainian exports 2011 - H12013(%)**  
Sources: EEC, Ukrainian government  
(NB Ukraine accounts for around 6% of Russia's total trade and for about 1% of the EU's.)

So the choice for Kiev obviously has economic ramifications. Closer integration with the EU market will lower input prices somewhat but it will also expose some of its producers to greater competition, at least in the short term. In the long term there is the prospect of wider access to the huge European market. The short term impacts will be made worse by the fact that Ukraine's terms of trade with Russia and the Customs Union will probably be deliberately worsened by Moscow if Kiev chooses the EU. The CU countries still account for over a quarter (Fig 1) of the Ukraine's exports and Ukraine's small but important high tech and industrial manufacturing

sector primarily serves the markets of the Customs Union. Their tariff rates will be an obvious target for Russian resentment. Some Russian state sources have threatened duties equivalent to a percentage point of Ukrainian GDP.

The compromises are not just economic. The Association Agreement, like many EU agreements of its kind, is a weaker version of the EU's *acquis communautaire* - it commits the Ukraine to applying a range of European norms and standards in the judiciary, electoral process, public health and public finance management. Brussels makes no secret of the expectation that an Association Agreement comes with an expectation of acceptance of a degree of pooled sovereignty and wider alignment with EU external and internal policy. The realities of close alignment with Moscow are probably not much different, although without much pretence of collective decision-making.

### Dealing with the bad loser in the Kremlin

Assuming that the signing happens in Vilnius in November it is likely to sour already toxic relations between the EU and Russia even further. The EU's ambitions on further eastward integration suffered a minor setback earlier this month when Armenian president Serge Sargsyan announced his country's intention to join the Customs Union instead of the planned FTA with the EU after a meeting with Putin in Moscow. But Kiev is an infinitely bigger prize for Brussels, and the EU is likely to smooth the process for November as much as it can, including brokering a deal for Yulia Tymoshenko to receive medical treatment in Germany that allows Yanukovich to release her from jail without losing face.

	EU	Ukraine
Duties removed as % of total trade value	99.1%	98.1%
Annual value of duties removed (2012)	€487mn	€391mn

**Table 1: Headline trade impact EU-Ukraine FTA**  
Source: European Commission

If things go to plan, Brussels anticipates a wave of retaliation from Moscow. Most of this will come in the

form of customs interference in Ukrainian (and possibly European) trade. Russia offered a taster over the summer when it blocked perishable Ukrainian food exports at Russian borders just long enough for them to spoil. Recent import bans on the chocolates produced by Petr Poroshenko's Roshen confectionery company - Poroshenko is a high profile advocate of the Association Agreement and an FTA with the EU - also give a taster of things to come. Russian gas exports to the Ukraine offer another possible tool of frustration, because Moscow is unlikely to continue to offer the incentives of passing on gas to the Ukraine at subsidised prices, or offering tariff-free oil exports. Businesses likely to be caught in the crossfire need to be aware.

The EU's response will inevitably be to try and blunt the impact of this as much as possible, especially through targeted trade concessions to ease the impact of Russian protectionism. Ukraine exports around 80% of its agricultural exports to Russia and it will put pressure on the EU to widen the quotas currently governing Ukrainian specialities such as sunflower oil and wheat. There is also likely to be further cranking up of EU challenges to Russian conduct in the WTO. Brussels has already threatened a WTO case on Russian automobile levies - a case that Ukraine joined as an observer, despite its own car duties which are a subject of EU complaint. But there is a substantial list of other irritants that could, in principle, be tested in Geneva, and Russia can be relied on to respond in kind.

### A half turn towards Europe

If the Association Agreement is signed in November in Vilnius it will represent the end of almost a decade of formal equivocation since the Orange Revolution of 2004 on the Ukraine's orientation towards Europe. It will not however necessarily resolve Ukrainian public uncertainty about closer ties with the EU. On average around half of the Ukrainian public still express doubt about the benefits of European integration, and much higher levels than this in more pro-Russian south eastern Ukraine. The communist party still provides a base in the Ukrainian Parliament for pro-Russian sentiment and Moscow will throw strong support a

politician like pro-Russian Victor Medvedchuk in the 2015 Presidential race.

Even the current President Victor Yanukovich, a politician who was seen as pro-Moscow after the events of 2004 and has only truly fallen out with the Kremlin comparatively recently is an unlikely champion of Ukrainian economic integration with the EU. Indeed, he is a reflection of the fact that the heavy-handed current occupant of the Kremlin is pushing Kiev westwards as effectively as Brussels is pulling it. The Association Agreement will provide a strong framework for closer EU ties, especially as it starts to lock in new patterns of trade and investment, but it has surely not resolved the question of Ukraine's European vocation definitively.

Nevertheless, Brussels will see shepherding the Association Agreement over the line in November as a highly significant piece of European regional geopolitics - one to rank alongside the opening of accession talks with Serbia in 2012 in a very short list of recent successes. Brussels' current disillusion with Putin and Moscow is hard to overstate, and it is playing out here just as it has with the European Commission's [pursuit of Gazprom](#). Reflective officials in Brussels have always seen Ukraine's choice as a test of the outer limits of the EU's ability to draw its regional satellites into its orbit, especially against the alternative gravity of Moscow. This step is not a definitive statement to that effect, but it is a highly symbolic one. Moscow sees the issue in an identical way, if as much more of a test of its brute coercive strength than the draw of its superior economic and political model. What Moscow does next will be important.

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