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Article

Free Trade from Lisbon to Vladivostok: Who Gains, Who Loses from a Eurasian Trade Agreement?

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Gabriel Felbermayr and Jasmin Gröschl

Free Trade from Lisbon to Vladivostok: Who Gains, Who Loses from a Eurasian Trade Agreement?¹

INTRODUCTION



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When Vladimir Putin came to Berlin for a summit meeting on 26 November 2010, one focus topic, among other things, was free trade. One big aspect was the question of when Russia would finally join the World Trade Organization (WTO), after 17 years of ongoing negotiations. Another essential point was that the German Chancellor Angela Merkel had to reply to Putin's proposal to establish a free trade area (FTA) with the EU 'from Lisbon to Vladivostok'. Already in 1989, Helmut Kohl and Mikhail Gorbachev had spoken of a 'Common European Home' also including close economic cooperation.

In August 2012, Russia finally joined the WTO; but the idea of an FTA was perceived with caution in Berlin. The German Chancellor described the idea as a 'vision for the future' and said "Europe and Russia are strategic partners who certainly have not yet fully exploited their potential of cooperation". However, no concrete steps were taken, and ever since the escalation over the association agreement between the EU and Ukraine in November 2013, the strategic differences in trade policy between the EU and Russia have become obvious.

Proposals to cooperate more closely with Russia in order to provide incentives for a peaceful settlement of the Ukraine conflict are constantly being discussed. In January 2015, for example, Chancellor Merkel said at the World Economic Forum in Davos: "*it would be desirable to first create stability on the basis of the Minsk Agreement. We can then consider the possibilities for cooperation between the European Union and the Eurasian Union in a larger context, which was already named by President Putin 'from Vladivostok to Lisbon'. This must definitely be our goal*".

¹ This article is a summary of a more comprehensive study (Felbermayr *et al.* 2016) carried out by the ifo Institute on behalf of the Bertelsmann Foundation. The study can be found at <https://www.bertelsmann-stiftung.de/de/publikationen/publikation/did/freihandel-von-lissabon-bis-wladiwostok/>.

Since then, the subject has again faded from the spotlight. The question of relations with Russia has been overshadowed by other aspects: the refugee crisis, Brexit or the future economic policy of the United States. Meanwhile, economic integration among former Soviet states is progressing. The Eurasian Economic Union (EAEU), founded on 1 January 2015, has five members: Armenia, Belarus, Kazakhstan, Kyrgyzstan and Russia. Tajikistan is considering membership and appears to be preparing for EAEU accession. The EAEU has emerged from the Eurasian Economic Community (a customs union) and has the goal of establishing a single market inspired by the EU model.

Paradoxically, the election of the free-trade sceptic Donald Trump as the 45th US President could help stimulate an agreement between the EU and the EAEU. A transatlantic trade agreement between the EU and the United States is now far off. This frees negotiation capacities in the EU. Moreover, Trump has put *détente* with Russia on the agenda, so a slow return to normal conditions between East and West is more likely. If Trump withdraws militarily from Europe, an understanding with Russia will be all the more important for the EU as maintaining confrontation would entail high additional armament costs. Such considerations are not yet reflected in the EU's actions. Only recently have the EU countries extended sanctions against Russia for another 6 months until June 2017.

Similar to the EU, the EAEU concludes trade agreements with third countries and is represented by a Commission. An agreement already exists with Vietnam; other already existing bilateral agreements, such as the FTA between Russia and Serbia, will have to be transformed into EAEU agreements. Theoretically, members of the EAEU cannot conclude separate agreements with third countries, similar to individual EU member states. For example, Armenia or Ukraine cannot be EAEU members and, at the same time, have a separate association agreement with the EU. In this area of tension, Armenia has settled for the EAEU, while Ukraine has opted for an agreement with the EU.

The EAEU is a fact, even if the institutional design still raises many questions. For example, a central member of the Union, Belarus, is not yet a member of the WTO, and power relations within the Union are highly asymmetrical due to the dominance of Russia. A trade agreement with the EAEU could hold significant economic benefits for EU member states. In fact, Russia's economic structure, with its focus on raw materials and basic industries, is complementary to that of the EU. However, resistance within the EU is still large. As long as the Ukraine conflict is not resolved, it is hard to imagine a free trade deal. Nevertheless, such a pact could be an integral part of a new strategic partnership between the EU and Russia, within which military conflicts may also be addressed. The chances of a rapprochement with Russia are at present possibly better than within the last few years: it seems that the American President Donald Trump would like to put the rela-

tionship with Russia on a new pragmatic basis, and Britain – so far a dedicated opponent of Russia – is on its way to leave the EU.

To date, there has been no quantification of the economic effects of a trade deal between the EU and the EAEU, involving other countries with whom both Russia and the EU maintain trade agreements (especially Ukraine).² In spring 2016, the ifo Institute carried out an initial assessment of the trade and income effects of such a trade deal on behalf of the Bertelsmann Foundation. This article presents the key results and central findings.

INITIAL SITUATION

The Soviet Union was an integrated economic area with a single currency, a single market and a single foreign trade policy. The result was a highly integrated economic space with industrial value added chains that linked Soviet republics with strong manufacturing sectors, such as Russia, Ukraine and Belarus, and the resource rich central Asian ones. The emergence of independent states endangered this system. Therefore, soon after the collapse of the Soviet Union, the former member states (excluding the Baltic republics) concluded a free trade agreement – the Commonwealth of Independent States (CIS). One problem, however, was the necessity of cumbersome rules of origin, which were costly to maintain and which brought with them legal uncertainties. As a result, some members joined forces in 1997 to form a customs union. In 2012, the relations of the customs union members with other former Soviet countries were deepened in an extended FTA. Finally, in 2015, the customs union was institutionalised through the creation of the EAEU. Table 1 gives an overview of trade agreements and their members. It becomes apparent that the post-Soviet space is eco-

² About 20 years ago, Brenton *et al.* (1997) analysed the trade effects of a free trade agreement between the EU15 and Russia. Parallel to our analysis, a team of researchers at the Institute for International Systems Analysis (IIASA) in Vienna has also proposed a study (Vinokurov *et al.* 2016).

Table 1

Trade agreements on the territory of the former Soviet Union

Agreement	CIS	CIS-FTA	EAEC	EAEU
Founding year	1994	2012	1997	2015
Type of agreement	FTA	FTA	CU	CU+EIA
Member:				
Armenia	X	X		X
Azerbaijan	X			
Belarus	X	X	X	X
Georgia	X			
Kazakhstan	X	X	X	X
Kyrgyzstan	X	X		X
Moldavia	X	X		
Russia	X	X	X	X
Tajikistan	X	X	X	
Turkmenistan	X			
Ukraine	X	X		
Uzbekistan	X			

Notes: CIS = Commonwealth of Independent States, FTA = free trade agreement, CU = customs union, EIA = economic integration agreement, EAEC = Eurasian Economic Community, EAEU = Eurasian Economic Union.

Source: WTO.

nomically fragmented and characterised by a multiplicity of overlapping agreements.

Another characteristic of the trade policy of the former Soviet republics was the absence of an active external liberalisation agenda. Russia has only one trade agreement that is notified to the WTO and is outside the CIS, namely with Serbia. Negotiations with EFTA (Norway, Iceland, Liechtenstein and Switzerland) and New Zealand were put on hold during the Ukraine crisis.

Russia, as the central player of the EAEU, is internationally isolated with respect to its trade policy and has hardly any options other than to conclude agreements with countries outside the influence of the United States and the EU. The EAEU strives to conclude trade deals with third countries, but there is little transparency about the activities. In addition to the agreement with Vietnam, a trade deal with China is said to be negotiated. And, according to press reports, Iran, India, and Turkey are also on the list.

The relative economic strength of Russia is decreasing. While the country still accounted for about 3.8 percent of global economic output in 2015, its share will fall to 2.6 percent in 2016, according to our projections based on demographic trends and as a result of the catching up of other emerging economies. Russia should therefore be strongly interested in concluding trade deals, since its negotiating power – the size of its own internal market – will be less significant in the future.

EU – EASTERN TRADE: STATUS QUO

EU trade with the former states of the Soviet Union developed only modestly during the first ten years after the end of communism. Above all, this can be traced back to difficulties of adapting to the open market economy environment. At the beginning of the new millennium, however, trade relations became much more dynamic. Total trade with Russia has almost increased six-fold from just over 60 billion euros to nearly 380 billion euros in 2008. The global financial and economic crisis of 2009 led to a slump, and trade reached its pre-crisis level again only in 2012. In the wake of the Ukraine crisis, Western countries introduced sanctions against Russia, and Russia issued an embargo against the EU; this has led to a collapse of trade. More important than trade policy measures, however, was the sharp collapse in world market prices for important raw materials (mainly oil): the resulting recession in Russia has also impacted trade relations. Total trade with the other

Figure 1
German Trade with Russia: January 2008 to October 2016

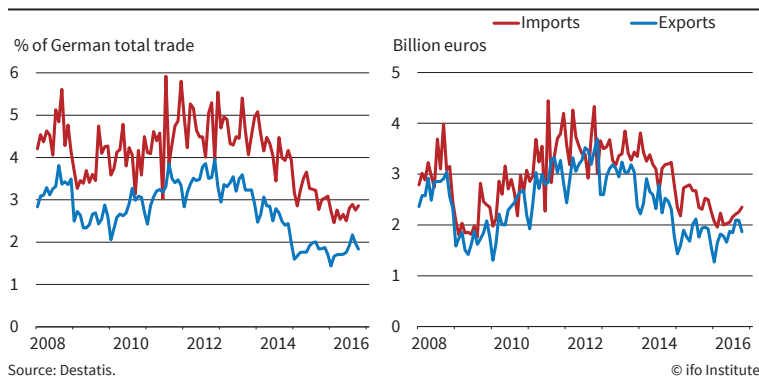


Figure 2
Trade Volume of Europe with Eurasia and Russia

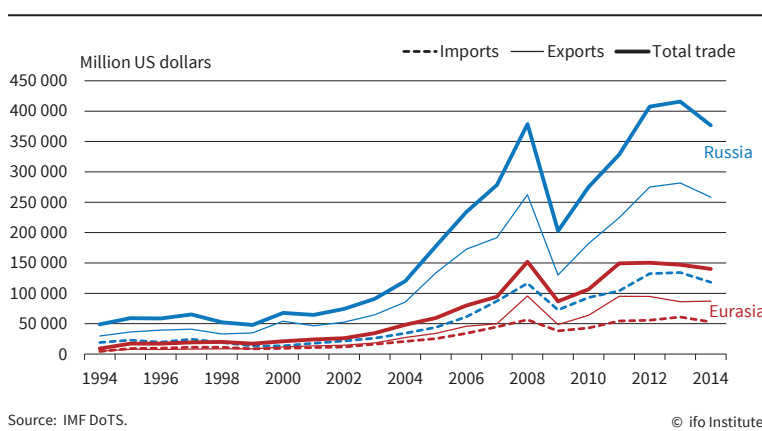


Figure 3
Sectoral Structure of Trade between the EU and Russia
1994 and 2014, million US dollars

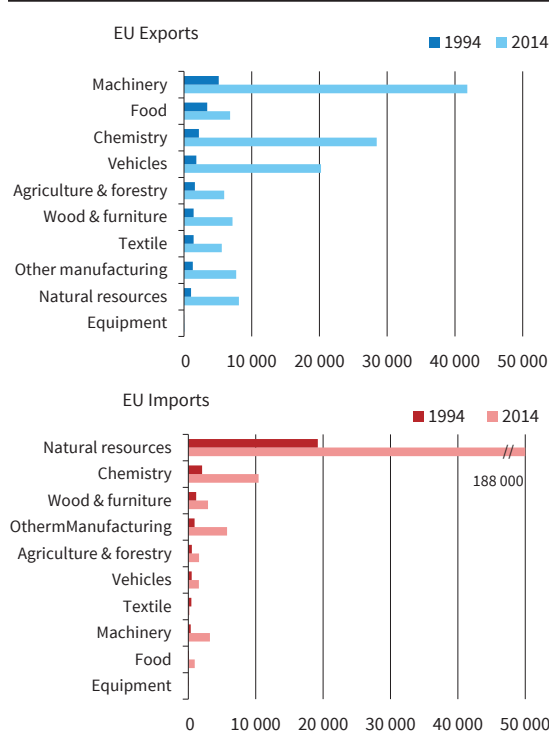
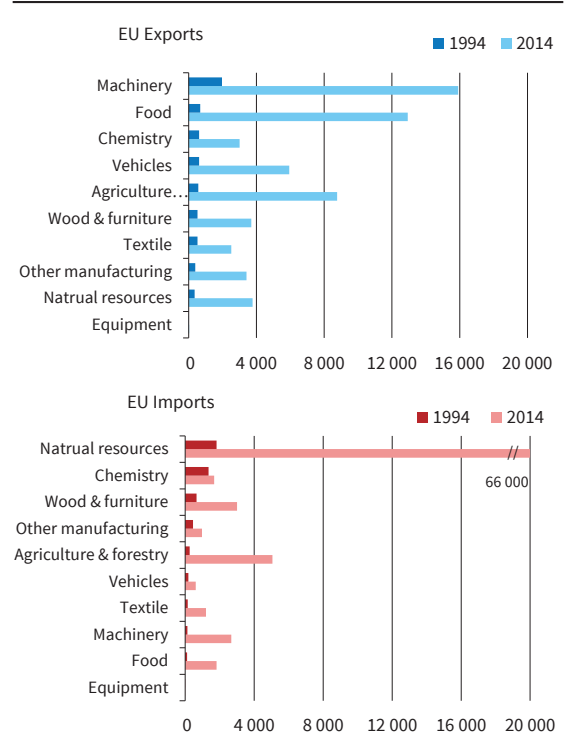


Figure 4
Sectoral Structure of Trade between the EU and EAEU
Countries, 1994 and 2014, million US dollars



countries of the former Soviet Union is comparatively stable, but at a significantly lower level (about 1/3 of Russian trade).

EU exports to Russia amounted to about 140 billion US dollars in 2014, while imports total 258 billion US dollars. Therefore, the EU has a considerable trade deficit with Russia. By contrast, trade with the other Eurasian countries is significantly lower: exports of 87 billion dollars are counterbalanced by imports worth 53 billion US dollars (see Figure 2). The EU thus has a trade surplus with this group of countries.

EU imports from Russia are heavily concentrated in raw materials (see Figure 3). In 2014, imports of natural resources (mainly mineral oil, gas and metal) amounted to about 188 billion euros; since 1994 imports in these industries have increased almost tenfold. Contrasting this, imports in chemicals (approx. 10 billion US dollars) or machinery (approx. 3 billion US dollars) are very modest.

Exports from the EU to Russia, however, are diversified. Machi-

neries (approx. 42 billion US dollars) and chemicals (about 28 billion US dollars) dominate, followed by the export of vehicles amounting to around 20 billion US dollars. To a relatively small extent Europe also exports food products to Russia (about 7 billion US dollars). Overall, the trade balance of the EU with Russia is strongly negative.

The structure of European external trade with other countries of the Eurasian Economic Union (EAEU) is similar to that of Russia (see Figure 4). Raw materials (66 billion US dollars), mainly oil and gas, again dominate. Compared to this the runner-up product category – agricultural and forestry products – represents only about 5 billion US dollars. This shows the strong dependency of the regions' exports to the EU on resources and raw materials. Again the EU is well diversified on the export side, which is dominated by machinery (16 billion US dollars) and chemicals (13 billion US dollars). Exports of vehicles amount to 6 billion US dollars, whereas raw materials total at 9 billion US dollars. While the EU has a trade deficit in goods with Russia, it has a surplus of about 20 billion US dollars (data from 2013, see Figure 5) in services. The surplus with the other Eurasian countries in services amounts to about 7 billion US dollars (data from 2012, see Figure 5).

TRADE BARRIERS: STATUS QUO

Compared to other trading partners of Europe, the countries of the former Soviet Union (CIS) have maintained relatively high import duties. Tariffs amount to about 6 percent for industrial goods in Russia, while in agriculture they are nearly twice as high. Given this, Russia belongs to the upper third of the countries shown in Figure 6. Import duties are highest in Uzbekistan, but the Russian market is relatively closed as well, especially with respect to the agricultural sector. Interestingly, the weighted average tariff of Belarus – not yet a member of the WTO – is relatively lower for both industrial and agricultural goods. Georgia and Armenia charge the low-

Figure 5
Import and Export of Services of EU28 with Russia and Other Eurasian Countries

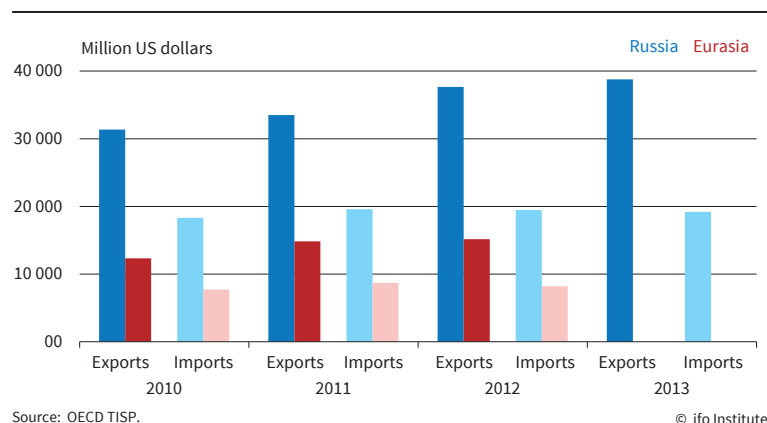


Figure 6
Import-Weighted Average Tariffs, CIS Countries, 2014

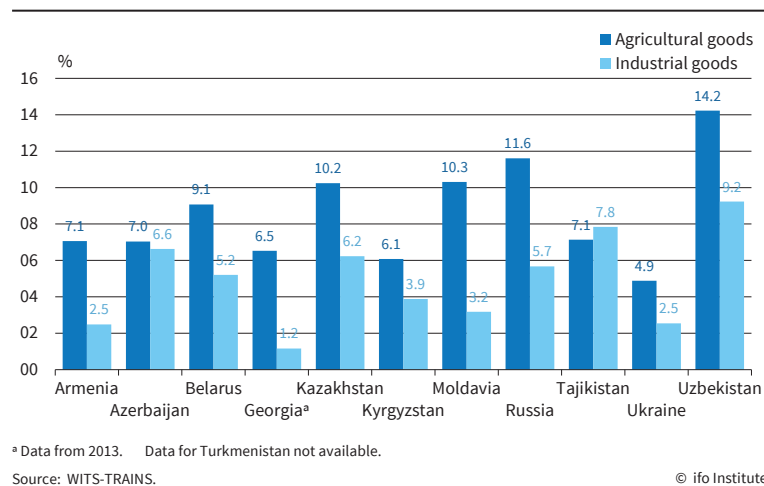
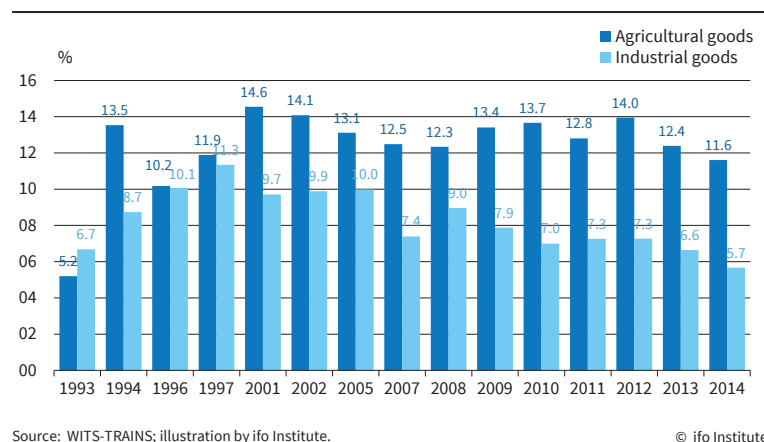


Figure 7
Import-Weight Average Tariffs, Russia over Time



est import duties. In the latter case, tariffs had to be adjusted to the higher common external tariffs of the Eurasian Customs Union when Armenia became a member of the EAEU.

Figure 7 provides a more detailed picture of Russia, the country that dominates the EAEU. Import-weighted average tariffs on industrial goods

rose from 7 percent to 11 percent in the early 1990s. They declined again prior to Russia's accession to the WTO, reaching a minimum of 6 percent in 2014. Tariffs on agricultural goods have tripled from 5 percent to 15 percent and still remain in the double-digit range. Russia also upholds relatively high non-tariff trade barriers. As described in Felbermayr, Aichele and Gröschl (2016), Russia is very active in technical, sanitary and phytosanitary measures. Russia is especially active in the latter area, which is of particular importance for food and agricultural products. Since Russia's accession to the WTO in 2012, it has notified 115 measures which affect 105 products (compare also Koch-Mehrin 2013).

THE IFO TRADE MODEL

The ifo trade model, described in detail in Aichele, Felbermayr and Heiland (2014) is a static, general equilibrium model of international trade. We include 134 countries and regions, and aggregate the 58 sectors into 32 tractable goods and services industries. Trade flows are impeded by tariffs and non-tariff barriers.³ The sectors are linked nationally and internationally through supply structures. The ifo simulation model thus proxies international value chains and sectoral details rather well.

The model can be parametrised using simple econometric equations resulting from the equilibrium conditions of the model. Two industry-specific parameters are of particular importance: the elasticity through which tariff changes affect trade flows and the effect of non-tariff trade barriers on these flows. We distinguish between free trade agreements (FTAs) of different integration depths which are based on the data by Dür, Baccini and Elsig (2014). This decomposition into deep and shallow agreements allows us to estimate the welfare and trade effects for different depths of trade liberalization in the scenarios, i.e. different measures of the reduction of non-tariff trade barriers.

The trade policy scenarios described in detail below are based on the following thought experiment: if the EU and the EAEU – counterfactually – had a free trade agreement, how trade flows, sectoral production structures and real income would look. In this experiment, everything else is held constant (*ceteris paribus assumption*). We assume that the extent of the dismantling of non-tariff trade barriers follows the liberalisation efforts of other existing FTAs. Our base year is 2011: hence, before the Western sanctions and the Russian embargo.

The calculated level effects on real income and trade flows are static. We cannot identify dynamic effects of trade – such as effects of innovation activities of companies. The model thus provides lower bounds of effects. Note, however, that static effects will not

occur immediately after trade liberalisation. This is particularly relevant for non-tariff barriers: increasing regulatory cooperation with the EU will only slowly unfold its effects. In accordance with the empirical literature (e.g. Jung, 2012), the adjustment takes about ten to twelve years.

SCENARIO

Due to the uncertainty with respect to the design of an FTA from Lisbon to Vladivostok, we examine a number of different scenarios when quantifying a potential agreement. It is important to consider the content of a trade deal but also the composition of potential contract partners. Regarding the countries involved, the following compositions are conceivable:

- All EU member states and Russia.
- All EU member states and all EAEU members.
- All EU member states and all former states of the Soviet Union (excluding the Baltic States).

We report mainly scenarios where we assume that the EU concludes a trade deal that is as profound and comprehensive as other modern EU FTAs. At the same time, we also provide a breakdown into individual components to visualise expected effects from an agreement that comprises only certain areas (i.e. industrial or agricultural sectors, tariff reductions vs. deep or rather shallow reforms of non-tariff barriers).

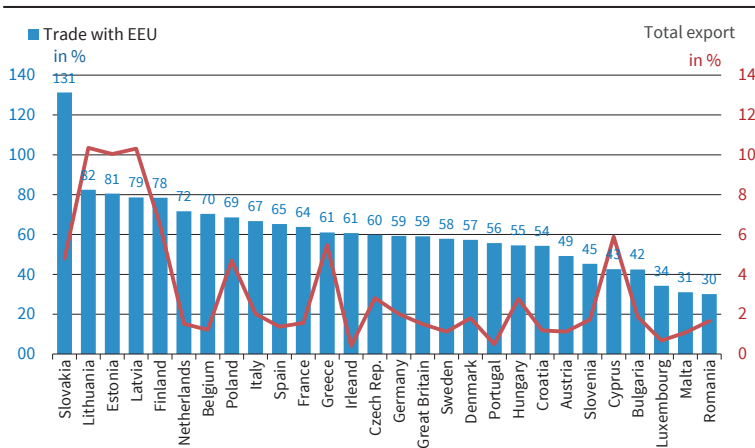
In order to depict trade policy developments since 2011, we first simulate the effects of an EU accession of Croatia. We handle the FTAs between the EU and Georgia, Moldova and Ukraine similarly. The effects of FTA scenarios discussed above are then based on this alternative, simulated initial scenario. This has implications for the expected trade diversion effects of Georgia, Moldova and Ukraine. The benefit of their preferential access to the EU market will be weakened if more countries such as Russia would get better access to the EU market ('preference erosion').

TRADE EFFECTS

Figure 8 shows simulated effects on exports of selected countries or regions respectively to the region of the new trading partners and to the rest of the world. The model therefore suggests that a deep agreement between the EU and the EAEU could raise Russia's exports to the EU by around 71 billion euros. The agreement would also stimulate Russian exports to the rest of the world (RoW), as the availability of cheaper machinery and intermediate products from the EU will increase Russia's overall competitiveness; this will also benefit Russia with respect to third country markets. Overall, Russian exports are expected to increase by around 77 billion euros. Figure 9 shows that this growth would bring a relative increase of 32 percent in Russian exports to the EU and a total increase of about 19 percent. In the initial situation, 53 percent of Russian exports are allotted to the EU.

³ The basis for this multi-sector model was developed by Caliendo and Parro (2015). It is based on the groundbreaking work of Eaton and Kortum (2002). Thus the model is anchored in the New Quantitative Trade Theory – see Costinot and Rodríguez-Clare (2015) for a description of these model types.

Figure 8
Growth Rates of Trade Due to a Deep EU-EAEU Agreement: EU



Source: Calculations by ifo Institute.

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Taking a look at Germany, a trade deal could increase exports to the EAEU by 31 billion euros. This trade creation is confronted by a negative trade diversion effect of 9 billion euros. The reason is that Russia's additional exports to the EU (e.g. metal products) would replace German exports in these sectors. Central and Eastern European countries (CEECs), which are not listed separately (Czech Republic, Slovakia, Slovenia, Austria, Hungary), could gain additional exports to EAEU countries of approx. 14 billion euros. Negative trade diversion effects would total 3 billion euros. The trade and diversion effects for Italy, Scandinavia (Denmark, Sweden and Finland), BENELUX, British Isles and France are similar in scale. Poland, which directly borders EAEU countries, could experience trade creation effects of around 8 billion euros, while trade diversion effects amount to 2 billion euros. Although the Baltic economies are rather small in scale, they are likely to experience high trade creation effects due to their close proximity to Russia (up to 5 billion euros); the negative diversion effects are estimated to amount to about half a billion euros.

Figure 9 depicts the expected export growth rates of countries affected by an EU-EAEU treaty. The EU would experience a 63-percent increase in exports to the former states of the Soviet Union (excluding the Baltic States); total exports (net trade creation and diversion effects) would increase by 2 percent. In comparison, the expected export growth for Russia is somewhat lower (+ 32 percent), mainly because Russian exports to the EU are already close to their potential and trade barriers in Europe are relatively low with respect to the goods Russia exports (e.g. raw materials). Nevertheless, as the EU is a very important export

market for Russia (52 percent of Russian exports), an overall agreement increases the country's total exports by about 19 percent.

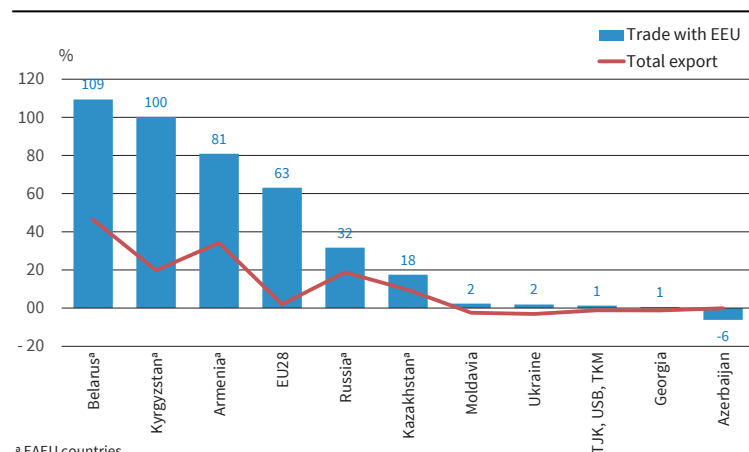
Belarus, Kyrgyzstan and Armenia could nearly double their exports to the EU due to an agreement. For Armenia and Belarus, who do have a high share of exports with Europe, a trade deal would also lead to a sharp increase in total exports of 46 percent and 34 percent, respectively. These are very high increases, which would result from the reduction of currently high trade barriers.

Non-member countries of the EAEU would indirectly be affected by an agreement. On the one hand, they might lose competitiveness relative to countries participating in an agreement. On the other hand, they would also benefit from an increase in income if this leads to a higher demand for their own goods and services. We show that the exports of Georgia, Moldova, the Central Asian economies outside the EAEU, and Ukraine to the EU would increase slightly, but total exports might drop. The reason is that these countries could lose market share against EAEU countries through stronger competitive pressure from the EU. They may at the same time compensate for some of the loss by higher exports to the EU. Note however, that the net effect is negative. Azerbaijan is an exception, as its energy supplies to the EU could be partially replaced by a FTA between the EU and the EAEU. But the country may avoid a slump in overall exports by exporting more to other countries.

MACROECONOMIC RESULTS

Figure 10 shows the simulated long-term effects of different potential agreements on real GDP per capita for the countries of the former Soviet Union. Percentage

Figure 9
Growth Rates of Trade Due to a Deep EU-EAEU Agreement: Former Soviet Union

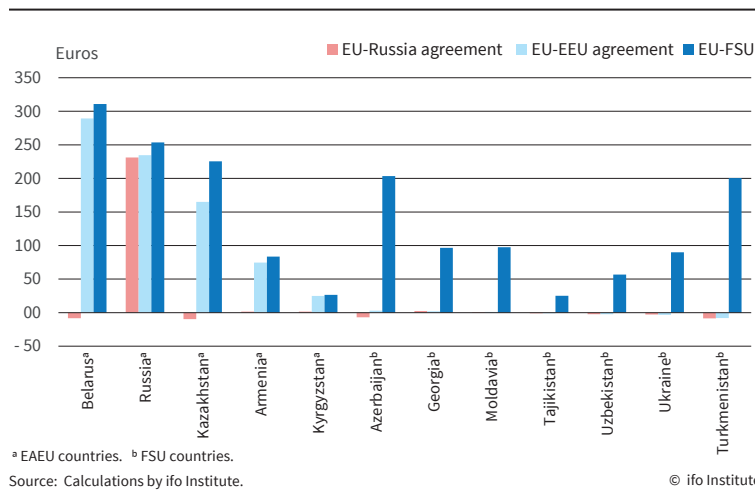


^a EAEU countries.

Source: Calculations by ifo Institute.

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Figure 10
Effects of Real per Capita Income per Year in Former Soviet Union States



growth rates for an EU-EAEU agreement are also depicted. Here, Belarus is the country with the highest advantage, both in absolute and relative terms. Its per capita income would rise by almost 4.9 percent or 290 euros per person (based on the *status quo* income of 2015). Russia would be able to increase its real average income by 3.1 percent, which equals 235 euros per person. Kazakhstan and Armenia could increase their per capita income by 2.3 percent, while Kyrgyzstan would have a slightly smaller relative advantage of 1.7 percent. In absolute terms, this means income gains of 165, 75 and 25 euros per person and year, respectively.

Countries that are not members of the EAEU would have very little to expect from an agreement with the EU. In particular, Central Asian countries would be adversely affected by trade diversion effects; but the effects are small, both, in relative and absolute terms. According to the simulation, Turkmenistan would be most affected. The loss in real per capita income would be about 8 euros per person and year.

Likewise, an agreement of only Russia with the EU would produce small negative effects in the per capita income of other former Soviet Union states. The absence of positive pull-in effects relates back to the fact that Russia's exports would rise primarily in raw materials. This industry requires little intermediate inputs from other former Soviet countries. For Russia, an exclusive agreement with the EU excluding other members of the EAEU would not be preferable. The increase in per capita income would be less than 3 euros per person and year. An agreement including all former Soviet Union states would, however,

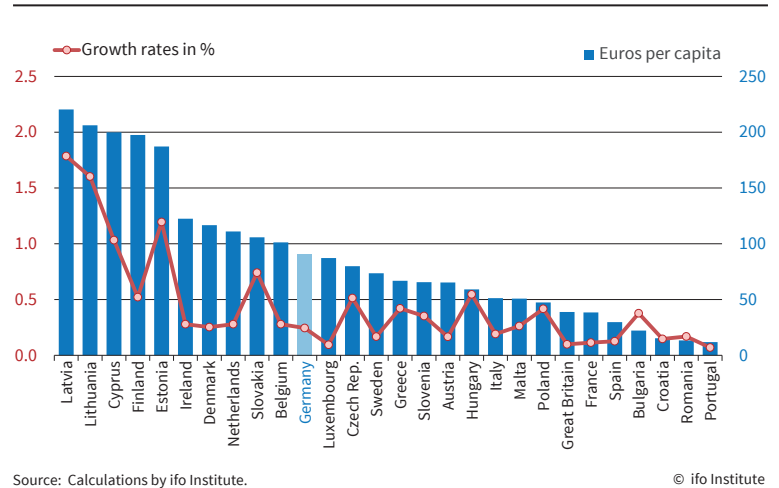
result in a further increase in Russian income per capita by about 20 euros per person and year compared to an EU-EAEU deal only. This does result from the fact that reviving or dampening the economy in other countries would also positively affect Russia by an increase in the demand for Russian products.

Figure 11 shows simulated gains in annual per capita income from an EU-EAEU agreement for EU member states, again relative to the *status quo* income of 2015 (in percent, left axis) and absolute values (in euros, right axis). German real per capita income would grow by about 91 euros; this equals

an increase of about 0.2 percent. Compared to Russia, this is a much smaller value: the EAEU is a comparatively unimportant market for Germany, whereas the EU is a rather important market for Russia. If one compares this growth rate with projected profits of Germany from other potential trade agreements – for example from TTIP, for which the same simulation model predicts growth rates of 0.6 percent – the effect is not negligible. Furthermore, note that the growth rates occur annually: in 2015 prices, we would find even higher annual benefits from an EU-EAEU deal in the future. Utilising a calculated interest rate, the present value of the income advantage would result in almost 2,300 euros (after full implementation of the FTA).

Germany is not the main beneficiary of an EU-EAEU agreement. Other EU members would benefit far more from their proximity to Russia and the resulting relative importance of the Russian market. Particularly the Baltic republics would benefit: Latvia, Lithuania and Estonia would increase their real income by 220, 206 and 187 euros per capita and year. This equals

Figure 11
Effects of a Deep EU-EAEU Agreement on Real per Capita Income in the EU Growth Rates



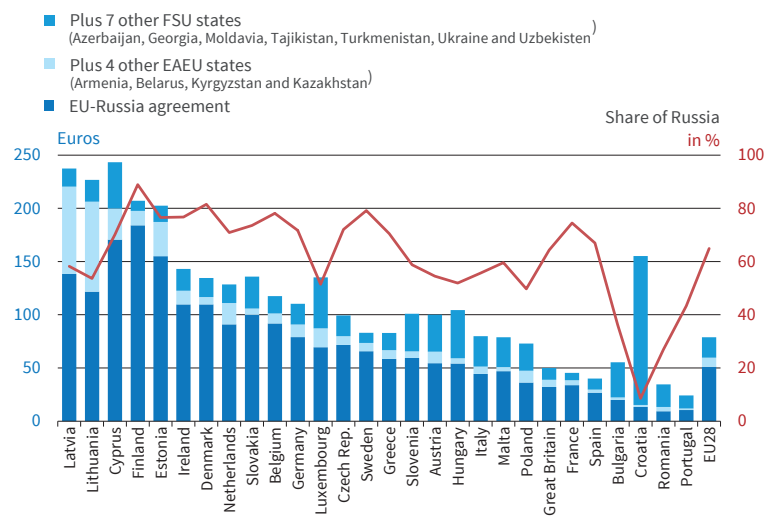
1.8, 1.6 and 1.2 percent of the *status quo* income, respectively. Similarly, Finland and Cyprus would have above average benefits, although percentage growth rates are lower than in the Baltic States as income levels are significantly higher. Among the old EU members, the agreement would generate higher absolute income in Ireland, Denmark, the Netherlands, and Belgium compared to that in Germany. Relative growth rates are of comparable size. Contrasting this, new EU members would experience higher impulses on growth, particularly Slovakia (0.7 percent), the Czech Republic (0.5 percent), Hungary (0.5 percent), Poland (0.4 percent) and Bulgaria (0.4 percent). Greece, similarly to Cyprus, has close cultural proximity with Russia. Its traditionally relatively high trade with Russia is thus positively affected (0.4 percent or 67 euros per capita and year).

A number of EU members traditionally trade very little with Russia. To them an EU-EAEU agreement is of little economic importance. Simulated growth rates of Britain, France and Spain are 0.1 percent, respectively, while Italy would see growth in income per capita by 0.2 percent per year. Interestingly, Eastern European countries (such as Croatia or Romania) would gain only very modestly, both, in percentage and absolute terms, mainly due to a lack of clear comparative advantages.

Figure 12 broadens the perspective on other potential agreements. Next to the EU-EAEU agreement, it also considers a trade deal between the EU and all successor states of the former Soviet Union (EU-FSU), as well as a partnership between the EU and only Russia. The benefits from an EU-FSU FTA are, without exception, higher than from an EU-EAEU agreement; while the latter agreement would be much more advantageous than a trade deal with only Russia. Germany, for example, would gain an additional 20 euros per capita and year from an extension of the FTA to the seven non-EAEU former Soviet countries. An agreement with Russia alone would reduce the gain by 12 euros. Germany would thus only achieve 72 percent of the maximum possible effect by an agreement with Russia alone.

Belarus is particularly important for the Baltic economies. In Latvia and Lithuania, more than 80 euros of welfare gains from an

Figure 12
Effect of a Different Agreements on Real Income per Capita in the EU and the Share of Russia



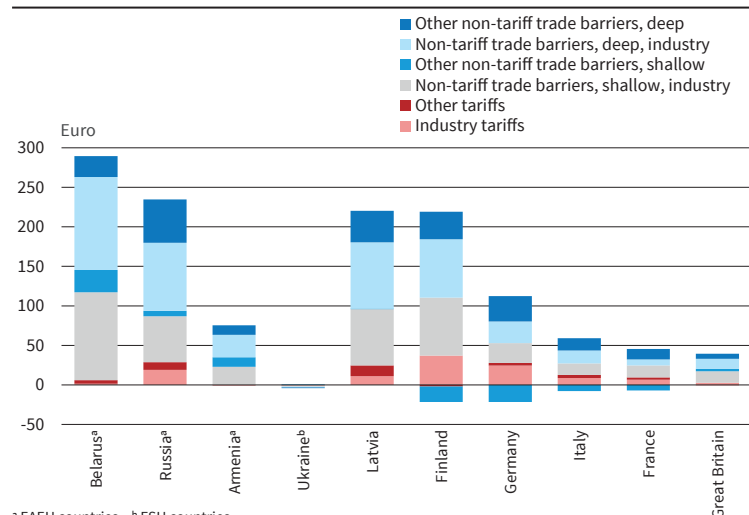
Source: Calculations by ifo Institute.

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EU-EAEU agreement are attributable to countries other than Russia. To have other former Soviet republics in the agreement is relatively important for Luxembourg, Slovenia, Austria, Hungary, Romania and particularly Croatia. Note that for Croatia this effect is difficult to reconstruct and could relate back to special factors which are accounted for in the base year (2011). The other above-mentioned countries have relatively large trade volumes with the seven other FSU countries.

Figure 13 shows the decomposition of per capita income effects due to an EU-EAEU agreement related to individual trade policy measures for selected countries. For Germany, more than 30 percent of the total aggregate income increase of 91 euros per capita and year trace back to the elimination of tariffs; a major share are industrial tariffs (24 euros), while agricultural tariffs contribute only marginally (3 euros). Tariffs also

Figure 13
Decomposition of the Effects of an EU-EAEU Agreement on per Capita Income



^a EAEU countries. ^b FSU countries.
Source: Calculations by ifo Institute.

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play an important role in Italy and France (about one quarter of the total effect, respectively). Liberalisation in agricultural tariffs constitutes 7.8 percent of the overall effect, which is more than twice as high as in Germany. While in Britain and Finland, the elimination of agricultural tariffs would generate less real income growth than tariff revenues. Hence, for them the result would be a small but negative contribution to the (positive) overall effect of an EU-EAEU free trade zone. For Russia, the elimination of tariff barriers is less important (12 percent of the total effect), while for Belarus it approaches zero.

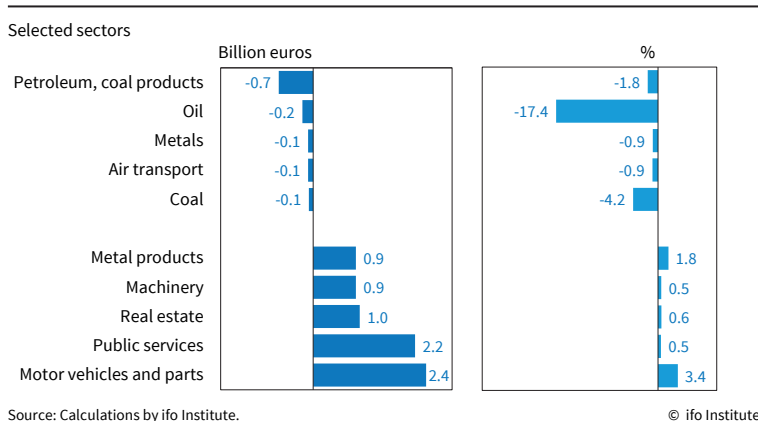
In all countries considered, most of the welfare gains stem from a reduction of non-tariff trade barriers (NTMs) in the industrial sector. In Russia and Germany, their share amounts to 61 percent of the total effect, respectively; about half of it is attributable to profound measures, which are only observable in deep trade agreements. In contrast, the reduction of NTMs in the agricultural and services sector is less important. These measures contribute very little (12 percent of the total effect) for Germany. In France (agricultural trade) and Britain (services), the proportion is higher with 16 and 24 percent, respectively. It is highest in Armenia (32 percent), which has a clear perspective of a revival in tourism.

SECTORAL EFFECTS

In this section, we consider the effects at the sectoral level. For this purpose, we pick the five sectors with the strongest positive and those with the largest negative value added effects. We again take a deep EU-EAEU agreement scenario as our basis, but focus only on the effects on Germany and Russia due to spatial restrictions.

The German sector with the highest value added growth rates of 3.4 percent (2.4 billion euros) would be the automotive sector. This sector accounts for about one third of the overall increase in net value added in Germany. Relatively high increases are also expected for metal products (1.8 percent) and machinery (0.5 percent). Interestingly, services sectors such as public services and real estate would also benefit. These industries are hardly ever directly affected by FTAs; they rather benefit indirectly from an increase in overall economic demand and from cheaper

Figure 14
Change in the Sectoral Value Added by a Deep EU-EAEU Agreement in Germany



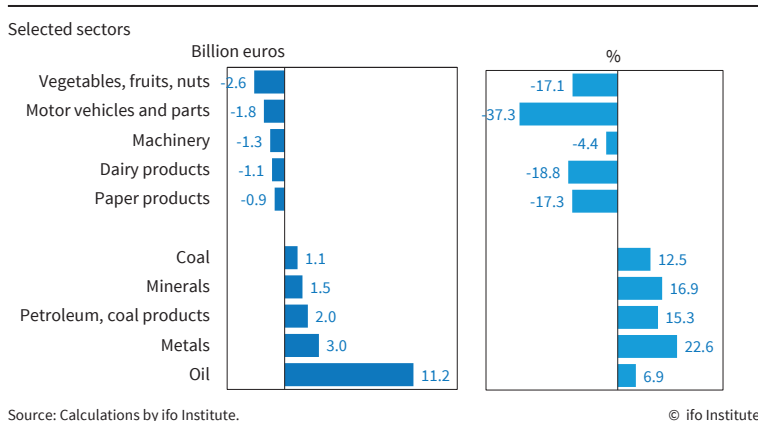
intermediate inputs (e.g. an FTA would reduce the prices of building materials).

The losses would be concentrated in industries based on natural resources, particularly oil, coal and especially refineries. The latter could lose approx. 0.7 billion euros of value added from an agreement, as imports of refined petroleum products from Russia would become cheaper. Germany could also lose value added in metals and air transport, but relative changes would be less than 1 percent, respectively.

The value added gains of Russia are concentrated on natural resources sectors, particularly energy products. An agreement would, however, not only facilitate trade in oil, gas and coal, but also in refinery products thereof, which embed further value added potentials. More than half of the growth in the oil producing sector is not attributable to additional direct oil exports to Europe but to higher supplies to petroleum processing industries, which in turn export more to the EU. Mining products such as metals or minerals would also benefit from a reduction of bureaucratic barriers.

Russian sectors with a comparative disadvantage would lose out. These comprise certain foods such as vegetables and fruits or dairy products, where double-digit losses are possible. The automotive sector could also come under considerably pressure; for a deep agreement, model simulations result in a value

Figure 15
Change in the Sectoral Value Added by a Deep EU-EAEU Agreement in Russia



added loss of 37 percent (compare Figure 15). This high effect is explained by relatively high protectionist barriers of Russia, which would be eliminated in an EU-EAEU agreement. Mechanical engineering could also be damaged – albeit to a lesser extent – with the percentage decline of 4 percent remaining within the framework.

SUMMARY

Russia and the other countries of the former Soviet Union could be interesting partners for a deep economic cooperation with the EU. The EU should have a strong interest in stable economic development in its immediate neighbourhood. In addition, the complementary specialisation structure of these countries promises substantial economic benefits also for the EU.

European imports from the countries of the Eurasian Economic Union are extremely concentrated on natural resources such as gas, petroleum and metals. Natural resources account for about 80 percent of exports to the EU. Imports are dominated by machinery and chemical products. Services trade is underdeveloped with respect to both exports and imports.

The trade barriers with the countries of the former Soviet Union are relatively high. Average tariffs for agricultural products are consistently above 10 percent, while the average tariff in industrial goods centres at around 5 percent. Non-tariff barriers to trade are considerably high, which is also reflected in a considerable number of disputes on technical barriers to trade and on sanitary and phytosanitary measures. This situation has been exacerbated by the current sanctions following the annexation of Crimea by Russia.

The potential for additional trade in goods and services between member states of the EAEU and the European Union is substantial. A deep agreement could increase Russia's exports to the EU by 32 percent compared to the *status quo* in 2011; Armenian exports could increase by more than 80 percent; exports of Belarus and Kyrgyzstan could double.

European exports to the countries of the EAEU could in a deep agreement increase by more than 60 percent compared to the 2011 *status quo*. The potential is highest in Slovakia, Finland and Poland. Nevertheless, German exports could also rise by as much as 59 percent. If a deep FTA including not only EAEU members, but all successor states of the USSR would be concluded, European exports could even rise by 74 percent compared to the *status quo* of 2011.

In Russia, an agreement would mainly benefit natural resources sectors, most notably the oil industry, but also metal products would be strengthened. In contrast, fruit and vegetables as well as automotive sector would be on the losing side. From an agreement with the EAEU, Europe could export agricultural products, foodstuffs and automotive to the countries of the former Soviet Union in an easier way.

With an agreement between the EU and the EAEU, Russia could increase its real income by 3.1 percent, worth 34 billion euros. Belarus would experience even higher effects (4.9 percent), and Armenia (2.3 percent), Kyrgyzstan (2.3 percent) and Kazakhstan (1.7 percent) would also show noticeable effects. Countries of the former Soviet Union that are not members of the EAEU today would easily lose from an EU-EEA agreement only. Turkmenistan would be most negatively affected by a decline in income of 8 euros per capita and year.

The Baltic republics would benefit more than other European countries from such an agreement. Their per capita income could increase by 1.2 to 1.8 percent; this amounts to 200 euros per capita and year. About 60 percent of these increases are attributable to Russia; the remainder can mainly be ascribed to deepened trade relations with Belarus. If the agreement would be extended to the other former Soviet republics, benefits increase slightly. The EU would increase its real income due to a deep agreement with the EAEU by about 30 billion euros; including the other states of the former USSR would add about 10 billion euros (40 billion euros in total). Germany could expect an increase in income of 7 or 9 billion euros, which equals 90 or 110 euros per capita and year.

A FTA that would only eliminate tariffs would be worth nearly 30 euros per capita in Russia. A similar value would be expected in Germany. If NTMs in all sectors were also reduced, benefits in Russia could amount to 151 to 290 euros per person and year, depending on the level of NTM eliminations. Similarly, Germany could gain 59 to 91 euros per capita and year.

The benefits from a more intensive economic cooperation between the EU and the former states of the Soviet Union cannot be dismissed. They are significantly larger for Russia than for the EU and could contribute to economic stabilisation in the region. The prospect of a deep and serious economic integration with the EU, which does not rule out Russia's Eurasian Customs Union, should become part of the European policy on Eastern Europe.

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