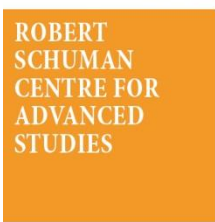




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Robert Schuman Centre for Advanced Studies  
Global Governance Programme

**A Vision for Ukraine in the World Economy:  
Defining a Trade Policy Strategy that Leverages Global  
Opportunities**

Bernard Hoekman, Jesper Jensen and David Tarr



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ISSN 1830-1541

© Bernard Hoekman, Jesper Jensen and David Tarr, 2013

Printed in Italy, November 2013

European University Institute

Badia Fiesolana

I – 50014 San Domenico di Fiesole (FI)

Italy

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## **Abstract**

A trade policy that is global in perspective and the lowering of trade costs are critical for Ukraine. Two regional trade agreements are at the center of attention in Ukraine. One is the Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU that Ukraine has, at least temporarily, recently rejected; the other is an invitation to join the Eurasian Customs Union (ECU) with Russia. We argue that Ukraine should focus on addressing specific policy areas that negatively affect trade with both of its neighboring customs unions. In addition to intergovernmental trade agreements that center on deeper integration with both blocs, we suggest Ukraine put in place a number of “supply chain councils” (public-private partnerships that focus on the main sources of supply chain trade frictions) organized around the major export sectors for Ukraine, the ECU countries as well as the EU. The councils would have a mandate to identify the most important sources of supply chain inefficiencies as well as actions to resolve them. The recent proposal by Ukraine to establish a joint commission among Ukraine, Russia and the EU to promote trade could be used as a step in this direction.

## **Keywords**

Ukraine, trade policy, Eurasian Customs Union, regional integration





## **A Vision for Ukraine in the World Economy\*** ***Defining a Trade Policy Strategy that Leverages Global Opportunities***

In 1991, Ukraine gained its independence from the former Soviet Union and began formulating a national trade policy. Ukraine achieved an important milestone in integrating with the international trading community on May 16, 2008, when it formally acceded to the World Trade Organization (WTO). Following its WTO accession, Ukraine negotiated a Deep and Comprehensive Free Trade Agreement (DCFTA) with the European Union (EU). On November 21, 2013, however, Ukraine suspended preparations for signing the DCFTA at the Third EU-Eastern Partnership Summit in Vilnius on November 28-29, 2013. High level EU officials held open the possibility of concluding the agreement with Ukraine in the future, and of closer cooperation in the interim.<sup>1</sup> In 2010, the Russian Federation, Belarus and Kazakhstan formed the Eurasian Customs Union (ECU) and have invited Ukraine to become a member. Some senior EU officials maintained that the Ukrainian decision not to sign the DCFTA was due to extreme pressure from Russia.<sup>2</sup>

The DCFTA and possible membership in the ECU have generated much attention in Ukraine—in the press, among policymakers and the business community. Both the EU and the ECU markets are very important to Ukraine. These trade agreements are worthy of extensive discussion and debate. In what follows we suggest that it would be best to do so in light of an overarching vision of how Ukraine can use integration into the global economy to achieve its national development and growth objectives. We propose new institutional mechanisms to identify concrete policy initiatives that will help realize this vision while also benefitting trade partners. While apparently rejecting the DCFTA with the EU, Ukraine appears to be suggesting new mechanisms that are compatible with our recommendation. Ukraine has proposed a joint commission to promote trade between Ukraine, Russia and the EU, and Russia's initial reaction was positive.<sup>3</sup>

### **I. Defining a Vision**

Any vision for trade policy should consider how integration of Ukraine into international markets can help achieve greater prosperity: new jobs and investments with advanced technologies; a good choice of products and services at reasonable prices, widely available to both companies and citizens. This will need to cover a broad set of policies, not just measures that apply at Ukraine's borders that increase the cost for Ukrainian companies of competing in internationally. Businesses often face multiple types of regulations, regulators, and regulatory institutions that impose standards for both goods and services. Many of these policies operate "behind the border." They are often justified on the basis of health, safety, security, quality, etc., but they can have a large impact on the costs of trade and trade opportunities.

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\* This paper was used as background material for the talk of Mr. Pascal Lamy at the 10th Yalta Annual Meeting on September 21, 2013. Financial support from the Yalta European Strategy (YES) is gratefully acknowledged. We would like to thank Michael Ferrantino and Marinos Tsingas for estimates of the impact of improved trade facilitation on Ukraine. The authors alone are responsible for the views and accuracy of the paper.

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<sup>1</sup> See statement of The EU's foreign policy chief Catherine Ashton, quoted in "EU Loses out on Ukraine but may have dodged a bullet," *Reuters*, November 21, 2013. Available at: <http://www.reuters.com/article/2013/11/22/us-eu-russia-ukraine-idUSBRE9AL0ER20131122>

<sup>2</sup> See, for example, statement by Stefan Fuele (EU Commissioner for Enlargement) in "Ukraine Suspends preparations for EU trade agreement," *BBC News Europe*. Available at: <http://www.bbc.co.uk/news/world-europe-25032275>

<sup>3</sup> See "Ukraine Suspends preparations for EU trade agreement," *BBC News Europe*. Available at: <http://www.bbc.co.uk/news/world-europe-25032275>

A growing number of countries have shown that a strategy centered on deep integration into international markets can be a powerful mechanism to sustain high growth rates over several decades. Examples are found in Asia, Europe and Latin America. The successful countries differ widely in terms of size, availability of natural resources and economic structure. But they have one thing in common: a clearly articulated and consistently implemented global trade strategy aimed at leveraging the opportunities offered by the world market to create high productivity industries as well as a wide variety of services. Given the importance of Ukraine's immediate neighbors for its exports—the EU and Russia—a key determinant of the extent to which Ukraine will be able to leverage its location and comparative advantages to the fullest will be its ability to trade effectively with both of these important neighbors.

Chile is a useful model for Ukraine to consider. It has been one of the world's faster growing economies in the past 30 years, and 20 years ago faced trade policy choices similar to what Ukraine faces today. In the early 1990s, its large neighbor Brazil led the formation of the MERCOSUR Customs Union among Brazil, Argentina, Uruguay and Paraguay. Analogous to the ECU's invitation to Ukraine, Chile was invited to join MERCOSUR. Chile's core trade strategy at the time (as it continues to be) was to pursue a global trade strategy involving a mix of free trade agreements with any country that was willing to do so, especially with the US and the EU, and also to lower its external tariff on a most favored nation basis. Since the common external trade policy of the MERCOSUR customs union would prevent Chile from pursuing this strategy, it declined to join the Customs Union. Crucially, its large neighbor Brazil and the other MERCOSUR members accommodated Chile's sovereign policy decision, and Chile negotiated a free trade agreement with MERCOSUR that forged closer relations. Chile subsequently negotiated a broad set of free trade agreements, including deep free trade agreements with the US and then the EU, while lowering its import tariffs to a uniform six percent. Research has found that Chile gained very significantly from implementing its core trade policy strategy of lowering its uniform tariff multilaterally and negotiating a large network of free trade agreements (Harrison *et al.* 2002). Building on the Observer status of Ukraine in the ECU, we discuss below some concrete proposals for deeper cooperation between Ukraine and the ECU, while preserving the global focus of our suggested trade strategy for Ukraine that is similar to that of Chile.

## **II. Strategies for Success from the Rapid Growth Countries**

In considering how trade policy can be designed to help achieve rapid growth of incomes, it is useful to consider concrete experiences. Annex table 1 provides per capita income data in purchasing power parity terms over time for six countries that have grown very rapidly over time: four so-called East Asian tigers (often described as “development miracle” countries)—Singapore, Hong Kong, South Korea, and Taiwan, China—which have all grown rapidly since the 1960s; and Chile and Mauritius, which have grown rapidly during the past 30 years. In the case of Singapore and Hong Kong, growth rates were such that by 2012 per capita incomes exceeded that of the United States. In the early 1960s South Korea's per capita income was less than \$200, among the poorest the world—comparable to the poorer sub-Saharan countries. By 2012, their per capita income had increased to more than \$32,000. Taiwan's real per capita income increased almost nine times in the past 30 years to almost \$39,000. In 2012, Chile's per capita income of \$18,400 was 6 times higher than its level of three decades earlier. Over the same 30 year time period (1982-2012), the per capita income of Mauritius grew more than seven-fold to \$15,600. Despite considerable diversity in policies and institutions among these countries, there are some important common features that spurred their development.

### ***1. Policy for Export Led Growth: Avoiding the Anti-Export Bias of High Tariffs***

All six rapid growth countries pursued a global trade strategy where their growth was fueled by exports. That is, they are examples of what is called “export led” growth. They achieved the large expansion of exports through both policies and institutions. Regarding policies, all these countries had

trade and regulatory regimes that provided exporters with incentives that were no worse than for sales on the domestic market. Tariff protection introduces an anti-export bias. The now rich countries of Singapore and Hong Kong, used free trade, i.e., zero tariffs, to avoid the anti-export bias. Chile used low uniform tariffs that declined over time combined with a large network of free trade agreements. Mauritius successfully used export processing zones. South Korea and Taiwan had declining tariffs over time and had efficient bureaucracies that allowed them to use complicated regulatory regimes (including assuring tariff free access to intermediate inputs for exporters through effective duty drawback mechanisms) that provided exporters with incentives that were no worse than for sales on the domestic market. Most developing countries have been unsuccessful implementing the regulatory measures employed by South Korea and Taiwan. Consequently, we believe the low uniform-tariff, open economy model of Chile is the best policy to avoid penalizing exports and encourage growth and poverty reduction through export led growth.

Upon accession to the WTO, Ukraine committed to maximum average tariffs on industrial goods of 4.95 percent and 10.66 percent for agricultural products, or an overall average of about 6 percent.<sup>4</sup> Ukraine's average tariff is comparable to other Transition economies that have acceded to the WTO, and lower than the average developing country. This indicates that the present tariff policy of Ukraine does not present substantial anti-export bias and, except for a few sectors with tariff peaks, the tariff regime is not an impediment to Ukrainian development. The main concern regarding tariff policy is to guard against internal pressures and regional alignments that would increase the anti-export bias and distortions of the tariff regime.

## **2. A Supportive Climate for Trade and Business**

In annex tables 2 and 3 we present data on institutions related to international trade and to the business climate. It is not coincidental that Singapore and Hong Kong, the two formerly developing countries that are now richer than the United States, are ranked numbers one and two in the world in the Doing Business rankings for 2012, while South Korea is eighth, Taiwan is 16<sup>th</sup>, Mauritius is 19<sup>th</sup> and Chile is 37<sup>th</sup>. On the component of the Doing Business survey for "Trading Across Borders," Singapore, Hong Kong and South Korea are ranked in the top three places in the world.

Ukraine ranks 137<sup>th</sup> out of 185 countries in the Doing Business rankings, and is 145<sup>th</sup> on the Trading Across Borders component, a measure of trade facilitation performance. In the global competitiveness indicators of the World Economic Forum, Ukraine ranks considerably below the high growth countries. Improving institutions and regulations that facilitate investment and trade is very challenging and takes considerable political will. But the example of Georgia during the past ten years demonstrates that very substantial improvement in the business climate is possible within a decade. Georgia moved up from 100 in the world in the 2006 Doing Business rankings to 9<sup>th</sup> in the world in the 2013.

UNCTAD's World Investment Report 2013 measures Ukraine's participation rate in the global value chain at 63%, above Russia but below many of the most successful exporting economies. The participation rate indicates the share of Ukraine's exports that is part of a global value chain.<sup>5</sup> The report also highlights that growth in a country's GDP per capita is correlated with growth in its participation in the global value chain. Although the reasons for growth in the participation in the global value chain differ widely across countries, many countries have seen increased participation in the global value chain follow initial increases in foreign (imported) value-added, e.g., via additional foreign investment.

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<sup>4</sup> See the website of the WTO at: [http://www.wto.org/english/news\\_e/pres08\\_e/pr511\\_e.htm](http://www.wto.org/english/news_e/pres08_e/pr511_e.htm).

<sup>5</sup> It adds the foreign value added used in Ukraine's exports and the value added supplied by Ukraine to other countries' exports, divided by total exports of Ukraine.

Ukraine is abundantly endowed with fertile land and natural resources and has a relatively low-cost skilled labor force. Educational attainment is high. It is specialized (has a comparative advantage) in ferrous metals and cereals, which generate more than 22% and some 10% of total export earnings, respectively. Mineral fuels, nuclear reactors and boilers, electrical machinery and rail locomotives, each account for another 5% or so of merchandise exports. In the last 15 years it has demonstrated the ability to diversify: new products and new markets accounted for over 60% of Ukraine's trade growth between 1994 and 2007 (Cheptea, Fontagné and Zignago, 2010).

There is great potential to exploit its endowments better, however, not just in food and natural resource-based products – where international demand will continue to expand rapidly as the global middle class continues to grow – but also in skill-intensive sectors, including services – e.g., information technology-related activities. Sectors where Ukraine has particularly strong competitive opportunities include grains, dairy, civil aircraft and related engineering and green energy (OECD, 2011). Our recommends below will help put in place policies and processes, including a trade policy, that create a business environment that attracts investment into these and other activities that build on Ukraine's endowments and location.

### **III. Expanding Participation in International Production Networks**

While comparative advantage in the past was based on vertically integrated industries, recent managerial and technological changes (including the decline in worldwide transport costs) have made it much easier for firms in countries to specialize in specific production activities that are part of an international production process. These changes have made it possible for firms to sell to the world market without having to have access to a variety of efficient domestic input suppliers or needing to rely on domestic demand. Competitiveness in today's global economy requires participation in supply chains.

The ability of firms in a country to participate in – and contribute to – supply chains depends on the level of prevailing trade and operating costs. These are determined by many factors including trade policies, such as import tariffs, export restrictions and local content requirements, as well as the efficiency of border management; the quality of transport and logistics services; product regulation, licensing requirements, certification and conformity assessment procedures for standards, and the degree of competition that prevails on services markets. Uncertainty regarding the treatment of products at borders and along transport routes can have major impacts on supply chain efficiency and investment. These regulations are often applied in an inefficient manner that raises costs; but since they also have a legitimate regulatory function, they cannot be simply eliminated as a policy decision. An effort to consider the impacts of regulation on trade costs more broadly can help Ukraine attain the nation's trade vision while at the same time improving trade outcomes for partner countries, deepening integration of neighboring markets and improving competitiveness more generally.

Although regulatory policies typically raise costs more for foreign firms (due to duplication), they raise costs for domestic firms as well – and thus the price of goods and services for buyers, whether firms or households. New estimates reveal that a concerted effort to improve trade facilitation performance and related transport and communications services to halfway global best practice in Ukraine could increase real incomes by 25% or more and increase exports by more than 50% (Ferrantino and Tsigas, 2013).

The challenge is to identify actions that are needed to achieve such gains and to build momentum and support for their implementation. In our view this requires cooperation between the public and private sectors. One mechanism that has been suggested by Hoekman (2013) to achieve this are supply chain councils. These comprise public-private partnerships that involve the business community and economic policy officials and regulators, that focus on the supply chain as a whole in a sector or area of trade. Reducing supply chain barriers is not straightforward as there may be several or even many

policies that impede the efficient operation of supply chains. If one policy problem is addressed, another may take its place by becoming more binding. To be effective in lowering supply chain barriers a comprehensive and integrated approach is needed that spans all of the key sectors that impact on international supply chains, including product standards and services such as transport, communication, banking and distribution that serve as the backbone of a modern economy. Policies to ensure that services are more widely available at reasonable cost are important if Ukraine is to better utilize the opportunities offered by participation in international supply chains. Close involvement of business is needed to ensure that priorities for concerted action to reduce supply chain barriers are identified and to generate information to allow monitoring of progress over time. A key feature of all the development miracle countries is effective communications with businesses and other stakeholders. Creating bodies that include representatives of the public sector (regulatory agencies) and industry could help generate information and on-going assessments of regulatory trade barriers and costs, and provide concrete proposals for reforms.<sup>6</sup>

Such supply chain councils should be action oriented and designed so that information on performance (outcomes) is compiled and discussed regularly. The key objective of the councils should be to make a tangible positive difference on the ground for business and thereby show that governments are serious in facilitating trade and enhancing incentives for supply chain participation and investment. Identifying how various policy areas jointly affect supply chains would complement the sector and policy instrument-specific disciplines of trade agreements by encouraging a focus on *all* policies that together impact on all the links in supply chains.

A key rationale for the proposed approach is to cut across prevailing regulatory “silos.” Each council would establish performance baselines, identify and agree on actions to improve on these and put in place effective quantitative monitoring mechanisms to track progress so as to be able to identify problems and hold governments accountable for making progress. Monitoring should be based in part on operating data that is supplied by business to an independent body that ensures data quality. Supply chain councils can be global or regional in their focus, and, if effective, will help improve Ukraine’s institutional basis for trade. The choice of specific supply chains councils to be selected is best determined in consultation with the business community, but given supply chain barriers prevalent in trade with Russia in August 2013, we suggest priority application to trade relations with Russia and the ECU.

#### **IV. Regional Trade Agreements and Ukraine’s Economic Growth**

In 2012, the EU and ECU trading blocs accounted for more than 57% of the value of Ukraine’s merchandise exports and 71% of merchandise imports (according to the State Statistics Service of Ukraine). The ECU countries account for 32.5% of exports and 40% of imports, while the EU27 accounts for 25% of exports and 31% of imports. Turkey, China, India, Egypt and United States combined account for another 17% of both export and imports.

The Eurasian Customs Union is an important export market for machinery and transport equipment, while the EU is a major market for metals. Fuels, including natural gas, dominate imports from ECU members. Trade with the EU is more diverse, including machinery, transport equipment and other manufactured products. Ukraine also exports pipeline transit services to Russia, whereas the EU is a major supplier of financial, technical and other business services.

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<sup>6</sup> Organizations such as the World Economic Forum, the World Bank and the International Trade Centre have endorsed similar approaches. See World Economic Forum et al (2013), Hoekman and Mattoo (2013), Inklaar (2009) and Cadot et al. (2012).

## **1. The Eurasian Customs Union and Ukraine**

Russia is keen to see Ukraine join the Eurasian Customs Union of Belarus, Kazakhstan, and Russia. Ukraine currently has a free trade status with the members of the ECU, which are very important markets that Ukraine must endeavor to preserve and expand.<sup>7</sup> The Institute of Economic Research and Policy Consulting (2011) has documented, however, that despite the existence of a free trade agreement between Ukraine and Russia, there are significant non-tariff barriers between the two countries. The border clearance problems in August 2013 dramatically highlight longstanding trade facilitation problems and suggest priority be given to using the Observer status in the ECU to find ways to resolve existing problems and to more closely cooperate with the ECU in areas where that cooperation supports its development goals, while avoiding the potentially negative aspects of the ECU. Such cooperation should entail not just expansion of the “deeper” aspects of trade agreements, but a change in the way deeper integration is approached, by building greater political support from the business community on both sides of the border through a supply chain centered approach to lower trade costs with Russia and the ECU.

**Develop “Deeper” aspects of trade agreements with Russia and the ECU.** Research has shown that the greatest benefits from preferential trade agreements comes from the deep aspects of the agreements, not from the preferential tariff commitments (Schiff and Winters, 2003). Analysis of the potential gains for Ukraine from trade reforms suggest that lowering trade costs created by regulatory policies will generate much larger gains than changes in import tariffs (Ferrantino and Tsigas, 2013).<sup>8</sup> There are many potential areas for closer relations with Russia and the ECU based on intergovernmental trade agreements, of which the following are possibilities: better border control procedures to facilitate trade; provision of rights for foreign investors in services; a government procurement agreement; mutual recognition of standards and technical regulations; agreement to accept the certification of conformity assessment authorities in the partner country; mutual recognition agreements of the qualifications of professionals such as lawyers, accountants and engineers; agreement to avoid antidumping actions against partner country firms, using domestic competition policy instead; and bilateral labor agreements. Negotiation of agreements in all of these areas and others will mutually benefit Russia, Ukraine, Belarus and Kazakhstan. In some areas this would bring trade relations with the ECU closer than with the EU even after ratification of the new DCFTA with the EU. The specific choice of what areas should be pursued as a priority in deeper trade cooperation is best left for supply chain councils established for trade between Ukraine and Russia and the ECU to determine.

**Develop supply chain councils for trade with the ECU and Russia.** The traditional approach to negotiating trade agreements and dealing with nontariff barriers ignores the new reality of how

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<sup>7</sup> The trade agreements between Ukraine and ECU member countries stipulate duty-free trade in all goods while allowing for unspecified potential exemptions. The core exemptions, frequently introduced in bilateral protocols, include sugar, tobacco and cigarettes, alcohol and sometimes non-alcoholic beverages. In addition, there is a practice of reciprocal responses to export duties set by a trading partner. An important source of tension is Russian bans on Ukrainian exports for SPS reasons, notably exports of livestock and dairy products; which are perceived as non-tariff barriers by Ukraine – see Institute for Economic Research (2011, pp. 16-17).

<sup>8</sup> Mkrtchyan (2013) undertakes an empirical analysis of the impacts on trade costs within the ECU and concludes that implementation of the customs union had a statistically significant impact on lowering intra-ECU trade costs. At the same time there is evidence that ECU rules have led to an increase in trade costs with the rest of the world for both Kazakhstan and Belarus. The global ranking of Kazakhstan on the World Bank’s Logistics Performance Index (LPI) declined from 62 in 2010 to 82 in 2012. There are no LPI data for Belarus in 2010, but the ranking of Belarus on the Trading Across Borders index (part of the World Bank’s Doing Business indicators) deteriorated from 129 in 2010 to 150 in 2013. (Russia’s global ranking on the LPI has remained about the same). A World Bank trade study for Kazakhstan, Vashakmadze (2012), indicates that trade costs for Kazakhstan have increased for trade with third countries. Russia is concerned about transshipment through Kazakhstan and Belarus. Consequently, ECU rules of origin for Kazakhstan’s trade with Central Asian CIS countries are being enforced more strictly. Trade costs for Belarus with the European Union have also increased.

international production is organized. Trade agreements are not designed with a supply chain perspective, and thus may not do enough to address the policies that have the biggest negative effects for business. A supply chain council approach is flexible in the sense of not pre-defining what will be the focus of cooperation. It instead allows the main constraints at a given point in time to be identified. Establishment of a number of supply chain councils organized around the major export sectors for both Ukraine and ECU countries with a mandate to identify the most important sources of supply chain inefficiencies as well as actions to resolve them is an alternative to seeking to address trade problems through traditional trade agreements, whether free trade agreement or customs unions. They are likely to be more effective than purely inter-governmental mechanisms by mobilizing the engagement and support of business on both sides. Business representatives and industry organizations have hands-on knowledge of the impacts of regulatory policies and enforcement and of how costly they are. And businessmen on both sides of the negotiations are likely to have many common interests in lowering trade costs. Recommendations for regulatory reform of these councils can be implemented by governments with the knowledge that they have support from business on all sides.

***Implementation of the Common External Tariff.*** As is common in customs unions worldwide, a fundamental feature of the ECU is that all the members implement the common external tariff of the customs union. This extends to exceptions from the most favored nation tariff, such as for free trade agreements. These are agreed at the level of the customs union with all members offering the same concessions to partner countries. This has both legal and economic implications.

***Incompatibility of the Eurasian Customs Union and the DCFTA with the EU.*** Since the ECU does not offer tariff free access to imports from the EU, this means that if Ukraine were to join the ECU, it would not be able to offer tariff free access to imports from the EU. That is, since the Eurasian Customs Union does not have a free trade agreement with the European Union, this means that Ukrainian participation in the ECU is incompatible with the DCFTA with the EU.

***Violation of WTO Commitments.*** In its accession to the WTO, Ukraine committed to an average maximum tariff of about six percent. In 2013, the average unweighted applied tariff of the ECU is 10 percent (Shepotylo and Tarr, 2012). This means that if Ukraine joins the ECU it would have to increase its tariffs to implement the ECU common external tariff, and in so doing, violate its WTO tariff commitments. WTO members would have the right to impose compensatory tariff increases specifically against Ukrainian exports, such as steel and agricultural exports. For Ukraine to avoid these tariff increases, the ECU would have to lower its bound tariffs at the WTO to “pay compensation.” It is not clear ECU members would be willing to do so; if they do not it would put Ukrainian exports at risk.

***Economic Losses to Ukraine from Applying the Common External Tariff.*** Movchan and Giucci (2011) have estimated economic losses to Ukraine from joining the ECU due to the fact that Ukraine would have to increase its tariffs outside of the CIS, so the costs of imports and the anti-export bias would increase from the tariff increase. These estimates of losses are consistent with research that finds a similar result for Kazakhstan as a result of its increase in tariffs when it joined the ECU in 2010 (World Bank, 2012).

## ***2. The Deep and Comprehensive Free Trade Agreement (DCFTA) with the EU***

Since the DCFTA is a free trade agreement and not a customs union, Ukraine would retain its full independence or sovereignty regarding its external tariffs with third countries, while both parties would provide tariff free access to imports originating in the partner region, with some exceptions. The DCFTA, as a “deep” agreement, covers many areas where Ukraine will be expected to approximate its legislation with that prevailing in the European Union. A very brief summary of the 15 chapters of the DCFTA is provided in Annex 2.

Movchan and Giucci (2011) estimate substantial welfare gains from a DCFTA, due mainly to better market access on EU markets for exports, and productivity gains from the deep aspects of the agreement. Shepotylo (2013) estimates a very substantial increase in exports to all countries following the DCFTA, due significantly to the elimination of uncertainty facing investors once a decision to proceed with the DCFTA is taken.

**Adoption of the EU Acquis.** The DCFTA requires substantial changes in Ukrainian regulation to be in line with current EU regulation. It may thus be seen as a large step along the path to eventual membership in the EU. Implementation of the DCFTA would likely lead to economic gains from improved Ukrainian institutions in several areas. For example, it is likely that the EU would assist with trade facilitation and the DCFTA would likely speed the progress regarding adoption of international standards.

The EU-Russia “Partnership for Modernization” has listed harmonization of Russia’s technical regulations and standards with the EU as a priority for cooperation<sup>9</sup> and the associated program of assistance is aimed at aligning Russian standards with EU norms and regulations.<sup>10</sup> As a result, the ECU (which has responsibility for technical regulations on industrial goods and sanitary and phytosanitary (SPS) measures throughout the Customs Union) may harmonize technical product regulations with those applied by the EU. Although this process will take considerable time (reportedly SPS approximation is not going well—see European Commission (2013b)),<sup>11</sup> an implication is that as Ukraine moves toward alignment of standards with the EU, it will also be converging toward a common target with the members of the ECU.

In some cases, however, approximation to the EU *acquis* may impose more costs than benefits and indeed might cause very substantial costs. A specific example concerns sanitary and phytosanitary measures. A necessary element in converging towards international standards and thus facilitating exports is to move away from production and import controls based on GOST standards inherited from the former Soviet Union. SPS norms based on GOST standards are non-tariff barriers since they regulate aspects of products unrelated to safety, are outdated and often are not science based (Asian Development Bank, 2013). As part of their WTO accession agreements, both Ukraine and Russia have agreed to move toward international SPS standards.

Nonetheless, experience has shown the full and *immediate* application of EU SPS requirements for sales on the Ukrainian market (as opposed to exports) is likely to force large parts of the Ukrainian food sector out of business and would raise food costs in Ukraine. Messerlin *et al.* (2011) estimate that similar SPS harmonization with the EU for Georgia could increase food costs in Georgia by 90 percent. Reporting on the experience of the Eastern European countries that acceded to the EU, the World Bank (2007, p.65) notes that despite very significant support from the EU, large parts of the food industry was forced out of business because of the costs of the upgrades needed to meet EU requirements. The report concludes that harmonization with EU food safety and agricultural health legislation is neither necessary nor realistic for CIS countries and that they are best served by carefully prioritizing actions in this area based on assessments of costs, benefits, and trade opportunities. This recommendation is bolstered given that the scale of financial and technical support provided to accession countries is not available for CIS countries.

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<sup>9</sup> See [http://www.consilium.europa.eu/uedocs/cms\\_data/docs/pressdata/en/er/114747.pdf](http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/er/114747.pdf).

<sup>10</sup> The European Commission (2013b) notes that under the Partnership for Modernization program there are projects to align 19 technical product and horizontal standards by the end of 2013. A draft agreement between Rosstandart and European standards bodies CEN and CENELEC was to be signed in 2013 and an EU-Russian industry task force was formed to pursue approximation of technical regulations and use of international standards.

<sup>11</sup> At the WTO SPS Committee in October 2012, Russia disputed EU allegations that Russia’s restrictions on imports of live animals were not supported by evidence or risk analysis. See [http://www.wto.org/english/news\\_e/news12\\_e/sps\\_18oct12\\_e.htm](http://www.wto.org/english/news_e/news12_e/sps_18oct12_e.htm).



This suggests a case by case approach to adoption of SPS norms. A differentiated approach is needed based on assessments of health risks, costs, benefits and trade opportunities. Presumably recognizing the high costs of adjustment, the SPS chapter in the DCFTA refers to adoption of SPS conditions as *a process*. Adopting some EU standards and regulations immediately may be important from a market access (export) perspective; for others, it may be better to defer until Ukrainian incomes are higher, thereby providing a domestic market for more expensive products. A “differentiated approach” has been adopted by some Latin American countries in free trade agreements with the U.S. These involve a dual production structure for some products where companies that export to the U.S. must meet the higher U.S. standards and products that meet these standards are admitted; but, crucially, for products where adaptation to U.S. standards would be excessively costly, companies that produce according to less costly standards are permitted to sell domestically.

The general point that is illustrated by the example of SPS standards is the importance of adopting a case-by-case approach to issues that involve regulatory reform and convergence. An area of particular importance from a growth perspective that is covered by the DCFTA is trade and investment in services. For Ukraine to be competitive on global markets and to be able to participate effectively in international supply chains and attract investment that relies on international production networks, Ukraine must offer efficient transport, financial, logistics and communications services.<sup>12</sup> A benefit of the DCFTA is that it will require concerted attention on services policies. However, a focus on the EU *acquis* in services will by itself not be sufficient to ensure Ukraine will have policies that are most conducive to substantial improvements in the productivity of services firms. Much will continue to depend on the national policy choices on a sector-by-sector basis. This also is true for Ukraine’s external trade and investment policies for services as it will retain substantial discretion in how to treat foreign (non-EU) investors.

### ***3. EU Membership or a Customs Union with the EU: the Cases of Poland and Turkey***

Membership in the EU would be a positive step for Ukraine. Outside of agriculture, the EU trade regime is generally rather open, and preferential market access to agricultural markets in the EU would benefit Ukraine; aid would likely be available for regulatory reforms; and membership would imply full participation in EU decision making. However, aligning external tariffs with those of the EU (that is, effectively creating a customs union with the EU) would be a mistake. The contrasting cases of Poland and Turkey, also large agricultural producers, are instructive.

Poland acceded to the EU as a member on May 1, 2004. As an EU member, Poland enjoys full market access to the EU markets, including in agriculture, coal and steel; its farmers receive subsidies under the Common Agricultural Policy and Poland received substantial support for harmonization of SPS measures and technical regulations. Regarding all countries with which the EU negotiates free trade agreements, Polish exporters receive preferential market access to the markets of those countries. These are major benefits to Poland of EU membership in addition to full participation in EU decision making.

Turkey is not an EU member, but signed a customs union agreement with the EU in 1995. Agriculture, coal and steel were predominantly excluded from its customs union agreement, it receives no support from the Common Agricultural Policy and it has received much more limited support for harmonization of standards (Ozturk, 2013). Regarding all countries with which the EU negotiates free trade agreements, Turkey is obligated to provide preferential tariff access to imports, but these free trade agreements do not provide for preferential market access for Turkish exports to those markets. The requirement to provide unilateral preferential market access to all these countries has led to considerable Turkish dissatisfaction with its Customs Union with the EU. In particular, Turkish

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<sup>12</sup> Using a large firm level dataset over the period 2001 to 2007, Shepotylo and Vakhitov (2012) show the strong impact on the productivity of Ukrainian firms from better access to services and from services liberalization.

Economy Minister Zafer Çağlayan said on March 2013 that Turkey should review the membership now that it “creates unfair treatment in trade with the union.”<sup>13</sup>

## V. Conclusions: Possible Elements of a Trade Strategy Looking Forward

The foregoing considerations and international experience more generally suggest a number of principles and approaches that can inform Ukraine’s trade strategy:

1. **Use supply chain councils as a focal point for international cooperation to integrate markets and lower trade costs.** Pursuit of specific public-private partnerships involving cooperation between business and regulatory authorities from both sides to reduce trade costs can do much to improve economic growth prospects and realize the objective of integrating markets with *both* the EU and the ECU. Given border control issues with the ECU, this is a priority in the near term. The proposal by the Government of Ukraine to establish a joint commission to promote trade ties between Ukraine, Russia and the EU is a positive step that could evolve into the supply chain councils we recommend.
2. **Safeguard current trade privileges, encourage foreign direct investment and think globally, including expanding the number of free trade agreements.** Ukraine enjoys tariff-free access to CIS countries and preferential tariffs for exports to the EU. Active pursuit of additional free trade agreements and encouragement on foreign direct investment will generate new job opportunities for Ukrainian workers. Ukraine has already started down this path, launching talks with Canada and Singapore, and having already concluded a free trade agreement with the EFTA countries.
3. **A strong national focus on reducing trade costs.** Import tariffs and other policies that increase the costs of products reduce the ability of Ukrainian firms to participate in international production networks. Holding tariffs low, pursuing trade facilitation initiatives and improving the quality of backbone services such as telecommunications and logistics are critical for Ukrainian competitiveness by ensuring firms benefit from low trade costs.

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<sup>13</sup> Quoted in *Today’s Zaman*. Available at: <http://www.todayszaman.com/news-310708-minister-says-turkey-to-reconsider-eu-customs-union.html>

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## **Annex 1: Statistical Tables**

**Table 1: Gross domestic product per capita based on purchasing-power-parity (PPP) (Current US dollars)**

<b>Country</b>	<b>Year</b>				<b>Ratios</b>	
	1982	1992	2002	2012*	2012/1982	2012/1992
<b>Chile</b>	3,012	6,185	10,440	18,419	6.1	3.0
<b>Hong Kong</b>	8,540	20,093	28,342	51,494	6.0	2.6
<b>Korea</b>	3,012	9,436	18,859	32,272	10.7	3.4
<b>Mauritius</b>	2,107	5,116	8,858	15,592	7.4	3.0
<b>Singapore</b>	8,792	19,882	34,726	60,410	6.9	3.0
<b>Taiwan</b>	4,425	11,892	21,591	38,749	8.8	3.3
<b>Ukraine</b>	n/a	5,164	4,007	7,374	n/a	1.4
<b>United States</b>	14,015	24,700	36,950	49,922	3.6	2.0

Notes: (\*) IMF estimate.

Source: International Monetary Fund, World Economic Outlook Database, April 2013  
<http://www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx>

**Table 2: Ranking on the Global Competitiveness Index and Several of its Components, rank out of 144 Countries in 2012-2013**

Overall		Detailed components				
Global Competitiveness Index		Institutions	Infrastructure	Goods market efficiency	Labor market efficiency	Financial market development
Chile	<b>33</b>	28	45	30	34	28
Hong Kong	<b>9</b>	10	1	2	3	1
Korea	<b>19</b>	62	9	29	73	71
Mauritius	<b>54</b>	39	54	27	70	35
Singapore	<b>2</b>	1	2	1	2	2
Taiwan	<b>13</b>	26	17	8	22	19
Ukraine	<b>73</b>	132	65	117	62	114
United States	<b>7</b>	41	14	23	6	16

Source: World Economic Forum, The Global Competitiveness Report 2012–2013

<http://www.weforum.org/issues/competitiveness-0/gci2012-data-platform/>

**Table 3: Rankings of Selected Countries from the Doing Business Database for 2013: Overall Ease of Doing Business, Trading Across Borders and its Components**

<b>Ease of Doing Business</b>		<b>Trading Across Borders</b>						
<b>Rank</b>	<b>Overall Rank on Trading Across Borders</b>	<b>Documents to export (number)</b>	<b>Time to export (days)</b>	<b>Cost to export per container (US\$)</b>	<b>Documents to import (number)</b>	<b>Time to import (days)</b>	<b>Cost to import per container (US\$)</b>	
<b>Chile</b>	<b>37</b>	48	6	15	980	6	12	965
<b>Hong Kong</b>	<b>2</b>	2	4	5	575	4	5	565
<b>Korea</b>	<b>8</b>	3	3	7	665	3	7	695
<b>Mauritius</b>	<b>19</b>	15	5	10	660	6	10	695
<b>Singapore</b>	<b>1</b>	1	4	5	456	4	4	439
<b>Taiwan</b>	<b>16</b>	23	6	10	655	6	10	720
<b>Ukraine</b>	<b>137</b>	145	6	30	1,865	8	33	2,155
<b>United States</b>	<b>4</b>	22	4	6	1,090	5	5	1,315

Source: World Bank Doing Business 2013 database.

<http://www.doingbusiness.org/>

## **Annex 2: Main Elements of the DCFTA**

1. Market Access for Goods: Removal of most import and export duties (more than 98 percent in value), with exceptions (claimed to be temporary) for some products, mainly in the agricultural, chemical, clothing, metals and automobile sectors.
2. Trade Remedies: Anti-dumping, anti-subsidy and global safeguard instruments will be WTO consistent. Ukraine may apply a specific safeguard measure for car imports from the EU for a period of 15 years.
3. Technical barriers to trade: The parties reiterate their commitment to the WTO TBT agreement. The parties will harmonize or mutually recognize technical standards. Ukraine will progressively adapt its technical regulations and standards to those of the EU. Trade in industrial products will eventually be conducted as between Member States of the EU.
4. Sanitary and phytosanitary (SPS) measures: Ukraine commits to a process in which it will align its SPS legislation to the EU's. The chapter addresses verification procedures and settlement of trade problems.
5. Customs and trade facilitation: Simplify customs requirements and formalities.
6. Establishment, trade in services and electronic commerce: The agreement provides for the right of establishment in services and non-services subject to a limited set of excluded sectors identified in a negative list, and the expansion and integration of Ukraine into the internal market of the EU in telecommunications, financial services, maritime services and postal and courier services once Ukraine effectively implements the EU *acquis* in these sectors.
7. Capital Movements: Provisions for the free movement of capital with safeguards.
8. Public procurement: With the exception of defense procurement, EU and Ukrainian suppliers will have integrated access to public procurement once Ukraine adopts EU legislation on public procurement.
9. Intellectual property: Enforcement based on the EU's internal rules.
10. Competition: Ukraine commits to state aids control, competition law and enforcement along the lines of the EU *acquis*.
11. Trade-related energy: Prohibition of dual pricing and commitment to ensure competition and market prices for gas and electricity. Interrupting transit of energy goods destined for another party is prohibited, e.g., blocking shipments of Russian gas to the EU is prohibited.
12. Transparency: Process for comments, review and appeal of proposed regulation by interested parties.
13. Trade and sustainable development: Commitment to environmental protection and to the core labor standards of the International Labor Organization.
14. Dispute Settlement: The WTO Dispute Settlement procedures will be followed with faster procedures.
15. Mediation mechanism: A mutually appointed mediator will mediate trade disputes and recommend solutions within 60 days. The parties can still access dispute settlement if they choose.

*Source:* European Commission (2013a).