

Will Ukraine Join (and Save) the Eurasian Customs Union?

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Since Vladimir Putin's return as Russian president, Ukraine has been a target of Moscow's attempts to have it accede to the Eurasian Customs Union. The Ukrainian opposition and national-minded analysts have expressed concerns that President Viktor Yanukovich may cede to the pressure, whether to seek economic relief for the country or to obtain Moscow's political support, which he could exploit for his re-election bid in 2015. This, however, is unlikely. Gains for either the country or the regime are too uncertain and insufficient to persuade Ukraine's leadership to break away from its balancing act in foreign policy, a feat that Kyiv has performed since independence.

Clouds over Eurasian Integration

The Customs Union and the Common Economic Space between Russia, Belarus, and Kazakhstan make up the most advanced and ambitious plan of post-Soviet regional integration to date. In 2010-2012, the three states created a common customs territory, removed internal border controls, and inaugurated the Eurasian Economic Commission, a regulatory body tasked with ensuring the functioning and development of the union. A full-fledged Eurasian Economic Union is officially supposed to emerge by January 2015. Drawing a parallel with the European integration project, some observers have noted that Russia and its partners plan to accomplish in a few years what the European Union took decades to achieve.

How economically significant the Customs Union is remains an open question. Russia's economy constitutes almost nine-tenths of the union's joint economic potential, making the accession of Kazakhstan not so significant in strictly economic terms (Belarus, for its part, has been closely integrated with Russia since the 1990s). But the political impact of Kazakhstan's accession is clear: a wealthy self-confident post-Soviet

state voluntarily decided to harmonize its trade norms with Russia, underlining the attractiveness of a Russia-centered partnership. As a result, the Kremlin scored points via the Customs Union in its diplomatic game with China. Perhaps more importantly, Moscow was able to present Brussels with a *fait accompli*: from now on, the Kremlin expects the European Commission to discuss trade issues exclusively with its Eurasian analogue. Bilateral negotiations on a new framework agreement between Russia and the EU are frozen, and respective competences have been transferred to the Eurasian Economic Commission.

However, the streak of Customs Union successes may well be over. The three member states do not share a common view of the future. Many European experts (like Rilka Dragneva, Kataryna Wolczuk, and Hannes Adomeit) believe that Russia is trying to create an economic regime to achieve geopolitical objectives. The interests of Kazakhstan and Belarus differ significantly from that vision. Kazakhstan is primarily interested in markets and access to Russia's pipeline system to export its hydrocarbons to Europe. Belarus wants to maximize the economic subsidies Russia provides to Belarus for its declared loyalty (and which Putin has euphemistically referred to as an "integration component" in their bilateral relations). But leaders in neither Minsk nor Astana are willing to lose even a fraction of the political power they enjoy domestically or their international freedom of maneuver.

Thus, in January 2013, Kazakhstan's president, Nursultan Nazarbaev, publicly ruled out the evolution of Eurasian integration to the point of political union (to say nothing about its potential reincarnation into the USSR). He said that existing bodies are sufficient to guarantee the success of economic integration. Several days later, Alexander Lukashenka of Belarus stated that "radical steps," which Russia might want, were not acceptable. He praised the bilateral Union State of Russia and Belarus as a more advanced form of integration compared with the Eurasian Economic Union, but only to conclude that Belarusian society is not "ripe" for another "breakthrough."

The deepening of Eurasian integration is thus up for question. The expansion of the Customs Union to Kyrgyzstan and Tajikistan is under discussion, but this is not a solution. Both countries are very small economically and unattractive as export markets. Their capacity to enforce new regulations or to protect the borders of the Customs Union (from smuggling) is weak. Most importantly, the prospect of granting these states, especially Tajikistan, freedom of labor mobility, which they would be entitled to if they joined the union, is politically very risky in Russia's current domestic political context, tainted as it is with anti-immigrant sentiment.

In other words, the stagnation of Eurasian integration is a realistic medium-term scenario. In this case, Ukraine's accession to the Customs Union may appear to the latter's architects to be more critical than ever. In addition to the oft-cited geopolitical rationale and the possibility for Moscow to declare victory in its contest with the EU over the common neighborhood, Ukraine's entry would bring a greater economic logic to the organization and help sustain the claim that the dynamism of the process could be reinstated after a logical slowdown, needed for Ukraine to catch up with the others.

No wonder Russian diplomacy is so focused on bringing Ukraine on board. Moscow promises colossal energy subsidies and other economic privileges in return for Ukraine's accession. At the same time, sanctions and the negative implications of the closure of Russian markets to Ukraine in case of its non-accession are openly discussed.

Any Rays for Ukraine?

While agreeing to look for ways to cooperate with the Customs Union, Ukraine so far refuses to join. There are several reasons for this.

The Custom Union's Controversial Economic Performance

In the first two years of its existence, the Customs Union exhibited rather impressive growth in its internal trade. In 2011, intra-Customs Union trade grew by 34 percent, and in the first six months of 2012 it increased by 15 percent. This, however, was primarily due to the recovery from the crisis of 2009, when Russian GDP fell by eight percent. In the second half of 2012, the situation changed – internal trade grew by only 3 percent. As analysts from the Brussels-based Center for European Policy Studies concluded, the short-term effects of the introduction of the Customs Union are over.

Moreover, comparing Ukrainian and Belarusian trade with Russia demonstrates that membership in the Customs Union has not critically affected trends in bilateral trade. In 2011, Belarusian trade with Russia increased by 40.7 percent, while Ukraine's increased by 36.1; in 2012, both fell, by 9.4 and 10.8 percent respectively.

At the same time, Kazakhstan, which had to radically change its trade policy to align it with Russia's own, experienced an almost doubling of average tariffs in 2009-2011. (This is similar to what would happen to Ukraine if it joined.) Kazakhstan's negative balance in trade with Russia and Belarus increased from approximately \$8.5 billion in 2011 to almost \$11 billion in 2012, as more expensive goods from Russia replaced cheaper imports from other places, China in particular.

Insufficient Credibility of the Russian Offer

Lack of trust is a fundamental problem in relations between Moscow and Kyiv. One major source of this at present is the Kharkiv agreement of 2010, by which Ukraine provided a lease to the Russian Black Sea Fleet for use of the Sevastopol naval base (good until 2042) for a discount of \$100 dollars per one thousand cubic meters (tcm) of imported Russian gas. However, despite the discount and lower transit costs, Ukraine ended up paying more for its imports than Germany or Italy, which Kyiv understandably found unfair.

Today, Moscow is again offering Ukraine preferentially-priced energy. In December 2012, Sergei Glazyev, an economic advisor to Vladimir Putin, estimated that Ukraine's gain would amount to \$9 billion a year, a figure that apparently combines the pricing of gas at Belarus' level (\$165 per tcm, as compared with the \$425 that Ukraine was paying in 2012) with the Custom Union's tariff-free trade in oil. Whether such an offer could be sustained, however, is another matter. As a WTO member, Russia has an obligation to make its gas sector operate on "normal commercial considerations," which

predicts a rise in Russian domestic gas prices. This rise can be quite steep, should there be a need to compensate for falling export revenues. It is also worth keeping in mind that Belarus enjoys low gas prices not only because it joined the Customs Union but because it sold its national gas transportation network to Russia, an outcome Kyiv would like to avoid.

Negative Attitude of the EU

Ideally, Kyiv would like to combine a privileged economic relationship with Russia with a free trade regime with the EU. Ukraine and the EU have negotiated a deep and comprehensive free trade agreement that could conceivably be signed in November 2013 during the EU Eastern Partnership summit in Vilnius – if, that is, Ukraine meets certain political conditions. Brussels, however, has made it clear that the agreement is incompatible with membership in the Customs Union. As a Customs Union member, Ukraine would have to partially transfer its economic sovereignty to an organization that does not have preferential relations with the EU. The Customs Union has little chance of establishing such relations in the near future, given that two of its member states (Belarus and Kazakhstan) are not members of the WTO and one (Belarus) has especially conflictual relations with the EU.

Domestic Political Risks for Yanukovych

Ukrainian public opinion is polarized between “European” and “Eurasian” options. Accession to the Customs Union would mobilize a range of supporters and opponents. In a December 2012 poll by the Kyiv-based Razumkov Center, 42 percent of respondents preferred to join the EU while 32 percent opted for the Customs Union (with 10.5 percent choosing neither). A poll the same month by the Social Monitoring Center found, on the contrary, that 46 percent of respondents were in favor of Customs Union accession while 35 percent preferred free trade with the EU and eventual membership. Either way, these results imply that as an electoral slogan the Customs Union is a double-edged sword. As well, parliamentary ratification of the accession agreement cannot be taken for granted. Resistance may come not only from pro-European opposition groups but also MPs representing Ukrainian businesses who lobbied for the country’s entry into the WTO in 2008 and who currently favor free trade policies with the EU. Meanwhile, the economic benefits of Customs Union membership, if any, would probably come too late to be felt by the wider population before the next round of elections in 2015.

An Easier Alternative

But a decisive factor may rest elsewhere. The Russian-Ukrainian energy relationship is currently undergoing a fundamental transformation. Since the collapse of the USSR, the two countries have been in a forced partnership: Ukraine has been totally dependent on Russia for gas while Russia has been almost totally dependent on Ukraine for gas transit. With the launch of the Nord Stream pipeline in 2011-12 and the start of construction of the South Stream line (to be operational in 2016), Moscow has appeared to many to be

gaining the upper hand. Yet Ukraine's administration has risen to the challenge and begun its own policy of diversification. It began purchasing gas on the spot market in Germany, expecting to obtain 5 billion cubic meters (bcm) in 2013. It signed an agreement with Shell to begin shale gas production in eastern Ukraine. Construction of a liquefied natural gas terminal is being seriously considered. Although it is too early to predict the overall success of this strategy, Ukraine has already dramatically reduced its imports of Russian gas—from 57 bcm in pre-crisis 2007 to 33 bcm in 2012 and an expected 26 bcm in 2013. In January-February 2013, Ukraine's state energy company Naftogaz decreased imports of Russian gas by 44 percent as compared with the same period the year before.

Russia thus faces the risk of losing a major market. Ukraine may be violating the "take or pay" provision included in its contract, but it may not be so easy for Russia to enforce it through the Stockholm court of arbitration. Litigation could take a long time and reveal details of Russia's "gas diplomacy" which the Kremlin would prefer not to disclose. And gas cut-offs, as in 2006 and 2009, could finally ruin Russia's reputation among European consumers. Lower prices accompanied by stronger guarantees of purchase and a possible agreement on transit cooperation would be a realistic way out of the current stalemate. Associate or observer status of Ukraine in the Customs Union cannot be fully ruled out as a kind of diplomatic save, but in reality such a status would be meaningless and, therefore, unlikely.

Conclusion

There is no urgency for Ukraine to join the Customs Union. It can obtain cheaper gas from alternative sources while preserving its sovereignty and the interests of its elites. The problem is that if a new Ukrainian-Russian gas (and transit) deal were to come to fruition, it would likely resemble previous arrangements by being short-term and non-transparent. Such an agreement would not make Ukraine genuinely independent, just enable the current leadership to continue its balancing act. Re-integration into Eurasia would be unlikely, but so would be further liberal reforms, postponed as Ukraine continued to delay adopting EU norms. Ukraine would thus consolidate its status as a "gray zone" of Europe, hardly a promising forecast.