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The Embargo That Never Was: How Should the EU Respond to Russia's "Message" to Ukraine?

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Short of triggering an all-out trade war between Russia and Ukraine, the EU faces a challenge ahead of the Vilnius summit with Moscow's recent threat of trade restrictions. The European Commission rebuked Russia's actions as "unacceptable," yet both Ukrainian authorities and the opposition expect a firmer EU stance in the run-up to the Eastern Partnership summit. The Union should therefore help provide Ukraine with viable options, such as institutional mechanisms and macroeconomic support, for countering repercussions of the likely return of Russian trade restrictions in the wake of the signing of an Association Agreement.

Casus Belli. In mid-August, Russian customs agents intensified inspections of Ukrainian imports by questioning the authenticity of CT-1 certificates, which give Ukrainian firms the right to duty-free exports within the free-trade area (FTA) established among members of the Commonwealth of Independent States (CIS). This disruption affected at least 35% of Ukrainian exports to Russia. Although the customs authorities of the two states declared they had returned to the "normal procedure" a week later, some exporters temporarily stopped supplies to Russia amid fears of further disruptions.

The inspections were widely interpreted as a tool to discourage Ukraine from signing the Association Agreement with the EU at the Eastern Partnership summit in November. Given prior political developments, Russia's decision to introduce trade restrictions have at least two motivations. First, the restrictions were preceded by a host of adverse developments in bilateral trade following protectionist steps by the Ukrainian government. In March 2013, Ukraine introduced special duties of over 30% on imported cars, and in May it prolonged antidumping duties for nitrogen fertilisers imported from Russia.

Most importantly though, Ukraine has failed to import the contractual volumes of natural gas from Gazprom: in the first half of 2013, imports were 30% lower than in 2012. Meanwhile, Ukraine has avoided paying a $7 billion bill for gas under-consumption under the "take-or-pay" terms and has ignored Russia's offer to establish a two-party gas transit consortium. As Ukraine's "observer status" in the Common Economic Space (CES) provides no clear mechanism for settling trade disputes, Russia's leverage in solving these issues has remained limited. Therefore, Russian decision-makers might have viewed a customs blockade as a tool to restore their negotiating position.

Second, the customs blockade with Ukraine was also justified by Russia on the grounds of increasing the CES' internal coherence ahead of the declared transition to the Eurasian Economic Union in 2015. By imposing protectionist measures against Ukrainian imports, Russia claims it is preventing the potential re-export of EU products (a problem normally solved by verifying the certificates of origin) and transfer of uncompetitive Ukrainian exports to Russia. Given the sharp slowdown of intra-Customs Union trade turnover (which decreased by 10% in the first half of 2013 against the previous year) and the persisting intra-union trade disputes, Russia seeks to reinforce the preferential treatment of its own producers within the CES.

Such an approach to "strengthening" the CES at a third-party's expense faces challenges, particularly from the other member states. Belarus and Kazakh authorities failed to follow suit in imposing parallel restrictions on Ukrainian exports, while the Eurasian Economic Commission (EEC) appeared sidelined from regulating stricter customs checks. Hence, the charge against Ukraine is likely to remain a Russian enterprise, unless Moscow coerces others into a more coherent policy.

Casualties of the Trade War to Come. Statements by Russian officials point to the possible re-introduction of customs restrictions if Ukraine signs the Association Agreement with the EU. Such a response can follow two scenarios. The "baseline" one entails the reintroduction of non-tariff restrictions to slow down the bulk of Ukrainian exports to Russia, similar to the blockade imposed in August. This scenario is fraught with temporary losses for Ukrainian companies stemming from the need to adapt to the new customs regulations. The potential disruption of a quarter of Ukrainian exports within the first six months might cost about 1% of the country's GDP.

The "worst-case" scenario was foreshadowed by Russian officials' statements that the FTA with Ukraine would not remain viable in parallel with an Association Agreement. This scenario would lead Russia to cancel the CIS free-trade regime with Ukraine and introduce the Customs Union's common external tariff (CET) on imports from the country. Given Russia's accession to the WTO, the weighted average CET is estimated to be 7.3% in 2014. To remain competitive in the Russian market, Ukrainian exporters would have to shoulder the costs of the import duties (about 0.6% of Ukraine's GDP annually). As exports to Russia account for about 8.6% of Ukraine's GDP, such an outcome would have adverse effects on Ukraine's economy in the medium term.

The two scenarios provide a backdrop for analysing Russia's motives in pursuing import restrictions. On the one hand, Russia's message was directed towards at least four oligarch groups represented in Ukraine's parliament, including one close to the ruling party. This prompted commentators to argue that the blockade was an attempt to prevent Ukraine from signing the Association Agreement with the EU. However, most of the "losers" from the trade blockade have little to no impact on erecting major obstacles to this signature.

On the other hand, the pressure may transform into tangible impact later, when it comes to the Agreement's ratification in parliament. Also, the beginning of the legal approximation process enshrined in the Agreement could be undermined, thus making it a "stillborn" pact rather than a serious reform roadmap. Besides, President Viktor Yanukovych may suffer bitter political consequences if Russia's restrictions are upheld in the long run: an economic crisis, aggravated by the worsening of Ukraine's current-account deficit, would pose a threat to his 2015 presidential bid. The actual results of Russia's blockade would be seen not in Vilnius in November 2013, but the following year in Kiev.

Thus, Russia's pressure is unlikely to drastically change Ukrainian decision-makers' calculations on the signature of the Agreement itself. However, the lack of viable options for coping with the possible damage of Russia's trade blockade bears significant risks for its implementation.

Options for a Post-Vilnius Settlement. In case of another customs dispute, Ukrainian authorities could consider four possible solutions. The first option—addressing the CIS Economic Court—appears increasingly futile. Although Russia violated the procedure of verifying the certificates' authenticity specified by the respective CIS Agreement, it is not subject to recourse in the CIS Economic Court. Also, the CIS executive committee is not prepared to mediate a settlement on bilateral disputes.

The second option—filing a case with the WTO—will encounter certain difficulties. Most important, a settlement is likely to take months of litigation before the Dispute Settlement Panel, according to WTO procedures. Also, Ukraine's previous attempts to revise its WTO tariff commitments will hardly earn it goodwill among major WTO members.

The third option—Ukraine making a commitment to join the CES—does not seem viable to decision-makers since they realise that Russia may still continue to apply non-tariff barriers as it currently does with some of Belarus' exports. So far, the EEC and the CES Court have failed to unwind these obstacles to trade due to substantial limits on their regulatory impact.

Thus, bilateral talks with Russia remain the only immediately available option for Ukraine should the customs dispute be repeated. It is unclear what exactly Ukrainian officials promised Russia in exchange for the ad-hoc suspension of the customs inspections. Hence, the major challenge lingers: it is unlikely that the parties will come up with any institutional set-up for regulating such customs blocks. What can the EU suggest to mitigate them after Vilnius would be the right question for EU policy-makers to discuss in the upcoming months.

Conclusions and Recommendations. The EU, including Poland, should adopt a more-for-more approach in dealing with the outcome of the customs spat. On the one hand, the Commission should keep persuading Ukraine's government to repeal the special duties on car imports to eliminate the most contentious issue in bilateral trade. Similarly, no concessions should be made on Ukraine's expected compliance with the three Council criteria concerning selective justice, electoral and judicial reform.

At the same time, the EU could promise Ukraine support in the WTO panel if it decides to use the WTO dispute-settlement mechanism. More preferably still, the EU should offer an institutional arrangement for resolving DCFTA-related disputes with CES members, for example, by including provisions on certificates of origin and countervailing measures in a new agreement with Russia. This might require closer engagement with the Eurasian Economic Commission, until now shunned by the EU.

Last but not least, the EU should provide a clear option for macroeconomic support of Ukraine if Russia's post-Association backlash follows the worst-case scenario. For example, Brussels could make it clear to the Ukrainian government that the EU will support the resumption of a badly needed IMF loan in December to help mitigate any potential macroeconomic blow, as long as Ukraine meets key IMF criteria.