

Political Economy aspects of Deep and Comprehensive Free Trade Agreements

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Abstract

Trade agreements are usually shaped by political considerations rather than pure welfare estimations. This article aims at discussing the political economy aspects of Deep and Comprehensive Free Trade Agreements offered by the European Union to its Eastern partners. It is argued that although the DCFTAs concern trade liberalization and remain a technically complicated elite-driven process, they are widely perceived by engaged partners and beyond as primary evidence of joining the European economic integration project which will fundamentally affect the distribution of wealth and power in Eastern neighbourhood redesigning its political economy map. Using trade jargon, these agreements have served geopolitical goals rather than economic interests.

Keywords: trade, Eastern Partnership, Russia, European neighbourhood, DCFTA

1. Introduction

The European Union (EU) has often opted for economic policy instruments – developmental aid, regional cooperation, trade agreements – to pursue foreign policy goals in its close vicinity and globally. It may even be argued that, above all, it is its Common Commercial Policy (CCP) that constitutes its most powerful ‘soft power’ tool, which is a commonly applied foreign policy tool, and what makes the EU a ‘civilian power’. As a world leader in preferential trade agreements (PTAs) – it has notified to the World Trade Organisation (WTO) more PTAs than any other member – the EU has used this tool especially with regard to its neighbours. It has further developed free trade agreements (FTA) talks with several countries worldwide including the USA, Canada, the ASEAN countries, Japan, India and the MERCOSUR countries. Comprehensive FTAs in force with countries such as Chile and South Korea envision a - selective - approximation of standards and norms and constitute

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attempts to influence global economic governance while extending EU standards and rules. With regard to its neighbours, who may have membership aspirations, the compliance with EU trade *acquis* is more comprehensive and rigid.

The case of Deep and Comprehensive Free Trade Agreements, (DCFTAs) developed along with the European Neighbourhood Policy (ENP) and enhanced following the Eastern Partnership (launched in 2009), is indicative of the political considerations underlying the EU's trade policy in its neighbourhood. Deployed in the pursuit of EaP's strategic objective to accelerate political association and further economic integration between the European Union and interested partner countries (Council of the European Union, 2009), the DCFTAs constitute part of the enhanced, second generation of Association Agreements (AA) between the EU and its six eastern partners (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine). The EU's overall goal in the region can be summarized as follows: "The European Union has a vital interest in seeing stability, better governance and economic development at its (...) borders" (European Commission, 2008) and "to build and consolidate healthy democracies, pursue sustainable economic growth and manage cross-border links" (European External Action Service and European Commission, 2011). The EU has also pledged to offer DCFTAs to four Mediterranean states in the aftermath of the 2011 "Arab Spring": Egypt, Jordan, Morocco and Tunisia. Though free trade agreements have been used extensively by the EU in its relations with other European countries, especially in the enlargement process, this time, the proposed DCFTAs differ significantly. The countries under the Eastern Partnership (EaP) scope are not expected to join the EU or the Single Market with its four freedoms – free movement of goods, services, capital and people – anytime soon. Despite this, the EU aims to push its neighbours for regulatory alignment.

As of now, bilateral relations between the EU and its Eastern partners are still being governed by almost identical, but outdated Partnership and Cooperation Agreements (PCA) which were concluded in the period between 1994 and 1998. The development of the DCFTAs constituted a European response to regime changes in Eastern partners in 2003-4, marked by the Coloured Revolutions, and to the Arab awakening in 2011. DCFTAs constitute part of a comprehensive toolbox offered to EU's neighbours that includes technical assistance, border management, mobility partnerships and democracy building instruments. Bilateral relations are upgraded through Association Agreements, Agreements on a Deep and Comprehensive Free Trade Area, and Visa Facilitation and Readmission Agreements. The DCFTAs consist of two parts: tariff reduction (built on WTO commitments) and adoption of EU trade *acquis*, going beyond tariff reductions to cover more extensively the dimensions of investment protection, public procurement, and competition policy. They cover all trade-related areas (including services, intellectual property rights,

customs, public procurement, energy-related issues, competition, etc.), also tackling *beyond the border* obstacles through regulatory approximation with the trade-related EU *acquis*. They are designed to deepen the EaP countries' access to the European market and to encourage further European investment in the eastern neighbourhood.

This article aims at discussing the political economy aspects of DCFTAs. It argues that DCFTAs remain primarily a vehicle of the EU's collective power on the one hand, while they constitute a tool deployed in Eastern neighbours' foreign policy. As it is discussed, despite the technical nature of the agreements, it is the (geo)political considerations of all interested parties that have heavily weighed in the negotiations and pace of development of DCFTAs rather than pure trade interests. That there are national security issues at the forefront of trade and economic agreements has been recognized first of all by mercantilists (economic nationalism). Liberals, on the other hand, view economy and politics as two separate domains, claiming that politics does not affect the decision to engage in trade agreements. Even when governments are under political pressure, they engage in trade agreements only to correct in terms of trade externalities (Grossman and Helpman, 1995). Still, liberal variations recognize the spill-over effects of trade and economic discourse in building cooperative and peaceful interstate relations. Others point to the role of domestic industrial interests and their interplay with the government (Moravcsik, 1997, p. 514). Scholars of international political economy have indicated a link between the pursuit of political goals, mainly those on security, and search for economic welfare. Keohane (1984, pp. 21-22) has argued that trade and power are complementary to each other in foreign policy making. Likewise, Gilpin (1975, p. 43) has argued that there is a "reciprocal and dynamic interaction in international relations of the pursuit of wealth and the pursuit of power."

2. Variable geometry of DCFTAs

Eastern neighbours have been offered DCFTAs as part of a larger political contract, the Association Agreements (AA)¹. Talks on AA have been launched with all EaP countries – except for Belarus –, and four of them have been involved in DCFTA talks. Though the offer has been extended to all Eastern neighbours, opening up the negotiation talks has taken a differentiated path.

The first AA/DCFTA negotiations started with Ukraine, the largest Eastern economy. Negotiations on the AA were launched in February 2007 with three chapters – on political, judicial and sectorial cooperation – opened

¹ As for now, the five EaP countries – with the exception of Belarus – use privileges provided by the Generalized System of Preferences (GSP) or the GSP+ or autonomous trade preferences.

immediately but the DCFTA negotiations were launched a year later, in February 2008, as soon as Ukraine joined WTO, which is a prerequisite for FTA negotiations to start. The EU-Ukraine AA/DCFTA has served as a blueprint for relations with other EaP countries. The pace of negotiations was however very slow, with negotiations formally concluded on 19 November 2011 (three and a half years since they were launched). The initialing of the EU-Ukraine Association Agreement took place in Brussels in March 2012, except for the DCFTA which was initialed on 19 July 2012, but the agreement has not been signed yet, as the EU has raised concerns on violations of human rights and the rule of law.² On 15 May 2013, the Commission adopted and transmitted to the Council the proposal for a Council decision on the signing and provisional application and a Council Decision on the conclusion of the Agreement. Ukraine was requested to free jailed former Prime Minister Yulia Tymoshenko by 18 November, i.e. before the last Foreign Affairs Council meeting ahead of the Vilnius Summit. Cumbersome negotiations with Ukraine prompted the EU to apply ‘ex ante conditionality’ with the other EaP countries requiring them to adopt ‘key recommendations’ prior to launching DCFTA negotiations. Expectations that Kiev would finally sign the Agreement at the Vilnius Summit in November 2013 were not met, thus questioning the future development of the whole EaP policy. EU officials have been cautious on their reaction to Yanukovych’s U-turn and at the follow-up to the Vilnius Summit Council Meeting they “confirmed that the EU is keen to sign the Association Agreement with its Deep and Comprehensive Free Trade Area part as soon as Ukraine is ready and the relevant conditions are met” (Council of the European Union, 2013).

The second country with which the EU started negotiations on a new Association Agreement was Moldova on 12 January 2010. The negotiations on the trade part of this agreement (DCFTA) which started in February 2012 were technically completed on 12 June 2013, in seven rounds in total. Soon after Moldova, the EU started negotiations on an AA with Georgia in July 2010 and on a bilateral comprehensive FTA in February 2012. The Agreement was negotiated in just seventeen months (and seven rounds) and it was concluded on 22 July 2013. Both AAs with Georgia and Moldova were initialed at the Vilnius Summit in November 2013, with Georgian President Giorgi Margvelashvili saying that his country hoped to sign its EU Association Agreement by September 2014. With Armenia, the negotiations on DCFTA were launched later in May 2012. After seven rounds of talks, parties concluded the talks at the technical level on 24 July 2013. However, the path to closer association with the EU was blocked following the announcement by President Serzh Sargsyan on 3

² The signing of a treaty is sometimes preceded by what is called initialing: the plenipotentiaries affix their signature to every page of the treaty to confirm that the present version is the agreed-upon text.

September 2013 that Armenia would join the Russia-led Customs Union. A couple of months later, on 6 November, a Memorandum of Understanding (MoU) was signed with the Eurasian Economic Commission, which oversees the integration of former Soviet republics around the Russia-led Customs Union. As a result, the EU Enlargement Commissioner, Štefan Füle, has said that Yerevan cannot sign a EU Association Agreement as the different regulations and tariffs applied by the EU and the Customs Union make it impossible to conclude agreements with both at the same time. According to reports, an alternative to the AA/DCFTA is being prepared. Arminfo mentions that "...Armenia and the European Union will create a new legal aspect for partnership. The new document will consist of 6 or 7 clauses, with priority to be given to mobility or simplicity of visa regime, education and sector-specific cooperation – that is, the financing will be continued but will be directed to specific sectors. The other points will concern the efforts to fight corruption, to ensure the rule of law and to protect human rights..."³. At this stage, the relations between the EU and Armenia are regulated by the Partnership and Cooperation Agreement (1999). The recently negotiated Visa Facilitation and Readmission Agreements will take effect as soon as all procedures are completed.

Since for the negotiation of a free trade agreement, the WTO membership is a prerequisite, Azerbaijan and Belarus are excluded from DCFTA discussions. However, with a view to supporting Azerbaijan's future WTO membership and a subsequent eventual bilateral FTA, negotiations on upgrading the existing trade related provisions of the Partnership and Cooperation Agreement (non-preferential trade and investment agreement) were launched on 16 July 2010. With regard to Belarus, negotiations on an AA/DCFTA have been impossible for a number of political and legal reasons, including the country's authoritarian regime and its membership of the Customs Union (with Russia and Kazakhstan), but not the WTO. The President of Belarus, Alexander Lukashenka, has expressed discontent that "they do not want to talk with us at all". There is a possibility that Belarus might resume its WTO accession process, as Russia would like the entire Customs Union to become an official WTO party (Vutz, 2013).

The Eastern Partnership Summit in Vilnius on 28-29 November 2013 delineated a two-speed EaP in which only the smaller eastern economies i.e. Moldova and Georgia have advanced on their EU path, while all other partners – Ukraine, Azerbaijan, Belarus, Armenia – have not.

³ Political scientist: A new phase of Armenia-EU cooperation may be announced in Vilnius, *Arminfo*, 10 October 2013, available at: http://www.arminfo.info/index.cfm?objectid=495043A0-31B7-11E3-93E60EB7_C0D21663. See also Richard Giragosian, Armenian-EU integration: Missed opportunities & strategic mistakes, Heinrich Böll Stiftung, November 2013, available at: <http://www.ge.boell.org/web/110-1601.html>.

3. Key features of EU-Ukraine DCFTA⁴

A feasibility study conducted by European and Ukrainian experts in 2004 constituted the basis upon which the DCFTA concept was drafted (CEPS, IFW & ICPS, 2006). According to that study, the Ukrainian economy should become more open, transparent and competitive and its growth model should no longer depend on high demand and high prices for metallurgical products (one of Ukraine's key exports). As a result of Ukraine's WTO accession, several aspects of free trade were to be implemented – import duties for agricultural and industrial products were lowered to 10.66% and 4.95% respectively (WTO, 2008) – but further normative approximation with its key trade partner, namely the EU, and more comprehensive liberalisation (covering trade in goods and services) were needed.

The EU-Ukraine DCFTA consists of 15 Chapters (plus 14 annexes and 3 protocols) offering a framework for the opening of markets via the progressive removal of customs tariffs and quotas, and by an extensive harmonisation of laws, norms and regulations in various trade-related sectors, creating the conditions for aligning key sectors of the Ukrainian economy to EU standards.

With regard to market access to goods, the DCFTA aims to remove *customs duties* on imports and exports (European Commission, 2013a, Chapter 1). The Agreement foresees the removal of the vast majority of customs duties on goods. Overall, Ukraine and the EU will eliminate respectively 99.1% and 98.1% of duties in trade value. For most industrial goods, tariffs will be removed immediately with some exceptions where the transition period is foreseen as in the automotive sector in Ukraine. It is estimated that the Ukrainian reduction on duties on machinery and appliance will be worth €75.2m. There are some exceptions for cars,⁵ but Ukraine will still cut duties on vehicles by €117.3m. The textiles sector will be fully liberalised with Ukraine and the EU cutting duties worth €8.7m and €24.4m respectively. Special conditions will apply for five years to second-hand clothing. Reduced EU tariffs on chemicals will cut duties paid by Ukrainian exporters by €26.8m, while Ukraine will cut duties by €64.3m. For agricultural goods, duty-free tariff rate quotas are granted to Ukraine for cereals, pork, beef, poultry and a handful of additional products, while for other, more sensitive sectors, the progressive elimination by the EU of the custom duties will occur over a longer transition period (generally ten years). During the negotiations process, the business interests of some Ukrainian industries (e.g. automobile) and the agricultural lobby turned the tariff talks into the main battleground between the EU and Ukraine threatening to put

⁴ This section is based on information provided in European Commission (2013a).

⁵ An agreement on cars will allow Ukraine to apply a well-defined safeguard measure for 15 years on cars imported from the EU. In the reference period 2002-2010, Ukraine imported on average 41.000 cars a year from the EU, 12.9% of the Ukrainian market.

negotiations on hold several times (Shumylo-Tapiola, 2012, p. 7). With regard to non-tariff barriers (NTB) on trade in goods, the Agreement incorporates fundamental WTO rules on NTBs, such as national treatment, prohibition of import and export restrictions, disciplines on state trading, etc. Export duties will be prohibited from day one, with some temporary exceptions for Ukraine on a few agricultural and metal products. It is expected that the cuts in duties will benefit particularly Ukrainian agricultural products (at €330m for agricultural products, and €53m for processed agricultural products). Overall, the EC estimates (European Commission, 2013a) that Ukrainian exporters will save €487m annually due to reduced EU import duties. Ukraine will remove around €391m in duties on imports from the EU, with longer transition periods than the EU for certain goods.

Building on current cooperation on customs matters, the DCFTA provides a stronger legal framework for efforts to ensure the correct application of customs legislation and the fight against infringement. Both sides will supply each other with all relevant information needed to conduct investigations, including the possibility for officials of one party to participate in administrative enquiries in the territory of the other party. The DCFTA contains a provision for temporary withdrawal of preferences as a safeguard in the event of insufficient cooperation.

WTO rights and obligations will be applied to traditional *trade defence instruments* (anti-dumping, anti-subsidy and global safeguard) to ensure fair treatment, for example, anti-dumping duties will be capped to the level of dumping or subsidy. The DCFTA will increase the transparency of investigations and Parties will set up a mechanism for cooperating on trade remedies.

The relevant WTO rules will also be applied to *Technical Barriers to Trade* (TBT) such as technical regulations, standards, conformity assessment procedures and similar requirements. Ukraine will progressively adapt its technical regulations and standards to those of the EU so that, following a future Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA), trade in specific sectors between the Parties will take place under the same conditions as between EU Member States. Harmonisation and/or mutual recognition of technical standards should cut existing non-tariff barriers in the agri-food sector by half and 35% in other sectors compared to 2004.

The Agreement will also facilitate trade in *SPS* related goods including animals, animal products, plants and plant products, whilst safeguarding animal welfare standards taking into account developments in the World Organisation for Animal Health.

Unlike classical FTAs, this Agreement provides for both the freedom of establishment in services and non-services sectors, subject to limited reservations, and the expansion of the internal market for a set of key services

sectors once Ukraine effectively implements the EU *acquis*. The agreement provides a right of establishment (as opposed to commercial presence) in services and non-services sectors. This right is subject to a number of reservations identified in a negative list. This approach is unprecedented for the EU and guarantees automatic coverage for new services and further liberalisation not listed as exceptions. Provisions for domestic regulation, postal and courier services, financial services and telecommunication services will improve transparency and legal certainty for EU investments in Ukraine. The focus here is on “behind the border” issues. The DCFTA is complemented by a process of legislative approximation in financial services, telecommunications services, postal and courier services, and international maritime services. Ukraine is committed to take over the existing and future EU *acquis* in those sectors and, when it has done so, Ukrainian firms will be granted access to the EU internal market for the sectors concerned: this is an unprecedented level of integration. The approximation process will also mean that EU investors in those sectors will find the same regulatory environment in Ukraine as in the EU.

This is the first FTA to include specific provisions on *trade related energy issues* (European Commission, 2013a, p. 7). As mentioned in the Agreement, Ukraine’s membership in the Energy Community Treaty (EnCT) imposes an obligation to implement the most relevant EU energy *acquis* on electricity and gas. The four pillars of the trade-related energy provisions are:

- Rules on pricing of energy goods: Commitment to let market prices prevail on the domestic gas and electricity markets and not to regulate prices for industry and prohibition of dual pricing (prices for exporting energy products which are higher than domestic prices).
- Transport and transit of energy goods: Interrupting transit or taking energy goods from transit that are destined for the other party is prohibited. An Expedited (fast track) Dispute Settlement procedure will allow quick intervention if these rules are breached. An Early Warning Mechanism lays down standards for diplomatic consultations in the event of a security of supply problem.
- Parties commit themselves to setting up a legally distinct and functionally independent regulator to ensure competition and an efficient functioning of the gas and electricity markets.
- Rules on non-discriminatory access to the exploration and production of hydrocarbons (gas and oil). Once an area has been made available for exploration and production, nondiscriminatory access and licensing should be provided to entities from both Parties.

Beyond the ordinary provisions on *transparency, dispute settlement and mediation mechanisms*, other key aspects of the DCFTA include:

- Provisions on *free movement of capital* will include standard safeguards with a possibility to apply measures to ensure the stability of the financial system.

- Alignment with EU legislation on *public procurement* over several years. With the exception of defence procurement, Ukrainian suppliers and service providers will have full access to EU public procurement markets, and EU suppliers and service providers will have the same to the Ukrainian procurement market. This constitutes an unprecedented example of the integration of a Non-EEA Member into the EU Single Market.
- Enforcement of *intellectual property rights* (IPRs) based on the EU's internal rules – on particular copyright, designs, patents and geographical indications (GIs) which complement and update the TRIPS Agreement–. Agricultural GIs will have also the same level of protection. The protection will be immediate for most EU GIs, but some names, long-used by Ukrainian producers, will be phased-out over different periods of time (e.g. ten years for Champagne, Cognac, Madeira, Porto, etc.).
- Alignment with *EU competition law* and practices. Competition law will apply to state-controlled enterprises. This ensures that companies of both Parties have equal access to each other's markets and there is no discrimination by monopolies. Ukraine commits itself to adopting a system of control of state aids similar to that in the EU, including an independent authority. It will prohibit certain types of particularly distortive subsidies. Both Parties will report annually the total amount, types and the sectoral distribution of subsidies and will provide further information on subsidies or schemes on request. The rules on subsidies apply to all areas liberalised in the DCFTA except agriculture and fisheries.

Provisions on *trade and sustainable development*: Commitment to environmental and labour protection (including respecting the labour standards of the International Labour Organisation (ILO) and the ILO Decent Work Agenda), and to refrain from waiving or derogating from such standards in a manner that affects trade or investment between the parties.

4. Economic Aspects

Once implemented, the DCFTAs negotiated between the EU and its eastern partners are expected to generate welfare gains and speed up economic integration. This section looks into these economic aspects of trade agreements emphasizing on their impact on the eastern partners' economies.

One of the most important developments of the last decade has been that the EU has become the main trade partner of each EaP country. This was not the case in the 1990s when several of these countries were trading mainly with Russia. Today, more than half (54%) of Moldova's trade is conducted with the EU while the EU represents 45.6% of the overall trade for Azerbaijan, 27.3% for

Armenia, 39.9% for Ukraine and 26.6% for Georgia (year 2012).⁶ The reorientation of foreign trade of EaP countries towards the EU reflects, of course, political imperatives (i.e. the signing of bilateral agreements with the EU or/and deterioration of political relations with Moscow) but this is only partly an explanation. It is interesting to note that even in the case of countries considered to be “Russia’s allies” such as Armenia, trade with the EU not only surpasses the one conducted with Russia but it has also been increasing faster. This is not however unexpected given the competitiveness of the European market and products.

The DCFTAs have been thus negotiated at a time when economic links between the EU and its neighbours are expanding and with the aim to re-enforce and broaden this dynamic. The commercial and economic objectives of the DCFTAs according to the Commission and the European External Action Service (European Commission, 2008) are to: “cover substantially all trade (...) and aim at the highest possible degree of liberalisation (with the asymmetry in the pace of liberalisation appropriate to the partners’ economies). They will contain legally binding commitments on regulatory approximation in trade-related areas and will thus contribute to the modernisation of the economies of the partner countries (...). They will create real perspectives for enhanced movement of goods (this could include Agreements on Conformity Assessment and Acceptance of Industrial Products and the recognition of the equivalence achieved by partners related to sanitary and phytosanitary standards for agricultural and food products)”. Thus, the fundamental issue at stake in the DCFTAs is not trade liberalisation as in tariffs reduction since EaP partners have already undertaken such commitments due to their WTO membership. In addition, trade openness of these economies is at least at the same level with the EU: they apply low tariffs and have a services trade regime that is as open as the EU’s. Similarly to the EU, these economies also tend to apply high tariffs in agriculture.

Furthermore, in terms of goods exports, the EU already offers preferential terms to EaP partners’ exports enjoying duty-free exports to the EU in the context of the Generalised Scheme of Preferences (GSP) regime. Consequently, DCFTAs will not be of much gain for eastern partners in terms of tariff reductions. The central concern of the DCFTAs is the incorporation of *acquis communautaire* in all trade and investment sectors in the partner countries and in particular with regard to technical and sanitary standards. As these comprehensive agreements require regulatory alignment and the integration of EU standards by countries at a much lower income level than the EU, adjustment costs especially in the short run are expected to occur for the EaP countries. A study conducted by Frey and Olekseyuk (2013) on the

⁶ Based on the statistics of the European Commission.

Ukraine-EU DCFTA found that the effects can even be negative if the country tries to refinance the trade liberalization costs by means of tax policy, suggesting that the most welfare enhancing option would be the provision of financial support by the EU.

On mere trade grounds, there is also limited interest by the EU in concluding DCFTAs with EaP countries as their weight in the EU's foreign trade remains very small. Armenia's, Georgia's and Moldova's share of the overall EU trade remains at around 0.1%. Azerbaijan's share in the EU's foreign trade is higher due to imports of energy products, but still remains at 0.8% while Ukraine's share is at 1.1% (year 2012).⁷

According to the classical trade theory, free trade would allow both sides (i.e. the EU and its partners) to realize their comparative advantages and increase their economic efficiency. There seems to be a significant degree of complementarities as EaP economies' comparative advantage lies in low to middle skilled labour-intensive activities in agriculture, manufacturing and services while the EU's comparative advantage is in capital and human-capital intensive activities in manufacturing and services. However, for the EU's partners, there will remain long established obstacles to the access to EU markets in agriculture, less in manufacturing, and especially in labour mobility, and in the temporary movement of services providers for low or middle levels of activities.

There are many studies conducted on the estimated impact of the DCFTAs, especially for the case of Ukraine (i.e. Shumylo-Tapiola 2012; Movchan and Giucci 2011; Institute of Economic Research 2010) which agree on the long run welfare gains for the eastern partners' economies. A EU-funded Feasibility Study conducted in 2004 and a 2007 Impact Assessment suggested that the Ukraine-EU DCFTA would deliver welfare gains of 4-7%, the reduction of capital costs would lead to further 4-5% welfare gains, and the improvement of institutions in Ukraine would increase the country's GDP "in the range of 20 to 30%".⁸ Along the same lines but more conservative estimations of Movchan and Giucci (2011, p. 11) suggest that the DCFTA would add 11.8% to Ukraine's GDP. In the long run, these gains could be doubled or tripled.⁹ Costs are expected to occur in the short and medium term which are related to legislative compliance, trade opening and institutional reforms (e.g. sanitary and phytosanitary standards, competition policy) (Shumylo-Tapiola, 2012).

⁷ Based on statistics of the European Commission.

⁸ Trade and Sustainability Impact Assessment of the Free Trade Area in the Framework of the Enhanced Agreement between the EU and Ukraine, ECORYS & CASE, Rotterdam, 5 April 2007.

⁹ Trade and Sustainability Impact Assessment of the Free Trade Area in the Framework of the Enhanced Agreement between the EU and Ukraine, ECORYS & CASE, Rotterdam, 5 April 2007.

Similar estimations for Georgia are presented in a Trade Sustainability Impact Assessment conducted for the EU which forecasts that the DCFTA will increase Georgia's exports to the EU by 12% and imports from the EU by 7.5%. Full implementation of trade-related reforms could increase Georgia's long-term GDP by +4.3% or €292 million (European Commission, 2013b). Oxford Analytica¹⁰ on the other hand considers that Georgia still lacks an economic agenda to foster long-term growth, to match the DCFTA and needs in particular to prepare its wine sector for competition. If the Armenia-EU DCFTAs were to be implemented, projections suggested that it would increase Armenia's exports to the EU by 15%, its imports from the EU by 8% and its GDP by 2.3% (Vutz, 2013).

As analyses indicate, there is opportunity for the EaP economies to enhance their place in the global and regional industrial supply chain. Benefiting from close geographical proximity to the EU market which is a major consumption market and industrial producer, and from DCFTAs-led reforms, EaP countries could participate in regional production networks and become part of the industrial and even services supply chains such as back office services (Dreyer, 2012). This will benefit their industrial production in many fields as textiles, electrical equipment, and machinery and automobiles. However, concerns have been raised on the economic implications of the regulatory approximation and harmonization of standards with the EU. Research indicates that regulatory harmonization among economies of different level of income and low integration with each other might bring negative effects on welfare, causing diversion of trade, reducing trade with third parties, potentially leading to a rise in domestic prices and economic loss. As Dreyer argues (2012, pp. 37-38), nothing guarantees that trade with the EU will increase symmetrically and this trade could even involve higher prices with a negative impact on the EaP countries' agricultural sectors and industrial enterprises. Estimates presented by Messerlin (Messerlin *et al.*, 2011) show for example that the adoption by Georgia of the EU's entire SPS rules to its economy would lead to a 90% hike in food prices which might bring social implications. It is estimated that, during EU enlargement, non-state actors who had to adjust to new regulations and SPS standards had to bear almost half of the over legal harmonization costs. The costs of implementing the DCFTA, which are going to be high for Eastern partners given their lower level of development, are neither reflected in the current level of EU assistance to the region, nor in the quotas for the products which those countries export to the EU (Delcour and Walczuk, 2013).

How will the DCFTAs impact on deeper economic integration? As said previously, EaP partners do not expect much gain from further tariff reduction. The elimination of tariffs in manufactured products will be relatively easy with longer transition periods for the partners but agricultural quotas and tariffs will

¹⁰ Obstacles strew Yerevan's EU road, *The Oxford Analytica Daily Brief*, 7 August 2013.

not be eliminated on the same scale. The main economic reason for signing DCFTAs for the EaP countries is to attract investment as most of them have low levels of capital accumulation (with some exceptions of energy exporters) (Dreyer, 2012). Investment to GDP ratios in these economies is particularly low, with some below 20% of GDP. Regulatory forms, elimination of import tariffs, opening up services sectors and improvement in business climate as a result of DCFTAs create good conditions for investment. Capital accumulation and facilitation of cross-border production networks will improve conditions for deeper integration among EaP economies and with the European market which has remained to low levels despite the mushrooming of multilateral institutions in the last decade. Giving a role to non-state actors and business communities, DCFTAs have the potential to strengthen a functional, “bottom-up” approach in the integration processes in Eastern European neighbourhood which has so far failed to produce significant results.

5. Political Considerations

Trade agreements are usually shaped by political considerations rather than pure welfare estimations. The EU has used trade agreements extensively and successfully in its relations with its neighbours especially in the enlargement process in the decade 1995-2005 as part of its ‘civilian’ power and as a tool for the integration of Eastern countries in the European processes. The prospect of increasing exports to the EU and access to single market has been a strong incentive for structural reforms in neighbouring economies with EU membership aspirations. The same cannot be said for the free trade agreements in the Euro-Mediterranean context which have largely remained on paper failing to meet the 2010 deadline for their conclusion.

In the case of DCFTAs between the EU and its eastern partners, much discussion has been held on the geopolitical implications of the agreements. The reason for this lies in the political significance of the DCFTAs which are considered as a clear indication of Europeanization – even if in some cases symbolically –. The implementation of the DCFTAs ties neighbourhood economies with the EU market (for example DCFTA with the EU is not compatible with membership in another Customs Union) but furthermore signifies the most advanced political association – before pre-accession – offered to third countries. The Association Agreements (AA) of which DCFTAs constitute a substantial part may not lead automatically to EU membership but constitute a significant step in this direction. As argued by Dreyer (2012) “...it is not deep trade *per se* that the EU has been seeking in its (European) neighbourhood; it has rather been seeking its own expansion, in the form of the export of the EU *acquis communautaire*, with access to its Single Market as the key attraction point for its partners” (Dreyer, 2012, p. 22).

The evolution of the AA/DCFTAs has been conditioned by domestic developments in the EaP countries and in the EU itself while power competition between the EU and Russia has played another significant role. It has been pro-democratic regime changes following the Rose Revolution in Georgia (2003) and the Orange Revolution in Ukraine (2004) that speeded up initially the necessity and conception of the Eastern Partnership policy setting the strategic framework for the implementation of AAs/DCFTAs. The so called coloured revolutions shifted the perception of eastern partners within the EU which, being in no position to offer a membership perspective, suggested deeper contractual bilateral relations. Especially the Visegrad countries –among which Poland was the first– once joining the EU were among the main promoters of closer political and economic integration with EaP countries advocating that the EU could not afford to leave neighbours such as Ukraine outside its orbit. Despite the disappointing pace of reforms and the backwards steps of democratization since the coloured revolutions in most EaP countries, the support for AA/DCFTAs has not declined. Steady public support for EU integration among the EaP societies has underscored the negotiations for AA/DCFTAs despite the fact that this remains a technical and elite driven process from which the general public is detached.

Indicative are the reports on Georgia's request for the inclusion of a commitment to EU membership in the AA/DCFTA.¹¹ Štefan Füle, the Enlargement Commissioner, has recently said that the perspective of EU membership should be held out to those EaP partners who have made most progress maybe as early as the Vilnius Summit.¹²

Strong pro-EU public support has actually pushed political elites in all EaP countries – but Armenia – to continue to declare their commitment to legislation approximation and closer integration with the EU-even if only for the sake of keeping the EU's symbolic engagement with their countries-. The electorate argument has been used to explain Yanukovych's pro-European rhetoric, as his political future seems to depend widely on the progress made with the signing of an agreement with the EU.¹³ It is not however only the

¹¹ DCFTAs with Armenia, Georgia and Moldova to be finalized before Vilnius?, Eastern Partnership Civil Society Forum, available at: <http://www.eap-csf.eu/en/news-events/news/dcftas-with-armenia-georgia-and-moldova-to-be-finalized-before-vilnius/>.

¹² DCFTAs with Armenia, Georgia and Moldova to be finalized before Vilnius?, Eastern Partnership Civil Society Forum, available at: <http://www.eap-csf.eu/en/news-events/news/dcftas-with-armenia-georgia-and-moldova-to-be-finalized-before-vilnius/>.

¹³ While 40% of Ukrainians, based mainly in Yanukovych's electoral heartland in the east and south of the country, would prefer to join the Customs Union, 60% of voters see their future with or in the EU (Åslund, 2013a). Another study (British Embassy, 2013, p. 7) indicates that, on average, opinion polls show that about 30% of respondents are in favour of European integration, 30% - for the Customs Union, and about 30% are

political elite that look committed to advancing contractual links with the EU but also the business elite in EaP countries look towards their European partners expecting benefits on trade and investment in the long run. As business has become unpredictable and difficult with their traditional partners in Russia as a result of Moscow imposed embargoes and customs constrains, EaP businessmen have been pushed to alternative, safer and more predictable markets in Europe and elsewhere.

The process of negotiating and completing the DCFTAs has not been a linear one facing mainly two types of political problems. The first cluster of obstacles comes from domestic politics, the state of democracy and rule of law in the Eastern partners. According to the “more for more” principle, the pace of reforms determine the intensity of bilateral cooperation, and the most engaged in reforms partners will benefit more from their relationship with the European Union, including closer political association, deeper gradual economic integration in the EU Internal Market and increased EU support. With the exception of Moldova, in all other EaP countries there have been shortcomings in the democratization process. Domestic politics have been an obstacle in particular in the case of EU-Ukrainian DCFTA whose final signature by the EU has been postponed on the grounds of democratic deficiencies as in the case of the continued imprisonment of Julia Tymoshenko, the former prime minister and Yuriy Lutsenko, the former interior minister of Ukraine.¹⁴ The European Union has protested persistently against eleven of Yanukovych’s malpractices including the imprisonment of several opposition leaders violating the rules for free and fair elections and imposing his control over courts, law enforcement, and media. Specifically, five people had been elected to parliament, but courts had disqualified them and the European Union demanded new elections be held. The European Union has also objected to the deteriorating business and investment climate, as well as Ukraine introducing protectionist recycling fees for imported cars in violation of WTO rules (Åslund, 2013b, p. 8). In explaining why Kiev is not ready yet for advancing relations with the EU, Charap and Darden (2013) point to the absence of any real reform in the country’s economic and political system since independence, rightly arguing that “[w]ealth - generated by graft, by skimming profits off of natural gas imported from Russia,

undecided. The share of citizens supporting the two blocks at the same time remains stable (25-30%).

¹⁴ Tymoshenko was arrested in August 2011 and received a seven-year prison sentence for “abuse of power” over a 2009 natural-gas deal with Russia. A EU-appointed mediation commission that includes former Polish President Alexander Kwasniewski and former European Parliament President Pat Cox has proposed a solution. At the commission’s request, Yanukovych would pardon Tymoshenko, who would be allowed to travel to Germany for medical reasons (Åslund, 2013a).

and by the seizure of profitable assets - still lies predominantly in the hands of government officials, their families, and their oligarchic allies”.

The assessment of a country's democratic qualifications remains a major factor for the EU and this for the moment puts Belarus and Azerbaijan beyond the DCFTA scope. Thus, the EU's readiness to sign the AA/DCFTA with Kiev which had actually taken but a few steps toward European political and economic standards has received criticism. As for Belarus and Azerbaijan, it might be well argued that they are also rather disinterested in the DCFTA as their elites seem mostly reluctant to undertake the commitments accompanying the agreement. Azerbaijan, a major energy exporter having a strong energy tie with the EU is confident enough not to pursue any political and institutional reforms or non-energy related trade dialogue with the EU. The economic elite or oligarchs in Azerbaijan benefit from the monopolistic nature of the country's economy and they are not interested in open markets which would threaten their privileges. This is equally valid either in the case of joining a EU or Russian economic union. There is thus no real perspective at the moment for Baku seeking a DCFTA with the EU nor joining the Russia-led Customs Union as economic interests of the Azeri elite are not independent from the political elite and rest within the Azeri economy itself (and Turkey) but not in Moscow or elsewhere in Europe (Valiyev, 2013).

Geopolitics has determined, beyond domestic concerns, the pace of development of DCFTAs. The second type of obstacles comes from the competition between the EU and Russia in their common neighbourhood over the regional distribution of power and wealth. Since the EaP started to take shape through the AA/DCFTAs, Russia has been advancing an alternative integration project, a Customs Union among former Soviet republics. Russia, which used to be the main trade partner of the Eastern economies, has seen its economic presence in the region declining steadily. The conclusion of DCFTAs with EaP countries would further isolate economically Russia from the markets where Russian goods are competitive and Russian capital is present especially in the banking and energy sectors. Moscow has been putting enormous pressure on EaP countries to join the Customs Union which came into existence in 2010 with the implementation of a common customs tariff and joint customs code among Russia, Belarus and Kazakhstan. In January 2012, border controls were abolished and a joint secretariat, the Eurasian Economic Commission, was set up in Moscow. A Eurasian Development Bank in Almaty and an arbitration court in Minsk were also established. Moscow's aim is to transform the Customs Union into a Eurasian Union by 2015, an economic and political counterpart to the European Union. As mentioned by Adomeit (2012, p. 8): “The ostensible purpose of [the Eurasian Union] is economic. Its primary objectives, however, are geopolitical, and these are to be achieved in large part by economic means”. But this approach is not shared by Belarus and Kazakhstan which resist closer

political integration. Though Russia has been pressuring all former Soviet republics to join, the real goal is to integrate Ukraine (Åslund, 2013b, p. 4).

On another development, eight CIS countries concluded a new multilateral FTA in October 2011 replacing the bilateral FTAs of 1993/4. This FTA has replaced the bilateral FTA of 1993 as the basis of trade and introduced two novelties, namely that WTO rules and procedures should apply to CIS members belonging to the WTO and that a customs union could be a party to the FTA (Åslund, 2013b, p. 5). So far, the agreement has been ratified by Russia, Belarus, Moldova, Ukraine and Armenia. For many countries in the post Soviet space, speeding efforts in the European integration process go in parallel with economic cooperation within the CIS which remains an important market for them as it is the case of Moldova where CIS states still hold a 33.8% share of the country's foreign trade.¹⁵

Uneasy with the prospect of losing Ukraine to the European Union, Moscow exerted heavy pressure on Kiev in the summer 2013, launching substantial trade sanctions against Ukrainian products and temporary increases in customs checks prior to the Vilnius Summit. In July and August 2013, the Russian government pulled important export quotas from two big Ukrainian steel pipe producers, Interpipe and the Industrial Union of Donbass, the Russian Customs Committee labeled 40 large Ukrainian companies as "risky," subjecting them to checks, the Russian food inspector banned imports of chocolates from the biggest Ukrainian producer, Roshen and Russian customs authorities classed all Ukrainian producers as "high risk," which subjected all their deliveries to onerous checks, thus barring most Ukrainian imports in Russia (Åslund, 2013b, p. 9). This was despite Ukraine having signed a memorandum on closer cooperation with the Eurasian Economic Commission in May 2013 and considering trilateral consultations with the EU and Russia on trade. Verbal threats were also put forward. Sergey Glazyev, an adviser of President Putin, warned Kiev that "We are preparing to tighten customs procedures if Ukraine makes the suicidal step to sign the association agreement with the EU."¹⁶

Similar threats were extended to Chisinau which was warned by Dmitri O. Rogozin, a deputy prime minister of Russia, that it would be "a serious mistake" for Moldova to seek closer ties with Europe. "We hope that you will not freeze," he said (Herszenhorn, 2013, p. A1). In addition to warnings on complicating the resolution of the Transnistrian case and as a means of immediate economic pressure, Moscow banned Moldovan wine and brandy on the basis of not meeting Russian standards in September 2013, while there have been rumors that thousands of Moldovan labour immigrants would be expelled from Russia

¹⁵ Based on statistics of the European Commission.

¹⁶ Kremlin Warns Kiev over 'Suicidal' Ukraine-EU Trade Deal, *Rianovosti*, 19 August 2013, available at: <http://en.ria.ru/russia/20130819/182849320.html>.

dramatically reducing the income of families living out of remittances. There are also rumors that a ban on apples or other products could be imposed after the signature of the DCFTA (Herszenhorn, 2013, p. A1). In response, the European Commission announced a proposal to open the internal market completely to Moldovan wine, even before provisional application of the AA/DCFTA, which would be possible from the moment of signature (Vutz, 2013).

The European Union institutions did not leave Moscow's pressure on EaP countries unanswered. The European Parliament, through the resolution of 12 September 2013, "calls on the Commission and the European External Action Service (EEAS) to consider those developments beyond a purely trade dimension, which is merely a cover for blatant political pressure, and to take action in defence of the Union's partners, sending a strong message of support for all Eastern Partnership countries in their European aspirations and choices" (European Parliament, 2013). Štefan Füle, European Commissioner for Enlargement and Neighbourhood Policy, in a statement on the pressure exercised by Russia on the Eastern Partnership countries showing the discontent of the EU stated that "This is not how international relations should function on our continent in the twenty-first century. Such actions clearly breach the principles to which all European states have subscribed. In the Helsinki Principles of the OSCE we have committed to respect each country's "right freely to define and conduct as it wishes its relations with other States in accordance with international law' " (Füle, 2013a). The statement mentioned that the EU will support those countries which are subject to undue pressures and that "Any threats from Russia linked to the possible signing of agreements with the European Union are unacceptable. This applies to all forms of pressure, including: the possible misuse of energy pricing; artificial trade obstacles such as import bans of dubious WTO compatibility and cumbersome customs procedures; military cooperation and security guarantees; and the instrumentalisation of protracted conflicts" (Füle, 2013a).

The heavy-handed intimidation of Moscow had an impact on Armenia whose President Serzh Sargsyan declared in September 2013, after a meeting with President Putin in Moscow, that Yerevan would join the Customs Union, thus putting an end to the completed DCFTA. This move is well understood by Yerevan's security concerns as it depends heavily on Moscow's military and diplomatic support over the Nagorno-Karabakh conflict with Azerbaijan. Still it has to be pointed out that Moscow has also a significant stake in the country's economy, especially in the transport (i.e. railway) and energy sector (i.e. the electricity and nuclear market as well as Gazprom being the majority owner of Armenia's pipeline system).

The most important derail from the pro-European track has been that of Ukraine despite Yanukovych's pro-European rhetoric claiming that "[f]or Ukraine, the association with the European Union must become an important

stimulus for forming a modern European state. At the same time, we must preserve and continue deepening our relations and processes of integration with Russia, countries of the Eurasian community...” (Balmforth, 2013). As of early September 2013 Yanukovich reached an agreement with the opposition speeding up legislative reforms in order to fulfill the EU’s legal and political conditions prior to the Vilnius Summit. The new legislation concerned the alignment of customs regulations to WTO standards, reform the prosecutor’s office, the judiciary, and the police and improvement of the enforcement of court rulings, the electoral law, media access for the opposition, the business environment, and conditions for prisoners (Åslund, 2013b, pp. 9-10) However, on 21 November, the Ukrainian parliament failed to pass the legislation permitting Tymoshenko to go abroad on medical reasons, a development which was followed by a governmental decree announcing the halt of the signing of AA/DCFTA. According to the decree, further examination of the impact of the Agreement with the EU on Ukraine’s industrial production and trade with Russia was required.

The Vilnius Summit Declaration (2013) leaves open the signing of the AA/DCFTA with Ukraine at a future time calling as a “temporary suspension” the decision of the Ukrainian government not to sign the agreements while both sides reiterated their commitment to the signing of this Agreement “on the basis of determined action and tangible progress in the three areas emphasised at the 2013 EU-Ukraine Summit”. Thus the only success of the Vilnius Summit was the signaling (not signing) of the AA/DCFTAs with Moldova and Georgia. The President of Moldova, Nicolae Timofti, said in an interview that “The signing of these agreements is the only chance that Moldova has in order to develop itself as a European country and in the European spirit” arguing for the Russian plans for a Eurasian Economic Union that “[w]e realize Russia has geopolitical interests in this area but there is also a saying here - ‘You cannot enter the same river twice’ ” (Herszenhorn, 2013, p. A1).

6. Conclusions

Trade as a means to pursue political goals has been used extensively in the Eastern neighbourhood. Still, there is a difference of perspectives between the EU, the Eastern partners and Russia. On the one hand, the EU has advanced comprehensive free trade agreements to take its neighbours in its own political and economic integration process mainly through exporting its *acquis* – rather than offering full membership – while on the other hand, the EaP partners are willing to undertake painful legislative and institutional reforms accompanied by the DCFTAs anticipating a secure place in the European political arena, sovereignty boosting and as a guarantee of future EU membership. As Delcour and Wolczuk (2013) argue, “[e]ach partner state is afflicted by the insecurities

which stem from weak statehood, concerns over territorial integrity and an overbearing neighbouring Russia” thus a basic difference between DCFTA partners is that while the EU focuses primarily on functional integration, the post Soviet elites seek closer links with the EU motivated by geopolitical concerns, i.e. to escape Russian stronghold (Delcour and Wolczuk, 2013).

Accordingly, seeing its political leverage decreasing among EaP political elites, Moscow has resorted to trade tools (embargoes, tight customs procedures, quotas, etc.) to coerce its former allies into a Russian-led Eurasian Union that would be a vehicle for its political reemergence. One should, of course, acknowledge that though the implementation of the bilateral DCFTAs by EaP countries is not incompatible with maintaining free trade agreements with Russia, it is expected that, due to the deep and comprehensive nature of DCFTAs, Russian trade and business interests in the eastern neighbourhood will be heavily affected. If the signing and implementation of the AA/DCFTAs move on smoothly, the political economy of Europe is going to change substantially. As mentioned by Štefan Füle, the EU will work on turning these agreements into instruments to regionalize this cooperation and create a special economic zone shared between the EU and its partners (Füle, 2013b).

Pointing to the main political question around the AA/DCFTAs, the most fought-over paragraph in the draft of the Vilnius Summit Declaration was about the status of the relationship of the six EaP countries to the EU. What has been at stake here is whether the Vilnius Summit would acknowledge more than “European aspirations” for the EaP countries and give them a “European perspective” which implies the possibility of a future membership (Jozwiak, 2013). The final document mentions that “[t]he participants in the Vilnius Summit reaffirm their acknowledgement of the European aspirations and the *European choice of some*¹⁷ partners...” indicating a compromise, pointing to the new division after the Vilnius Summit between those partners having made a clear choice to integrate with the EU structures and those who simply seek cooperative relations with the EU (policy coordination).

Although the DCFTAs concern trade liberalization at first sight, they are widely perceived by engaged partners and beyond as primary evidence of joining the European economic integration project which fundamentally redesigns the political economy map of Eastern neighbourhood. The Eastern partners that will proceed with implementing the AA/DCFTAs will upgrade their status to more than neighbours. As long as a membership perspective is not open for them yet, the frontrunners may as well join the European Economic Area (EEA) with other non-EU members in an ever closer economic union.

¹⁷ Emphasis added by the author.

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