Mega Deal Between
the European Union and the Eurasian Economic Union

Evgeny Vinokurov, Ph.D.
Director, Center for Integration Studies,
Eurasian Development Bank
vinokurov_ey@eabr.org

Abridged version published in Russian in: Izvestiya, October 6th, 2014 and TASS, October 14th. Abridged English version published in: World Finance Review, December 2014. Complete paper published in: Russia in Global Politics, November-December 2014.

EU-EEU mega deal against the backdrop of a relationship in crisis

Will the idea of an economic integration agreement between the European Union and the Eurasian Economic Union ever come to fruition?

At this point, even raising the question seems a non-starter. Relations between the EU and Russia – the country that accounts for 87% of total GDP and a full 75% of the population of the EEU – are in deep crisis. Economic cooperation is being consumed by the current exchange of sanctions. Firmly grasping the gravity of the situation, we are reminded of the origins of the European Union – and of the discussions that took place in 1944-1945. It was at this time that the foundations of European integration were first laid (just as, back in its day, the Bretton-Woods system created the present-day structure of trade and financial relations). The foundations of the new have frequently been laid in times of crisis. Who would have thought back in 1944 that in just ten short years, the European Community would start to take on tangible forms?

Country leaders and officials are already expressing their support for the idea of 'European-Eurasian' economic integration. The President of the Russian Federation, Vladimir Putin, put forward a proposal to begin consideration of the idea of a free-trade zone with the EU at the EU-Russia summit held on 28 January 2014. On 5 February, the proposal was embraced by the President of Kazakhstan, Nursultan Nazarbayev. By 12 September, we were hearing words of official support for free-trade negotiations from the European Commissioner for Enlargement and Neighborhood Policy, Štefan Füle. According to Füle, the time has come for the establishment of official ties at the level of the two unions – the European and the Eurasian – with a view to starting the negotiation process. The Europeans are coming to the realization that the problem of Eastern partnership cannot be solved without Russian participation. Moreover, a new entity has arisen that must be dealt with – the EEU (heretofore, the EU had been blatantly ignoring both the Customs Union and the Eurasian Economic Commission for years). On the other hand, there's always a fly in the ointment: Füle's term in office is swiftly coming to an end.

An economic integration agreement between the European Union and the Eurasian Economic Union has been under discussion by the expert community for several years now. From among the most recent works on the subject, particularly noteworthy are the report by the Center for Integration Studies at the Eurasian Development Bank *Quantitative Analysis of Economic Integration between the EU and the EEU: Methodological Approaches* (April 2014) and the report *Deadlock of Integrations' Struggle in Europe*, published in May 2014 under the auspices of the Committee for Civic Initiatives. Today, the future of ‘European-Eurasian’ relations must be regarded in a new light, against the backdrop of deep crisis, in view of EEU establishment and in the most practical way possible.

The main thesis of this article is that, due to the sheer scope of related issues, the anticipated agreement – or set of agreements – must be framed as a “mega deal”. Mutual concessions and compromises will be necessarily interconnected. The importance of various domains will be different for both parties. Deferring in one area, the partner will expect a “trade-off” with respect to another problem. While not claiming to be exhaustive or conclusive, listed below are 19 substantive questions forming the possible negotiation agenda.

It could fairly be assumed that the work ahead will be long, hard, and dotted by moments when it seems that the outlook for reaching the finish line is grim. But there are chances for success. A key question in this context, of course, is the position taken by the U.S. – a country clearly unenthusiastic about the prospects of a mega deal between the EU and the EEU. Finding common ground with American interests is a separate topic – one of critical importance to the success of our project, but nevertheless beyond the scope of this short article.

In our opinion, the problem of shared neighborhood could be addressed by a long-term framework solution within the scope of the anticipated integration agreement. At issue here, first and foremost, are Ukraine and Moldova, though Georgia and Azerbaijan are certainly on the agenda as well. Among these four countries the status quo is acceptable only for Azerbaijan as long as the relatively benign oil and gas pricing persists. The economic potential of Georgia and Moldova will be substantially lower. Finally, in the Ukrainian case there is no viable alternative whatsoever. Last three countries of our shared neighborhood are the most directly invested in an EU-EEU mega deal – in its absence, they will be unable to chart a course for sustainable growth.

Natural interdependence

In 2003–2004, the issue of economic cooperation and integration between the European Union and the Russian Federation was of great common interest. Yet, negotiations on an EU-Russia common space hit an impasse, with the topic relegated to the back burner soon thereafter. Nevertheless, the *foundation for mutual interest in the project objectively exists*: it is based on territorial proximity, significant trade flows, potential investment ties, issues of economic security, the EEU’s interest in the transfer of European technology, outstanding issues of the development of cross-border infrastructure, and the presence of common contiguous states.

For the emerging Eurasian Economic Union, close economic cooperation with the EU is of critical importance:

- The EU is the largest trading partner of both Russia and Kazakhstan, accounting for more than half of the Russian Federation’s total trade turnover (while Russia is the third-largest trading partner of the European Union).
- The EU could play a key role in addressing CU-country modernization issues.
- The emerging Eurasian Economic Union is currently initiating a series of free-trade agreements with partners of lesser importance in terms of economic size and overall significance, such as Vietnam and Israel. Yet, the very fact of these negotiations is beneficial: they help clarify priorities, shape areas of expertise and polish negotiating tactics. At the same

time, it is precisely the European Union that should be viewed as the main long-term partner in this context.

- The Ukrainian problem can *only* be resolved within the scope of deep economic cooperation between the EU and the Eurasian Economic Union, which only serves to underscore the importance of this cooperation.

For the EU, close economic cooperation with the EEU is also of fundamental importance:

- The EEU is the European Union's third-largest trading partner after the U.S. and China. The impact of Russian restrictions on food imports clearly demonstrates the current level of trade interdependence and the interest European manufacturers and farmers have in normal commercial relations.
- Security issues, including those of our shared neighborhood, can only be addressed within the scope of cooperation with EEU countries.
- Ongoing structural dependence on "Eurasian" hydrocarbons.
- In general, the free trade regime with the EEU will provide the EU producers with an opportunity not only to strengthen their competitiveness on this important market but also to enhance terms of trade on the markets adjacent to the Eurasian Union. The combination of the EU and EEU competitive advantages will create a change to realize the 'double rent' – both technological rent for the EU and the resource rent for its Eurasian counterpart. This will lead to higher competitiveness of all economies adjacent to the Lisbon to Vladivostok framework.

Growing trend of global interregionalism

Over the past two decades, interest in regional integration has spiked, spurring an increase in the number of newly created regional trading agreements. Regionalism has emerged as the dominating factor in the development of global trade, investments and labor flows. It has a tremendous impact on both economic and political relations between individual countries, prompting them to face some critical questions: Which trading block should we join? Which form of integration would be the most preferable? Which authorities should be transferred to the supranational level? Which institutions are most aligned with our national interests?

The number of regional trade agreements (RTA) has risen sharply. As of early 2014, the WTO had received 583 notifications on the creation of goods-and-services RTA – 377 of which have already come into force. The EU has served notice of the creation of 47 RTA, while the U.S. is a party to a total of 14 RTA, Japan – 17, Chile – 24, China – 15, and Brazil – 4. According to the WTO database, most of the RTA created around the world involve the establishment of free-trade zones, with only 17 classified as customs unions. That said, only six CU are actually functioning, and only three of those are full-fledged customs unions (EU, EU–Turkey and the CU of Belarus, Kazakhstan and Russia). The rest, including MERCOSUR and the South African Customs Union, have an exemption rate from the common customs tariff of 30% or higher.

The ascendance of regionalism has been predicated on a number of factors. In particular, it has been associated with the fact that progress within the scope of WTO rounds has been painfully slow – namely the Doha round. Then the "domino effect" came into play: countries started coming to the conclusion that the costs of remaining on the sidelines of trade-and-economic unions might be higher than the costs of joining. Nevertheless, the overall desire of individual countries to form RTA is primarily prompted by their desire to stimulate economic growth by taking advantage of the many opportunities offered to members: improved market access, economies of scale, attraction of foreign direct investments (FDI), technology transfer, and so on.

At present, the various forms of economic integration are constantly evolving – becoming more sophisticated and mutually complementary. For instance, a free trade zone and customs union can encompass elements of higher levels of integration, namely: a reduction in non-tariff barriers, the removal of restrictions on trade in services, capital movement and labor flows, dispute-resolution mechanisms, trade facilitation policies, protectionary measures, and the creation of institutional mechanisms, etc. This is associated with the growing understanding that, from the standpoint of economic impact, the elimination of trade barriers alone is likely to have much fewer positive effects than deeper integration.

There are several stages of trade liberalization and a whole range of different integration models. The first model – that of bilateral free-trade agreements concluded between two national economies – can be relatively straightforward. Most agreements of this kind deal only with free trade in goods, a significant share add free trade in services, and only a few aim for the more ambitious goal of the establishment of customs unions.

The second model involves the formation of integrated regional blocks, the prime example of which is the European Union. In South America, the Mercosur group made an attempt to form a robust customs union, but its trade policy still contains numerous exemptions and has effectively stalled. A valiant attempt was made by the 10-member ASEAN group in South-East Asia, but it still does not constitute a customs union. The North American Free-Trade Agreement (NAFTA) between the United States, Canada and Mexico represents yet another regional integration initiative, but it is quite loose in terms of member integration and is similarly not a customs union. From among the more recent examples, the Customs Union of Belarus, Kazakhstan and Russia is the dynamic stand-out.

The third model – *interregional integration agreements* – features a number of different variants. The most impressive of these are intercontinental initiatives, of which only two are currently up and running. The first is the Trans-Pacific Partnership (TPP), uniting the bulk of East and South-East Asia and the Pacific West Coast, with the exception of China. The second initiative is the Trans-Atlantic Trade and Investment Partnership (TTIP), negotiations on which are currently underway between the United States and the European Union. The subject of lively discussion, the TTIP is aiming at greater convergence on regulatory matters, which lies well beyond the scope of routine free trade pursuits.

Work on both the TPP and the TTIP is still ongoing. Both initiatives aim at the sweeping liberalization of a high volume of global trade in the regions of the Pacific and Atlantic Oceans, while the anticipated degree of their integration is both comprehensive and deep. Yet, experts believe that the Trans-Pacific initiative's chances of success are minimal, since the structure is simply too loose. On the other hand, the outlook for the Euro-American TTIP is formidable. *These integration processes, should they come to fruition, will have a powerful impact on the world economy and global trade and investments*. *At their core lies the potential for at least an erosion – and quite possibly a partial replacement – of the contemporary WTO regime.*

Another variation on the theme of potential interregionalism (and one that entails the most complex negotiations) is offered by *inter-block agreements.* There have been no such precedents thus far. The European Union is attempting to conduct negotiations with

Mercosur, but is swiftly coming to the conclusion that the week internal cohesiveness among Mercosur members is problematic and a complicating factor in the overall process. At the same time, it is precisely this form of inter-regionalism that is most likely to play an increasing role, making the system of global trade and investments even more multilayered and intricate.

Features and Contents of the EU-EEU Mega Deal

The EU-EAEU mega deal assumes exactly this idea of an interregional integration agreement that unites two blocks. It is a new idea, which means it is particularly complicated. What might be the main characteristics of this agreement?

First, *the party to the mega deal, irrespective of the legal form it might take, would be not Russia but the Eurasian Economic Union,* by virtue of its supranational authority. National representatives (the relevant departments of economic ministries, foreign affairs ministries, etc.), would certainly be present at and, at the decisive stage – influence the course of – negotiations and final agreements, but these negotiations would formally be led by the EEC. This is an important nuance – just as new and unfamiliar to the participants of the Eurasian integration process as it would be to the European Union.

Second, *EEU member states would be interested not merely in a free trade agreement per se but in a deep and comprehensive agreement with the European Union*. The motivation is quite simple: a "bare-bones" free-trade zone is not advantageous to either Russia or Kazakhstan, both of whose exports encompass primarily raw materials. Due to their current trade structure, Russia and Kazakhstan would have little interest in a narrowly defined free-trade regime with the EU (this holds true for Belarus as well, though to a lesser extent). That said, obvious problems in the realm of trading concessions would have to be offset by gains in other areas. Significant progress is needed in other areas of economic cooperation in order for the idea to become truly viable.

Third, the prototypes of such an agreement between the EU and the EEU encompassing the broad swath of pertinent issues are numerous and diverse – from a deep and comprehensive free-trade agreement (DCFTA) to a comprehensive economic and trade agreement (CETA). The latter is in fact the legal form of the agreement in principle reached between the EU and Canada in 2013. *CETA and the aforementioned US-EU Trans-Atlantic Trade and Investment Partnership (TTIP) could fairly be viewed as particularly instructive prototypes for the EU-EAEU mega deal.*

Fourth, it should be noted that *full-fledged negotiations between the EU and the EEU will be impossible without the WTO membership of all member states of the Eurasian Economic Union.* Consequently, Russia should lend its full support to Kazakhstan and particularly Belarus in their negotiations with Geneva. Russia should become the driver of both countries' ascension to the WTO.

However, this WTO membership depends not only on the EU or even Russia but to a great extent on the position taken by the United States. In the U.S., the relationship with Russia falls within the realm of internal politics and squabbles between the country's two main political parties, and that is where it is likely to remain. No swift improvements should be expected: suffice it to recall the Jackson-Vanik amendment, whose repeal with respect to

Russia took more than 20 years (while it continues to remain in force in the case of both Belarus and Kazakhstan).

A separate question which demands for an answer is how the EU-US TTIP regulations will coincide with the norms of the prospective EU-EEU deal.

Fifth, *the scope of potential issues that could be addressed by the mega deal* (whether it takes the form of a single agreement or set of agreements) *encompasses dozens of items*. Here are but a few of them:

1. Trade in goods (abolishment of import duties with a clearly-defined set of exemptions).
2. Elimination/streamlining of non-tariff trade barriers.
3. Regulation of cross-border electronic trade.
4. Trade in services.
5. Liberalization of access to financial markets.
6. Free capital movement.
7. Regulatory convergence (norms and standards).
8. Intellectual property rules.
9. Reciprocal recognition of diplomas (degrees), including in terms of professional education.
10. Vise free regime, including a set of agreements on readmission.
11. Special regime for Kaliningrad Region (investment or trade-and-investment).
12. Special neighborhood regions.
13. Mass educational exchanges (Erasmus Mundus, and so forth).
14. Application of the EU's Third Energy Package to projects envisioning Russian gas exports.
15. Development of international transport infrastructure (road and rail corridors).
16. Establishment of an EU-EAEU common electric power market.
17. Regulation of partial reciprocal access to public procurements.
18. Competition rules.
19. Dispute resolution mechanisms.

Sixth, *according to the baseline scenario, work on the agreement will take several years, while the comprehensive agreement itself could be concluded sometime in the 2020s*.

Determination of the desirable or even possible date of agreement conclusion necessarily entails the use of two approaches. The first stems from EEU countries' need to modernize. In their recent article in *Eurasian Economic Integration* magazine, A. Shirov and A. Yantovsky tackle the question of determining the possible timeframe for the creation of a free-trade zone between the two integrated blocks. They proceed from the following basic argument: at present, free trade would be disadvantageous for EEU countries by virtue of the low competitiveness of Eurasian manufacturers and high barriers to the EU markets due to discrepancies in technological standards (as opposed to import duties). Modernization efforts inside the EEU, combined with positive forecasts for the heightened efficiency of primary-resource use and growth in manufacturing productivity, lead the authors to settle on 2021-2024 as the earliest possible date for an FTA.

We share this opinion, in due consideration of various technical factors. Even after the tentative abatement of the Ukrainian crisis and the first advent of an opportunity to commence substantive negotiations, for purely technical reasons (predicated on the extreme complexity and sheer scope of related issues), talks are bound to take at least several years. Clearly, these negotiations promise to be anything but easy. A realistic estimate of the duration of EU-EEU negotiations would be 5 to 8 years. *In order to have a chance at toasting a signed agreement in the mid-2020s, it is vital to sit down to the negotiating table as soon as the political situation allows.* In the meantime, it is the job of the expert community and the concerned state bodies to get down to the work of determining the prospective agenda and prerequisites for future negotiations right now.