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Is Free Trade with the EU Good for Ukraine?

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The negotiations on the Association Agreement (AA) between the European Union (EU) and Ukraine, including its trade component, i.e., the Deep and Comprehensive Free Trade Agreement (DCFTA), were completed in December 2011. The agreement is practically ready to be signed, if the EU's concerns related to the deteriorating political freedoms in Ukraine are addressed (especially the jailing of former Prime Minister Yulia Timoshenko). The ball is now in Ukraine's court and the correct and rapid response is crucial for the country's future. Both the AA and the DCFTA offer Ukraine an opportunity to deepen its political and economic relations with the EU and modernize its own economy and state institutions[1].

The concept of DGFTA

LTC The concept of the DCFTA has been offered to the EU's neighbors as the major economic integration instrument within the framework of the European Neighborhood Policy and Eastern Partnership. It is based on the experience of the Single European Market, the European Economic Area, and trade agreements between the EU and the prospective EU candidates. It goes beyond the traditional concept of trade liberalization, which focuses mostly on reducing and removing customs tariffs and is sometimes limited to trade in manufactured goods only. Apart from scrapping tariffs on the trade of goods (with some exceptions related to agriculture products), the concept of a deep FTA also includes the reduction/removal of non-tariff barriers (NTB), the liberalization of the investment regime, the liberalization of trade in services, and far-reaching harmonization/mutual recognition of various trade and investment-related regulations and institutions.

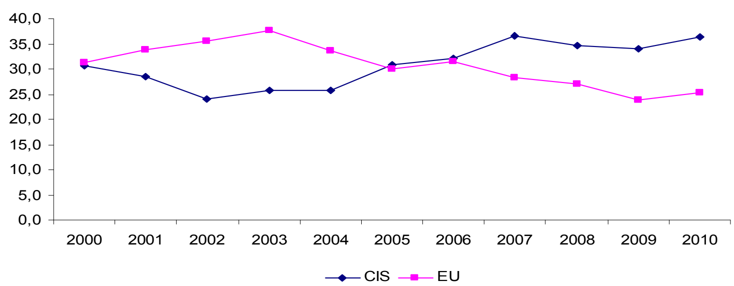
While the general purpose and the conceptual background of the DCFTA seem to be clear, its exact content remains dependent on the interests of the negotiating parties. For this reason, the DCFTA between the EU and Ukraine plays a pioneering role, at least in respect to economic relations between the EU and its Eastern neighbors (in December 2011, the EU opened negotiations on the DCFTA with Georgia and Moldova).

Ukraine's trade relations with the EU

Ukraine is an open economy: its exports of goods and services accounted for 50.2% of GDP in 2010 and imports accounted for 53% of GDP. However, the product structure of its trade is not diversified enough. Ukraine's exports are concentrated on commodities such as steel, fertilizers, and unprocessed or low-processed agriculture products. Import is dominated by energy products (32.3% of the total in 2010) purchased mostly from Russia.

The EU is Ukraine's second largest regional trade partner after the CIS countries (primarily Russia - see Figure 1). With the exception of the crisis year of 2009, bilateral trade grew quite rapidly in the first decade of the 2000s (with imports to Ukraine growing faster than exports - see Figure 2).

Figure 1: EU27 vs. CIS: Share in Ukraine's exports of goods



Source: State Statistics Service of Ukraine

[1] This article is based on the background study on "The Free Trade Agreement between the EU and Ukraine: Conceptual Background, Economic Context and Potential Impact" presented at the workshop on "The EU-Ukraine Association Agreement: Trade and Economic Issues at Stake" organized by the European Parliament Committee for International Trade, Brussels, October 20, 2011 – see http://www.europarl.europa.eu/committees/fi/studiesdownload.html?languageDocument=EN&file=59671

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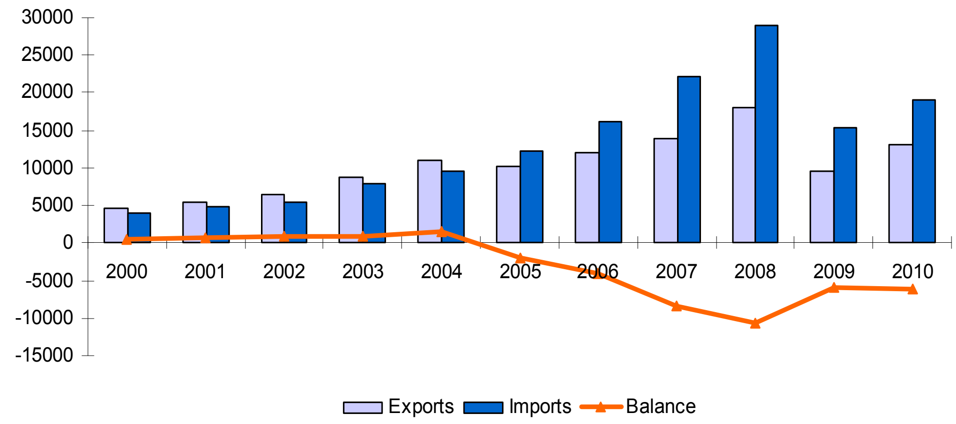
Figure 2: Ukraine's merchandise trade with the EU27 in USD million



Source: State Statistics Service of Ukraine

Trade and economic relations between Ukraine and the EU have been based on the Partnership and Cooperation Agreement, which entered into force on March 1, 1998 and which offered Ukraine Most Favored Nation (MFN) status in bilateral trade. In addition, since 1993, Ukraine has benefited from the Generalized System of Preferences (GSP) offered by the EU to developing countries. Although less than 25% of Ukraine's exports to the EU are eligible for preferences, their rate of utilization is very high, close to 100%[2].

In 2005, the EU granted Ukraine 'market economy status'. This ensures that antidumping investigations against Ukrainian exporters to the EU are conducted applying the normal value of exports based on prices paid or payable in Ukraine, and not in the third country as is done for non-market economies.

Consequences of WTO Accession

The Ukraine-EU trade regime was further liberalized when Ukraine joined the WTO in 2008. Ukraine's average MFN tariffs were bound at 5.8% for all products (11% for agricultural products and 5% for non-agricultural products). The actual tariffs are even lower: they equaled 4.6% for all products, of which 9.8% are for agricultural products and 3.8% for non-agricultural products in 2010[3]. The quotas on rolled metal exports to the EU were cancelled and there are currently no quantitative restrictions on trade between Ukraine and the EU.

Ukraine agreed to gradual reductions on a number of exports duties: for sunflower seeds (to 10%), ferrous metal scrap (to EUR 10/t), non-ferrous metal scrap (to 15%), livestock (to 10%) and leather raw materials (to 20%). Ukraine also made a commitment to reform its food safety and technical regulation systems, including the alignment of Ukrainian technical regulations with relevant international and European standards by the end of 2011 (a deadline which was not met). All existing national and regional standards in Ukraine should be voluntary.

DCFTA negotiations

Even after Ukraine's WTO accession, its bilateral trade with the EU has been the subject of serious tariff and non-tariff barriers. Thus the DCFTA negotiation, which started in 2008, had to address a very broad range of issues, the most controversial of which concerned[4]:

1/ The EU wanted to continue import barriers on several agricultural products while Ukraine was interested in completely eliminating them. As result of the negotiation, Ukraine obtained a full elimination of tariffs for some items (e.g. confectionery or tobacco products) and higher Tariff Rate Quotas (TRQ) for others (such as grain, meat products and fruits) compared to the initial EU proposal. However, for some products (e.g., vegetables and eggs), the quotas remained low in terms of Ukraine's export potential.

2/ The EU wanted to observe the WTO commitments of both sides in respect to export subsidies and domestic support to agriculture, while Ukraine (due to insufficient budget resources and stricter WTO commitments than those of the EU) was interested in reducing the the level of EU support, including abolishing EU export subsidies.

3/ Ukraine wanted to continue import protection, at least temporarily, for "sensitive" industries, especially the car industry. As a compromise, import tariffs for cars will be gradually reduced during a 10-year period and Ukraine will retain the possibility to adopt safeguard measures if car imports increase rapidly.

[2] See Gasiorek, M. et al. (2010): Mid-term Evaluation of the EU's Generalised System of Preferences, CARIS, http://trade.ec.europa.eu/doclib/docs/2010/may/tradoc_146196.pdf

[3] See http://stat.wto.org/TariffProfile/WSDBTariffPFView.aspx?Language=E&Country=UA

[4] We were unable to obtain official information on the content of DCFTA and thus had to rely on secondary sources of information, including media comments and speculations and public statements by policymakers.

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4/ The EU demanded the removal of all export tariffs in Ukraine while Ukraine was reluctant to do so. In the end, Ukraine was granted a long transition period (10-15 years) in which export tariffs would be gradually reduced to zero.

5/ The EU demanded protection for some 3,000 Geographical Indications (GIs) such as cognac or champagne produced by Ukrainian companies and a product rebranding if necessary. Ukraine wanted to obtain a transition period for such a rebranding and a compensation mechanism for its firms.

6/ The trade aspects of cooperation in the energy sector, especially guarantees of the safe and uninterrupted transit of natural gas through Ukraine, were also an issue. As a result of negotiation, Ukraine committed to ensuring that the country's internal legislation would facilitate the free and uninterrupted transit of gas. However, neither the EU nor Ukraine can bear responsibility for actions undertaken by third parties. The EU also expects that domestic energy pricing in Ukraine will be conducted on a market basis.

7/ Ukraine wanted free access to the EU market for all types of transportation services for its firms, including the free movement of physical persons to provide these services on EU territory. The EU side was reluctant to grant such access, mostly due to the unfinished process of creating the Single European Market for services. There was also the question of the incompatibility of Ukraine's labor and ecological standards in transportation services with those of the EU. As result, Ukraine will have to rely on bilateral agreements with individual EU member states.

Potential benefits and costs

As neither the AA nor the DCFTA have been published yet, it is difficult to assess all of their detailed provisions and potential benefits and costs. While free trade offers net benefits for both sides, the potential gains and adjustment costs will be greater for Ukraine as it is the smaller partner with higher initial trade barriers and higher exposure to bilateral trade.

In the case of Ukraine, the main benefits can be characterized as follows:

- The DCFTA will provide Ukrainian enterprises with better access to the EU market and third-country markets (as a result of harmonization with EU product standards and benefits of scale); it should also help Ukrainian enterprises become part of global production networks by encouraging intra-industry trade;

- The DCFTA will increase competition on the domestic market, leading to better consumer choice;

- The harmonization of Ukrainian standards with those of the EU will also increase the quality and safety of domestically produced and traded goods and services;

- The additional inflow of FDI will contribute to the modernization of Ukraine's economy, enterprise restructuring, job creation, and possibly a greater diversification of its sectoral and product structure; indirectly, it should help reduce its high energy intensity;

- Regulatory and institutional harmonization may help to improve the business and investment climate in Ukraine;

- The institutional provisions of both the AA and the DCFTA may help to improve the rule of law, domestic policy transparency and corruption; both agreements will serve as an external anchor to domestic policies and regulations.

Computable General Equilibrium (CGE) modeling exercises conducted by various authors estimate the potential long-term cumulative welfare gains for Ukraine in the range of 5 to 10% and less than 1% for the EU. However, most of these estimates used pre-WTO-accession, pre-DCFTA-negotiation, and pre-2008-crisis data and without the knowledge of the details of the DCFTA, so these figures may not accurately reflect the actual implementation conditions.

Potential implementation obstacles

With all of its potential benefits, the DCFTA does not guarantee an automatic success. Much will depend on the political will and administrative capacity to implement all of its provisions in a timely and accurate manner. This is a serious challenge for Ukraine, which has a mixed historical record of reforming its economy and government, and which continues to struggle to meet its WTO commitments.

Ukraine's business and investment climate is rated as very poor by numerous international comparative research and indices, and the feeling is shared by the domestic business community. This is a result of various institutional deficiencies such as high barriers to market entry, overregulation, an excessive number of administrative inspections, non-transparent and poorly administered tax and custom systems, an unstable and non-transparent legal system, a weak and corrupt public administration and judiciary, weak contract enforcement, insufficient property rights protection, the excessive

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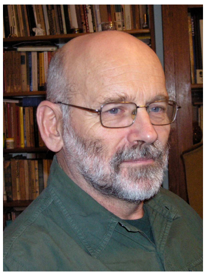
prerogatives of law enforcement agencies, and the underdevelopment and monopolization of infrastructure. Many of these problems have their roots in the unreformed post-Soviet state.

The DCFTA can help in resolving some of these problems, for example, by reforming trade-related technical regulations and customs procedures or by stabilizing trade and investment regimes. However, one cannot overestimate the potential of the DCFTA to address more fundamental issues such as the poor quality of public administration or the judiciary. Thus, if the fundamental economic, political, and institutional reforms are not accelerated and conducted in a more comprehensive and consistent way, the prospect of implementing the DCFTA (and its potential benefits) will come under question.

This E-brief summarises the outcome of the European Parliament DG External Policies project "The EU-Ukraine Association Agreement: Trade and Economic Issues at Stake" http://www.case-research.eu/en/node/57555.

For the full report please see:
www.europarl.europa.eu/delegations/pl/studiesdownload.html?languageDocument=EN&file=59671



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