

Trade policy choice for Ukraine: comparison of FTA EU and CU integration scenarios

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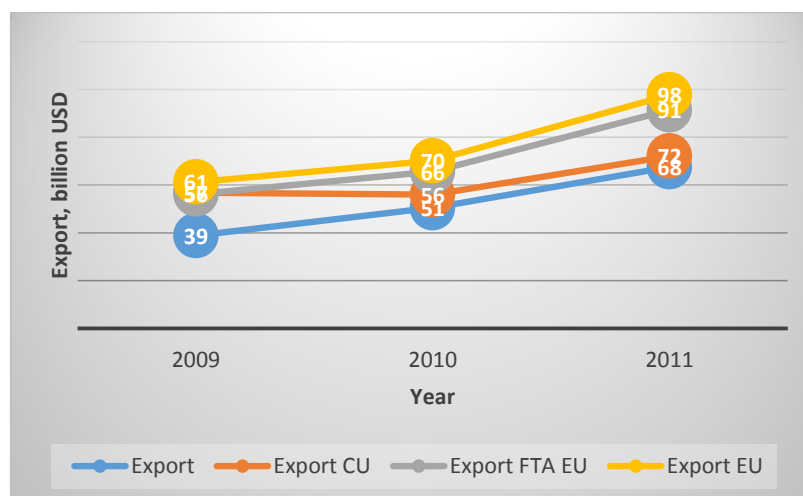
Ukraine severely underperforms in its external trade. It is located near two large regional trading areas and has well-educated population, rich arable lands suited for agriculture, and natural resources. Yet, it misses the export potential by about 100 percent – more than any country in the region.

One of the obstacles that do not allow Ukraine to realize its export potential is the trade policy uncertainty. Before investing in joint ventures, carrying out green field investments, or building a distribution network, foreign companies would like to know the rules of the game for the near future.

Ukraine came to a point where it has to make a choice of the integration strategy and resolve the trade policy uncertainty. One policy option is to sign a deep and comprehensive free trade agreement with European Union (EU FTA). The other policy option is to join the Customs Union with Belarus, Kazakhstan, and Russia (CU).

We evaluate the benefits of both integration scenarios in addition to a longer run scenario of the EU accession (EU), and conclude that Ukraine would be better off by signing a deep and comprehensive trade agreement with EU and integrating into its production chains. Moreover, Ukraine should be interested in moving the integration process even further, because the EU accession would bring even better results.

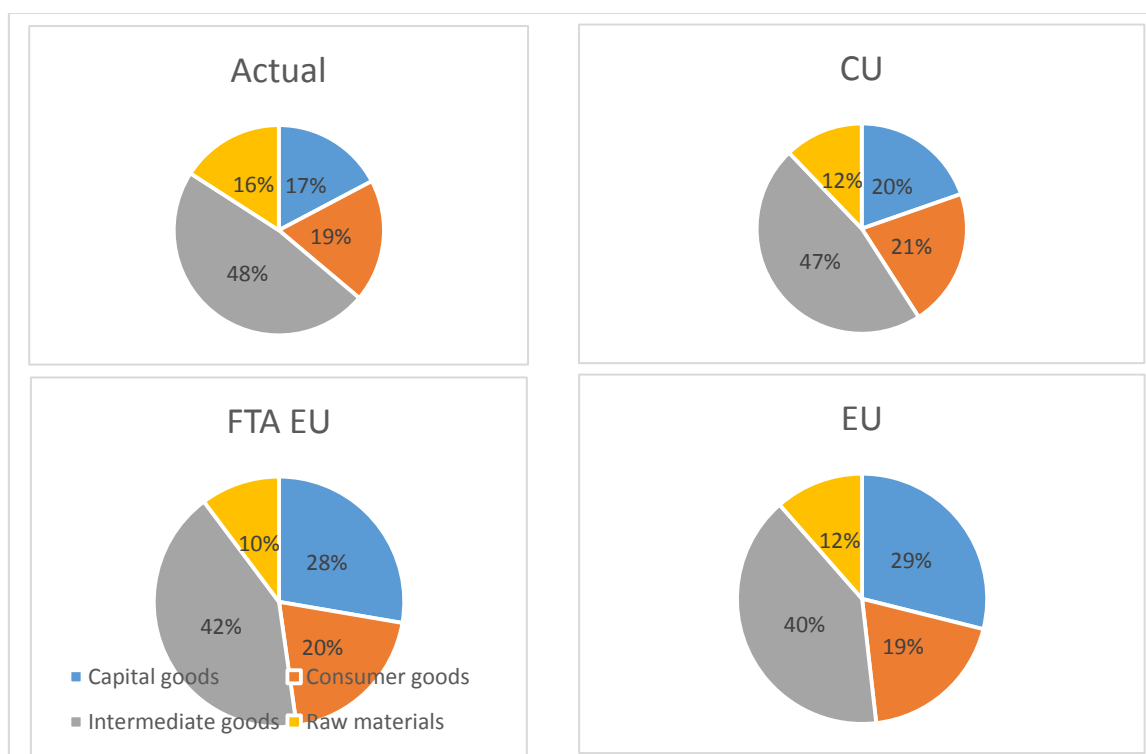
Figure 1 Actual and potential exports of Ukraine in 2009-2011



This conclusion is based on the following results of the paper:

- Expected long run gains in Ukrainian exports under the CU scenario are equal to 17.9 percent, under the FTA EU scenario 36 percent, and under the full EU scenario 46.1 percent
- Differences between CU and FTA EU scenarios grow over time
- CU integration is more beneficial for agriculture and food industry, while FTA EU and EU integration are more beneficial for textiles, metals, machinery and electrical goods, and transportation
- Under EU FTA and EU scenarios, Ukraine expands its export to most of the countries, including Russia and other members of CU
- FTA EU and EU scenarios considerably increase the share of capital goods in total export, the share of raw materials and intermediate goods decline

Figure 2 Structure of Ukrainian exports under different integration scenarios



Predictions are generated by the gravity model estimated for each two-digit product category of the harmonized system classification, using the 2001-2011 export data for two group of countries EU FTA countries and CIS countries. In our comparison of the three integration scenarios, we account for differences in economic size, trade costs, industrial structure, institutions, and aggregate economic shocks. We use a modern approach of estimation of the gravity equation, pioneered by Helpman, Melitz, and Rubinstein (2008). It accounts for the fact that not all countries trade all goods with each other and is able to generate predictions for growth of export of goods that have not been traded before (extensive margins of trade).