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The Free Trade Agreement between the EU and Ukraine: Conceptual Background, Economic Context and Potential Impact

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Contents

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Abstract

The idea of a Deep and Comprehensive Free Trade Agreement goes beyond the traditional concept of trade liberalization and, apart from the elimination of tariffs in trade of goods, it also includes the reduction/ removal of non-tariff barriers, the liberalization of the investment regime, the liberalization of trade in services, and the far-reaching harmonization/ mutual recognition of various trade and investment-related regulations and institutions. The economic literature, CGE modeling exercises and the practical experience of "deep" trade integration suggest a substantial potential for the future EU-Ukraine DCFTA in promoting trade and investments, creating additional welfare and employment, regulatory and institutional harmonization with EU's *acquis*, and modernizing Ukraine's economy. While beneficial for both sides, the potential gains (but also potential adjustment costs) are greater for Ukraine as it is the smaller partner with higher initial trade barriers. However, the DCFTA does not include an automatic guarantee of success. Very much depends 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 record in reforming its economy and state and which is still struggling to fulfill all of its commitments undertaken during the WTO accession process.

1. Introduction

The purpose of this paper is to provide a background analysis of the forthcoming Deep and Comprehensive Free Trade Agreement (DCFTA) between the European Union (EU) and Ukraine and its potential impact on the economy of Ukraine. The negotiations between the two parties began in 2008 and were completed in December 2011. The agreement is practically ready to be signed, if the EU's concerns related to deteriorating political freedoms in Ukraine are addressed (especially the selective prosecutions of the political opposition). In the meantime, the EU has initiated negotiations on similar DCFTAs with two other Eastern neighbors – Georgia and Moldova. The lessons learned during the EU-Ukraine negotiation can hopefully be applied by other countries in the region.

Our study is structured as follows: Section 2 analyzes the concept of DCFTA, its origins and development as the major instrument of the European Neighborhood Policy (ENP) and Eastern Partnership (EaP). Section 3 provides basic information on Ukraine's trade volume and product and geographic structure and presents a more detailed picture of bilateral EU-Ukraine trade flows. It also contains an analysis of inward foreign direct investment (FDI). Section 4 is devoted to the key components of both current and future trade regimes between Ukraine and the EU: Partnership and Cooperation Agreement (PCA), Generalized System Preferences (GSP), Ukraine's accession and membership in the World Trade Organization (WTO), and negotiation of the DCFTA. Section 5 provides an overview of various quantitative analyses of the potential net benefits of the DCFTA for the economy of Ukraine. Section 6 addresses the issues which are closely related to the successful conclusion and implementation of the DCFTA by the Ukrainian side but often go beyond the formal DCFTA agenda, such as the necessity to improve the business and investment climate and continue key economic and institutional reforms in Ukraine. Section 7 contains the major conclusions of our analysis.

The biggest obstacle in preparing this paper has been the lack of public information on the detailed content of the negotiated DCFTA. Without this knowledge, it is difficult to assess how deep and comprehensive the negotiated agreement really is and whether or not it corresponds to the concept of deep free trade as elaborated in the economic literature and assumed in most quantitative estimates of its potential economic impact. If there is substantial gap between both, i.e. the actual agreement falls short of the most frequently used definition of deep trade, the optimistic estimates produced by most CGE modeling exercises may prove irrelevant. It is also difficult to draw lessons for future DCFTA negotiations in the absence of information on the current negotiation process.

As we were unable to obtain full information on the content of negotiated DCFTA, we had to rely on less reliable sources of information, including media comments and speculations and public statements by policymakers, usually related to some narrow questions subject to special public attention (such as the size of tariff-free quotas for certain sensitive goods).

2. The Concept of DCFTA

DCFTA is a relatively new concept in the EU trade policy. The notion of a deep free trade area first emerged in the decade of the 1990s when the Barcelona Process was launched and a series of trade agreements between the EU and the Southern Mediterranean countries started to be negotiated (see Hoekman & Konan, 1999; De Wulf, Maliszewska et al., 2009). Later it gradually developed into the key economic instrument of the European Neighborhood Policy (ENP) in respect to both the Eastern and Southern neighbors of the EU.

The idea of a deep free trade area (sometimes referred to as a free trade area “plus”) goes beyond the traditional concept of trade liberalization, which focuses mostly on reducing and removing customs tariffs, sometimes limited to trade in manufactured goods only (so-called “shallow” integration). Apart from scrapping tariffs in the trade of goods, 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. According to some authors (see Evans et al., 2004), the concept of deep integration can be interpreted in a broader sense, beyond trade and investment issues, and may also include the free movement of people and labor, the harmonization of macroeconomic policies or monetary integration. In practice, most deep FTAs include the following components (Evans et al., 2004):

- investment rules
- a degree of regulatory harmonization (product standards or process standards)
- regulation of anti-dumping procedures
- limitation of using export subsidies (beyond WTO rules)
- competition policy alignment

- regulation of service provision
- dispute settlement mechanism
- institution/s to monitor implementation of agreement

In the case of the EU, the concept of deep trade integration with external partners and the detailed design of deep FTAs has been drawn from the experience of building the Single European Market and the European Economic Area (EEA) in the 1980s and 1990s and the subsequent EU enlargements. The 2004/2007 Eastern Enlargement was preceded by a series of Trade and Association Agreements (TAAs) between the EU and the countries of Central and Eastern Europe and Baltic region, which contained an ambitious deep trade, investment and institutional harmonization agenda. Similarly, in the decade of the 2000s, several Western Balkan countries became parties of the Stabilization and Association Agreements (SAAs) with the EU, containing similar or even more ambitious economic integration goals.

When the ENP was launched in May 2004, one of its most meaningful offers addressed to neighboring countries related to "*…the prospect of a stake in the EU Internal Market based on legislative and regulatory approximation, the participation in a number of EU programmes and improved interconnection and physical links with the EU*" (European Commission 2004). The subsequent document (European Commission, 2006) explicitly offered the neighboring countries DCFTAs which "*…should cover substantially all trade in goods and services between the EU and ENP partners including those products of particular importance for our partners and should include strong legally-binding provisions on trade and economic regulatory issues*." The Council of the European Union (2007) suggested the DCFTA as a tool of modernization and support to economic and institutional reforms in neighborhood countries.

In May 2009, the EU launched the Eastern Partnership (EaP) initiative to address the regional specifics of its six Eastern neighbors: Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. The EaP is the supplementary cooperation framework (in addition to the ENP) aimed at deepening both bilateral and multilateral integration beyond the original ENP design. It involves, among others, the perspective of bilateral association agreements and the DCFTA, close cooperation in various sectors, visa facilitation and, as the next steps in the future, visa liberalization and the launching of Comprehensive Institution-Building Programs aimed at improving the administrative capacity of the Eastern partners (Council of the European Union, 2009).

Going beyond the prospective EU members and EU Eastern and Southern neighbors, the recent round of trade negotiations between the EU and other external partners has also followed, to various degrees, the concept of deep FTA. This concerns, for example, the already completed agreements with the Republic of Korea (Das, 2012) and several Latin American partners (e.g., Chile, Peru, and Colombia) as well as ongoing FTA negotiations with Canada or India.

The above short overview clearly demonstrates that while the general purpose and conceptual background of DCFTA seems clear (broad-based trade and investment integration), its exact content is not determined by trade theory and remains subject to policy decisions based on the interests of the negotiating parties. For this reason, the DCFTA between the EU and Ukraine will play a pioneering role, at least in respect to the economic relations between the EU and its Eastern neighbors.

3. Ukraine: Trade and Investment Flows

3.1. General characteristics of Ukraine's trade

Ukraine is a relatively open economy, taking into account its size. Exports of goods and services accounted for 50.2% of GDP in 2010 and imports for 53% of GDP. However, the product structure of both exports and imports represents a rather low degree of diversification.

Ukraine's exports are concentrated on low value-added commodities (such as steel, fertilizers and unprocessed or low-processed agriculture products) and are dependent on the fluctuation of their prices on international markets. In 2011, metallurgical products accounted for 32.3% of total exports, and minerals accounted for 15% (in 2001, 34.6% and 10.8% respectively). Machinery & transportation equipment represented 17% of exports (share of machinery exports has been gradually increasing from 14% in 2001). The share of agricultural and food products in total exports also increased - from 11.2% in 2001 up to 18.8% in 2011. On the other hand, the role of chemicals has diminished (to 7.9% in 2011), partly as a result of higher energy prices.

As seen from the above statistics, Ukraine did not manage to increase its degree of export diversification during the decade of the 2000s, with metals and minerals gradually increasing their contribution to export growth. This could be partly explained by external factors, i.e. a positive terms-of-trade shock resulting from high world commodity prices in the 2001-2008 period, primarily metals. However, this made the economy of Ukraine even more vulnerable to global cyclical fluctuations, as experienced during the global financial and economic crisis of 2008-2009. Ukraine's major export markets (EU and Russia) were heavily affected by this crisis and, as a result, in 2009, the country recorded more than a 50% decline in its exports which, in turn, led to a severe recession, especially in industry. According to the International Monetary Fund World Economic Outlook (IMF WEO) database, Ukraine's GDP growth rate decelerated from 7.5% in 2007 to 1.9% in 2008, recorded a sharp decline of 14.5% in 2009 and only experienced a modest recovery of 4.2% in 2010[1].

Ukraine's import structure is characterized by a significant share of energy products (34.6% in 2011) and a low geographical diversification of energy suppliers (mostly Russia). The share of machinery and transport imports equaled 23% in 2011 (in the pre-crisis year of 2008 this was 30%). Chemicals represent other important category of Ukrainian imports (9.7%). Overall, Ukraine imports high value-added products from the EU and energy resources from the CIS countries (mostly Russia).

The high share of imports in GDP (53%) can be explained by Ukraine's high energy intensity (one of the highest in Europe), high demand for imported intermediate inputs (about 60% of total imports) and imported capital goods, as well as the increasing import intensity of private consumption. High energy consumption is closely linked to the domination of energy-intensive industries such as metallurgy and heavy chemistry in Ukraine's exports (see above). This makes the economy excessively dependent on fluctuations in world energy prices and on political turbulence related to natural gas imports from Russia as well as pricing.

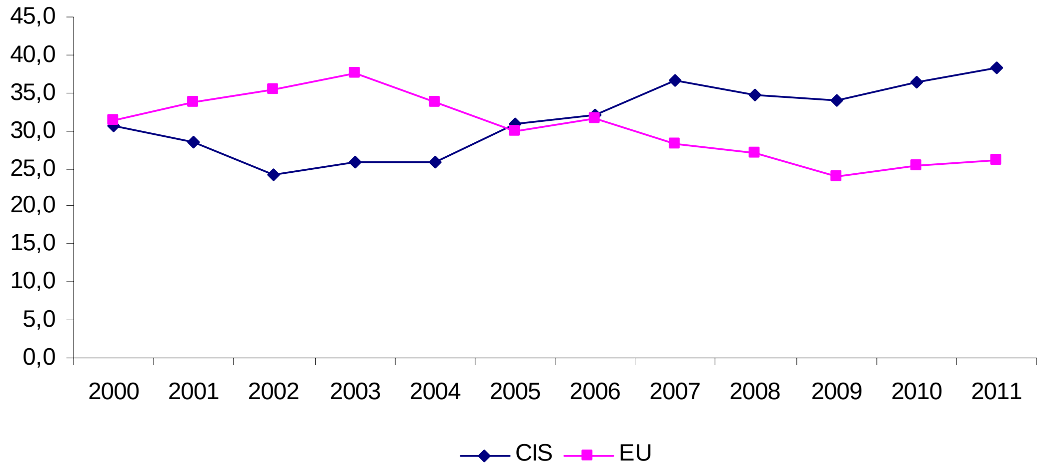
[1] In 2011, according to preliminary estimates of the National Bank of Ukraine, real GDP grew by 5.2%

Table 1: Ukraine's geographic structure of merchandise exports, % of total

Year	EU	CIS	Asia	Africa	America
2000	31.3	30.6	23.9	5.0	8.4
2001	33.9	28.5	24.6	5.4	6.2
2002	35.5	24.1	28.5	5.9	5.2
2003	37.7	25.8	23.9	5.4	5.3
2004	33.7	25.7	25.0	5.4	7.8
2005	29.9	30.8	25.1	7.0	5.3
2006	31.5	32.2	22.0	6.2	6.6
2007	28.2	36.7	22.1	5.7	5.4
2008	27.1	34.6	23.7	5.8	6.2
2009	23.9	33.9	30.6	6.6	2.8
2010	25.4	36.5	26.7	5.9	3.9
2011	26.3	38.3	25.9	4.9	3.7

Source: State Statistics Service of Ukraine

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



Source: State Statistics Service of Ukraine

Furthermore, Ukraine's trade and current account balance deteriorated substantially in 2000-2008. According to the IMF WEO database, Ukraine's current account deteriorated from a surplus of 10.6% of GDP in 2004 to a deficit of 7.1% of GDP in 2008. This radical shift in the balance of payments was caused by several factors, some of them beyond the control of Ukrainian authorities (like higher prices of imported energy or acceleration of capital inflows after 2004) but others related to lax monetary and fiscal policies. As a result, the deterioration of its current account balance added to the country's macroeconomic vulnerability. When the world economy was hit by the consequences of the global financial crisis in 2008-2009, several emerging-market economies experienced a sudden stop of capital inflow and a resulting liquidity crisis. In the case of Ukraine this was the second major external shock

(http://www.bank.gov.ua/files/1-Macroeconomic_indicators.xls#'1.1'!A1) (apart from losing a substantial part of export markets) which determined the extreme depth of the 2009 recession[2].

In terms of geographic structure, the CIS (mostly Russia) and EU27 (main partners: Italy, Poland and Germany) are the main export markets for Ukrainian goods (see Table 1). The highest share of the EU in foreign trade of Ukraine was recorded in 2003 (see Figure 1). Since 2003 the share of Ukraine's merchandise exports to the EU27 has been declining (from 38% in 2003 to 26% in 2011). On the contrary, exports to CIS countries grew from 25% in 2002 to 38% in 2011 of the total, of which Russia's share was 29% and other CIS countries – 9%. CIS countries remain the major markets for Ukrainian exports of machinery, vehicles, transport equipment and food products and demand for these products grew rapidly in the 2000s.

On the imports side (see Table 2), CIS countries (mostly Russia) are the most important partners although their share in total merchandise imports has gradually decreased from 57.5% in 2000 to 39.0% in 2008 (to increase again to 45% in 2011). The EU comes second with a share exceeding 30% and the highest share recorded in 2007 (36.7%). Asian countries (mostly China) occupy the third place and their role has been grown considerably in the previous decade.

Table 2: Ukraine's geographic structure of merchandise imports, % of total

Year	EU	CIS	Asia	Africa	America
2000	28.9	57.5	6.0	1.0	4.2
2001	30.1	55.9	6.2	1.3	4.7
2002	32.4	52.7	7.0	1.0	5.0
2003	34.2	49.8	8.7	1.1	4.7
2004	32.9	52.4	8.9	1.0	3.3
2005	33.7	47.0	13.0	1.2	3.5
2006	36.0	44.7	13.6	0.9	3.3
2007	36.7	42.0	14.9	1.1	3.7
2008	33.8	39.0	18.1	1.8	4.9
2009	33.9	43.3	14.4	1.4	4.8
2010	31.4	44.0	16.5	1.4	4.7
2011	31.2	45.0	16.1	1.1	4.7

Source: State Statistics Service of Ukraine

[2] As a result of the global financial crisis and recession, Ukraine's current account deficit contracted to 1.5% of GDP in 2009 and to 2.1% of GDP in 2010 (according to the IMF WEO data) but then it started to rise again.

3.2. Volume and structure of Ukraine-EU trade

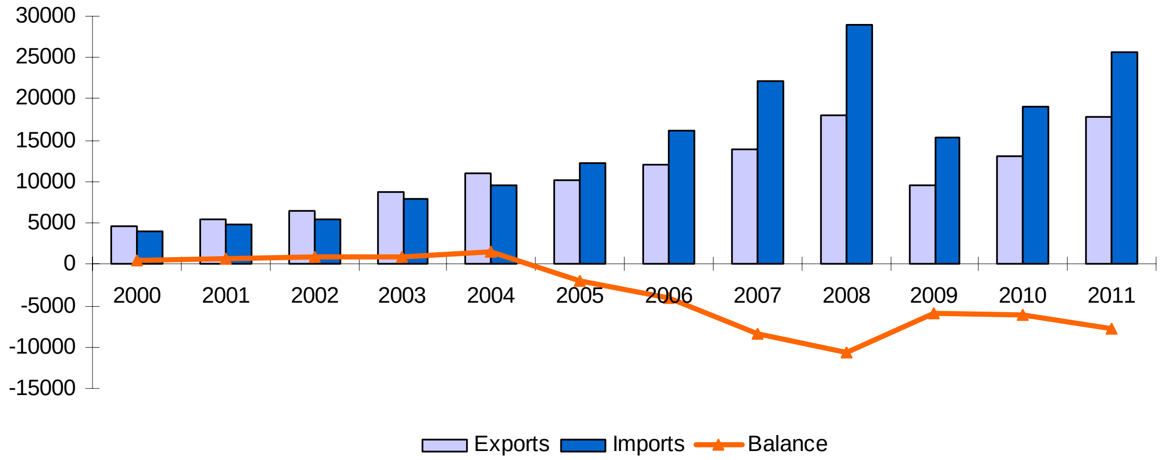
Table 3 and Figure 2 illustrate the dynamics of Ukraine's merchandise trade with the EU27. It increased rapidly in 2000-2008 – four-fold on the export side and seven-fold on the import side. As a result, in the same period the trade balance deteriorated from a small surplus (of ca. USD 0.5 billion in 2000) to a large deficit close to USD 11 billion in 2008.

Table 3: Ukraine's merchandise trade with the EU27 in USD million

Item	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Exports	4,561.0	5,506.3	6,376.2	8,685.4	11,009.6	10,233.4	12,087.9	13,916.4	18,129.5	9,499.3	13,051.9	17,969.9
Imports	4,039.3	4,748.1	5,505.4	7,864.5	9,547.4	12,191.9	16,194.6	22,218.7	28,868.4	15,392.7	19,101.2	25,750.6
Balance	521.7	758.2	870.8	820.9	1,462.2	-1,958.5	-4,106.7	-8,302.3	-10,738.9	-5,893.4	-6,049.3	-7,812.5

Source: State Statistics Service of Ukraine (data were recalculated for 27 EU members)

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



Source: State Statistics Service of Ukraine

The global financial crisis and recession in 2009 brought a serious correction of the previous trends with a decline in Ukraine's exports to the EU27 by 47.6% and imports by 46.7%. In the next two years (2010-2011), trade flows largely recovered to pre-crisis levels.

Ukraine 's exports to the EU continue to be concentrated in iron and steel, ore, agricultural products, energy, and chemicals (see Table 4) although the role of raw materials, chemicals and related products decreased somewhat in the 2000s. On the other hand, the importance of machinery and transport equipment has been steadily increasing, reaching 12.5% of total exports in 2010. The same concerned food products and live animals, animal and vegetable oils, fats, and waxes. EU exports to Ukraine are dominated by machinery, transport equipment, pharmaceuticals, other chemicals, plastics and paper (see Table 5).

Table 4: Ten largest commodity groups of Ukraine's exports to EU27, 2010, HS 2-digit

HS code	Product description	million USD	% of total exports
72	Iron and steel	3,826.0	29.3
26	Ores, slag and ash	1,416.4	10.9
85	Electrical machinery and equipment	1,236.7	9.5
27	Mineral fuels, mineral oils and products of their distillation	887.9	6.8
12	Oil seeds and oleaginous fruits; miscellaneous grains, seeds and fruit	704.4	5.4
15	Animal or vegetable fats and oils	631.9	4.8
44	Wood and articles of wood	513.2	3.9
62	Articles of apparel and clothing accessories not knitted or crocheted	405.4	3.1
84	Machinery and mechanical appliances	386.7	3.0
73	Articles of iron or steel	266.8	2.0
	Total	10,275.4	78.7

Source: State Statistics Service of Ukraine

The EU is Ukraine's biggest partner in trade in services. In contrast to merchandise trade, Ukraine has recorded a positive balance in trade in services with the EU (except in 2009). In 2011, exports of services to the EU reached USD 3.57 bln (26.1% of Ukraine's total exports of services) and imports reached USD 3.35 bln (53.6% of the total). The main service export items in trade with the EU are transport services (57.4% of the total) and other business, professional and technical services (22.2%). On the imports side, transport services (22.6%), financial services (21.2% of the total), and other business, professional and technical services (17%) are the dominating items.

Table 5: Ten largest commodity groups of Ukraine's imports from EU27, 2010, HS 2-digit

HS code	Product description	million USD	% of total imports
84	Machinery and mechanical appliances	2,107.7	11.0
85	Electrical machinery and equipment	1,786.5	9.4
30	Pharmaceutical products	1,634.5	8.6
39	Plastics and articles thereof	1,547.5	8.1
87	Vehicles other than railway or tramway rolling-stock	1,515.1	7.9
27	Mineral fuels, mineral oils and products of their distillation	1,221.3	6.4
48	Paper, paperboard and articles thereof	1,010.3	5.3
38	Other chemical industry products	621.9	3.3
33	Essential oils; perfumery, cosmetic or toilet preparations	500.1	2.6
90	Optical, photographic, cinematographic, measuring and other instruments	410.5	2.1
	Total	12,355.4	64.7

Source: State Statistics Service of Ukraine

Table 6 compares the shares of intra-industry trade (IIT) in Ukraine and the EU, which differ approximately by a factor of two. Usually countries with diversified industrial bases and involved in deep trade and investment integration with their partners record higher levels of IIT. The expansion of IIT is an indication that a given country has succeeded in entering international value chains and attracting strategic foreign investors. The level of IIT in bilateral trade between Ukraine and the EU is even lower suggesting that there is little evidence of deep economic integration between both partners at the moment. In addition, it signifies a non-significant overlap between Ukraine and the EU trade and production patterns.

Table 6: Share of intra-industry trade, 2008, in % of total trade

	Ukraine		EU	
	Total	Manufacturing	Total	Manufacturing
3-digit SITC level	34.5	37.4	77.0	67.7

Source: UN Comtrade, 3-digit SITC level, own calculations.

3.3. Foreign direct investments

In the 1990s and in the first half of the 2000s, Ukraine, like most other countries in the former USSR lagged seriously behind Central Europe and Baltic countries in attracting FDI. This was caused by a lack of sufficient macroeconomic stability, a delay in market-oriented reforms and a generally poor business and investment climate. The situation started to change after the Orange Revolution in 2004. In 2005, FDI almost doubled due to the re-selling of Kryvorizhstal to Mittal Steel (Germany) and acquisitions of Ukrainian banks by EU banks. In subsequent years, more foreign investments came to industry and services, especially financial services in the form of acquisitions of Ukrainian banks by foreign financial groups. Fortunately, unlike in some other countries, the global financial crisis in 2008 and 2009 did not reverse this trend (though the FDI inflow slowed down noticeably). On the contrary, several “mother” European banks contributed to the recapitalization of their Ukrainian subsidiaries during that period.

Table 7: Foreign direct investment in selected countries, inward stock

Country	USD per capita [a]		Percentage of GDP	
	2007	2009	2007	2009
EaP countries + Russia				
Armenia	797	1,177	26.6	41.6
Azerbaijan	990	1,024	25.8	21.0
Belarus	461	878	9.9	17.2
Georgia	1,229	1,771	52.7	70.3
Moldova	504	723	42.0	48.2
Russia	3,461	1,792	38.0	20.3
Ukraine	822	1,138	26.7	45.0
EU NMS				
Bulgaria	4,955	6,724	95.7	107.7
Cyprus	23,484	33,771	84.9	116.1
Czech Republic	10,947	11,177	64.6	59.2
Estonia	12,493	12,123	80.3	86.3
Hungary	19,809	24,886	143.2	192.8
Latvia	4,779	5,213	37.7	44.8
Lithuania	4,488	4,210	38.7	37.0
Malta	20,642	23,037	112.4	120.0
Poland	4,679	4,801	42.0	42.5
Romania	2,935	3,478	37.2	46.1
Slovakia	8,389	9,297	60.3	56.8
Slovenia	7,151	7,542	30.5	31.2
EU candidates and potential candidates				
Albania	792	1,121	22.8	28.5
Bosnia and Herzegovina	1,822	2,075	45.5	45.9
Croatia	10,175	8,288	76.9	58.1
Macedonia	1,833	2,208	47.2	51.7
Montenegro	_	7,336	_	105.1
Serbia	_	2,090	_	42.3
Turkey	2,097	1,039	23.3	12.4

Note: [a] - at current prices and current exchange rates
Source: http://unctadstat.unctad.org/TableViewer/tableView.aspx (accessed on March 7, 2011)

However, as seen in Table 7, Ukraine continues to underperform in attracting FDI as compared to EU new member states and most EU actual and potential candidates in South Eastern Europe. Furthermore, as demonstrated by Kudina and Jakubiak (2011), FDI in Ukraine and other post-Soviet countries differs from that in EU NMS and EU candidate countries: foreign investors in the former predominantly seek domestic market opportunities in the host country (with most production supplies coming from abroad) rather than efficiency considerations (low-cost opportunities for developing global production chain)[3]. Therefore, the potential innovation and efficiency spillovers to domestic producers are limited. This strategy is due to a continuous poor business climate in countries of the former USSR.

[3] This corresponds with the low share of IIT analyzed in Section 3.2

The EU investment stock in Ukraine as of the end of 2011 amounted to USD 39.4 billion, or 79.8% of total inward stock. The three major EU countries of origin are: Cyprus (32.1%), Germany (18.7%) and Netherlands – (12.2%). The high share of Cyprus indicates, most likely, the substantial role of Russian, Ukrainian and other CIS capital domiciled in this country.

In terms of sectoral structure, FDI is mostly concentrated in the field of industrial production and in the financial sector (33.4% and 33.1% of total inward FDI stock, respectively). As mentioned before, thanks to a high share of European ownership in the Ukrainian banking system, FDI from the EU continued to flow in during the financial crisis in order to recapitalize the Ukrainian subsidiaries of the EU “mother” banks.

4. Trade Regime between Ukraine and the EU

4.1. Partnership and Cooperation Agreement

Trade and economic relations between Ukraine and the EU have been based so far on the PCA signed in June 1994, which entered into force on March 1, 1998.

All PCAs signed between the EU and countries of the former Soviet Union in the 1990s have been relatively modest in the area of economic integration. The most important provision has related to the Most Favored Nation (MFN) clause in bilateral trade. In addition, some technical, legal and institutional cooperation in such sectors as transportation, energy, competition policy, some legal approximation in the areas of custom law, corporate law, banking law, intellectual property rights, technical standards and certification, etc. have also been included. However, the PCAs have lacked sufficient incentives (like those offered to countries of Central and Eastern Europe at the same time) to encourage CIS countries to move faster in the area of regulatory and institutional harmonization with the EU.

These shortcomings of the PCAs were openly recognized in the official communication of the European Commission (2003): “*In contrast to contractual relations with all the EU’s other neighboring countries, the Partnership and Cooperation Agreements (PCAs) in force with Russia, Ukraine and Moldova grant neither preferential treatment for trade, nor a timetable for regulatory approximation*.”

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.

However, this decision did not eliminate the use of commercial defense instruments between both partners. As of April 2010, there have been six anti-dumping measures adopted by the EU against the products originating from Ukraine. In Ukraine, there have been three anti-dumping measures against products from selected EU countries, and six safeguard measures concerning all trade partners including the EU.

4.2. Generalized System of Preferences

In addition to PCA, since 1993 Ukraine has been a beneficiary of GSP, the unilateral trade promotion program addressed by the EU to developing countries¸ which allows for lower duties than the MFN rates on over 6,000 products. Currently there are two categories of products covered by this scheme: non-sensitive, for which duties are suspended, and sensitive, for which rates are reduced. The scheme allows for a high proportionate reduction for most industrial products, but relatively low reductions for agricultural products. Preferential EU imports include chemicals, plant oils, minerals, base metals, machinery, and mechanical appliances. Although less than 25% of Ukraine's exports to EU are eligible for GSP, their rate of utilization is very high, close to 100% in some years (Gasiorek et al., 2010).

In 2010, the GSP utilization rate accounted for 72.2% of eligible products. With €2.15 billion of GSP imports to the EU, Ukraine ranks 12th among the most effective users of the system[4].

Due to its income status, Ukraine is not eligible for more generous unilateral trade preferences such as GSP+ or the Everything but Arms (EBA) regimes, which are enjoyed, for example, by Southern Caucasus countries.

4.3. Consequences of Ukraine's WTO membership

The Ukraine-EU trade regime was further liberalized when Ukraine joined the WTO in 2008. Ukraine's tariff protection was significantly lowered as a result of WTO accession. Ukraine's simple average MFN tariffs were bound at 5.8% for all products (11% for agricultural

[4] http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/ukraine/

products and 5% for non-agricultural products)[5]. The EU quotas on rolled metal imports from Ukraine were cancelled and currently there are no quantitative restrictions on trade between Ukraine and the EU.

Ukraine agreed to gradual reductions on a number of export 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%).

Regarding the NTB in trade between Ukraine and EU, technical barriers to trade (TBT) and sanitary and phyto-sanitary (SPS) measures continue to play the most important role. When entering the WTO, Ukraine made a commitment to reform its food safety and technical regulation systems, including aligning Ukrainian technical regulations with relevant international and European standards by the end of 2011. All existing national and regional standards in Ukraine should be voluntary. The technical regulation reform will allow Ukraine to avoid the mandatory certification of a broad list of products and, thus, will facilitate external trade.

However, according to the State Committee for Technical Regulation and Consumers Protection (now the State Inspection of Ukraine for Consumer Protection), as of the end of 2010, only some 25% of national standards were harmonized with the EU and international standards (Movchan & Shportyuk, 2010). Unfortunately, at the end of 2011, the deadline for technical regulations harmonization was missed. Other NTBs include burdensome and inefficient customs procedures, government procurement rules, regulatory policy, etc.

Summing up, although the current trade regime between Ukraine and the EU has been quite liberalized after WTO accession and under the GSP, it continues to maintain serious tariff and especially non-tariff barriers.

4.4. Towards the DCFTA with the EU

In March 2007, Ukraine and the EU started negotiations on a new enhanced agreement in order to replace the PCA. Since the Paris EU-Ukraine Summit in September 2008 the negotiated agreement was upgraded to the Association Agreement (AA), which would include the DCFTA as an integral part.

[5] According to the WTO, in 2010 Ukraine's simple applied MFN tariffs were lower than Ukraine's tariff commitments and equaled 4.6% for all products, including 9.8% for agricultural products and 3.8% for non-agricultural products, - see http://stat.wto.org/TariffProfile/WSDBTariffPFView.aspx?Language=E&Country=UA

On February 5, 2008 the WTO General Council approved Ukraine's accession to this organization. At this time, the EU and Ukraine commenced talks on a DCFTA, which covered a wide range of trade-related matters and "behind the border" obstacles to trade. The latter were to be removed through regulatory approximation with the trade-related EU *acquis*, which would lead to a partial opening of the EU's internal market to Ukrainian enterprises. The negotiations were conducted in 18 working groups related to the following thematic areas:

A. Trade in goods

- tariff offer,
- trade in goods, including TBT,
- trade protection instruments,
- SPS measures,
- trade facilitation,
- customs cooperation and administrative cooperation on customs matters,
- rules of origin,
- trade relations in energy sector.

B. Services, establishment, investment, and capital movements:

- services, right of establishment, and investments, capital movement, and current payments,

C. Rules of trade:

- intellectual property rights,
- geographical indications,
- competition policy: anti-monopoly measures,
- competition policy: state aid,
- public procurement,
- trade and sustainable development,
- dispute settlement,
- dispute settlement in energy,
- transparency of regulations.

Although both the AA and DCFTA between Ukraine and the EU were agreed upon in December 2012 and the text of the AA was initiated on 30 March, 2012, very little is officially known about their content and the details of the negotiation process. Due to the scarcity of official information, we had to rely on second-hand sources of information such as public statements by official figures and the media, while being aware of their imperfection.

Regarding the DCFTA, the most difficult negotiation problems seemed to be related to the following issues:

1/ Free access to the EU agriculture market: the EU wanted to continue import barriers on several agricultural products which resulted from the existing mechanism of the EU Common Agriculture Policy (CAP) while Ukraine, as a large agriculture producer, 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/ Export subsidies and domestic support to agriculture: the EU wanted to observe the WTO commitments of both sides, while Ukraine (due to insufficient budget resources and stricter WTO commitments than those of the EU) was interested in reducing the level of EU support, including abolishing EU export subsidies.

3/ Import protection of "sensitive" sectors/ industries: Ukraine wanted to continue import protection, at least temporarily, for "sensitive" industries, especially the car industry. The lobby of car producers is very strong in Ukraine and already feels it is suffering after Ukraine's WTO accession (when Ukraine's import tariffs were reduced from 25 to 10%). In the beginning of the DCFTA negotiation, the EU demanded the total elimination of Ukraine's import tariffs for cars imported from the EU while Ukraine proposed a 10-year transition period. Finally, it looks like Ukraine's position was at least partially accepted: import tariffs for cars will be gradually reduced throughout a 10 year period and Ukraine will retain the right to adopt safeguard measures if car imports increase rapidly.

4/ Ukraine's export tariffs: the EU demanded the removal of all remaining tariffs (see Section 4.3) while Ukraine was reluctant to do so. In the end, it looks like the EU gave in, at least partly, to Ukraine's demands and accepted the idea of a long transition period (10-15 years) in which export tariffs would be gradually reduced to zero.

Fairly speaking, this is a very controversial and distortive instrument of industrial policy which spoiled Ukraine's relations with the international community and international financial organizations (IFIs) from the very beginning of the transition process. The purpose of export tariffs is to indirectly subsidize both domestic producers who use these raw materials and consumers by keeping domestic prices below the international level. This is also a source of budget revenues.

5/ Geographical Indications (GIs): the EU demanded protection for some 3,000 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/ Trade aspects of energy cooperation: the EU demanded guarantees of the safe and uninterrupted transit of natural gas through Ukraine. 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/ Transportation services: 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 a result, Ukraine will have to rely on bilateral agreements with individual EU member states.

4.5. Political economy of the negotiation process

One must be aware that the political economy and politics of the negotiation process were not easy, particularly on the Ukrainian side. This was related to the different sizes of actual trade barriers on both sides at the start of the negotiations.

The EU import tariffs for manufactured goods are low by international standards, much lower than in the case of Ukraine. The same concerns NTB which are much higher in Ukraine. This asymmetry has been additionally amplified by the GSP. As a result, Ukraine had to offer much bigger concessions in the trade of manufactured goods than the EU in order to build a truly deep free trade area. The same concerns liberalization of investment regimes.

Even if such an asymmetrical liberalization is beneficial for the economy of Ukraine and Ukrainian consumers in the long term (see Section 5), it will bring substantial adjustment costs for certain sectors in the short-to-medium term. It can be also considered unfair in political discussions and from the point of view of the very logic of any negotiation process (negotiators usually tend to minimize unilateral concessions and try to achieve a balanced agreement).

The bigger relative concessions of the Ukrainian side in respect to trade in manufactured goods, services and investments could be at least partly compensated by longer transition periods for the liberalization of Ukrainian sensitive markets, as well as a more generous opening of the EU market for agriculture products for Ukrainian exporters. The latter, however, seems impossible as far as the CAP continues to exist in the current form. Another incentive, which played a very powerful role in negotiating TAAs and SAAs with the countries of Central Europe and the Western Balkans, i.e., a potential chance of EU membership (even in the very distant future) was also ruled out by the EU side.

An analysis of the geographical structure of Ukraine's trade (see Section 3.1) suggests another potential difficulty related to political economy and politics of the negotiated trade deal. Unlike in the case of the current EU NMS in the 1990s and the EU candidates now, for Ukraine the EU is the second largest trade partner after CIS countries. This may change in the future as a result of trade creation and trade divergence effects of the DCFTA. However, the current geographical structure of trade generates the map of economic interests both within Ukraine and outside (among its CIS trade partners, especially in Russia) which do not always favor closer Ukraine – EU trade and economic relations. These interests had to be taken into consideration by both sides of negotiations. The EU can neutralize the concerns of Ukraine's trade partners in the CIS, especially Russia, related to the potential trade divergence effect of EU-Ukraine DCFTA by offering them similar trade arrangements (see Emerson et al., 2006, p. 66) in the near future[6].

Regardless of the complicated political economy of the negotiation process itself and the deep internal political conflict in Ukraine between the current president and government and the major opposition party (*Bloc Yulia Tymoshenko-Batkivschyna*) the perspective of ratification of the DCFTA by the Ukrainian parliament seems to be unthreatened. Both the Party of Regions, which is currently in power, and the opposition parties represented in

[6] Again this would follow the experience of TAAs and SAAs which were negotiated and signed parallelly with the entire regional group of countries. Furthermore, countries which signed TAA or SAA with the EU were encouraged to negotiate the respective FTAs among themselves (the example of CEFTA).

parliament (with the exception of the Communist Party of Ukraine) continue to support both the AA and the DCFTA as documented by numerous recent political statements (including those of Yulia Tymoshenko).

There is a much bigger ratification risk on the EU side,[7] which has been caused by the negative perception of political processes in Ukraine after the 2010 presidential election. Thus if the Ukrainian authorities want to have the AA and DCFTA signed and then ratified smoothly they must respect European democratic standards, political freedoms and democratic institutions, demonstrate improvement in the rule of law and ensure democratic parliamentary elections in October 2012.

5. Potential Benefits of the DCFTA

5.1. General remarks

It is widely expected that the DCFTA will decrease/ eliminate existing trade barriers in bilateral trade between Ukraine and the EU and will bring important net benefits to both sides such as trade and investment creation, welfare and employment gains, improved market competitiveness, etc., even if individual sectors/ industries will contract as a result of stronger competition.

Saying that, we will concentrate our further analysis on the costs and benefits for Ukraine. There are two reasons for such an analytical approach. First, by its nature, the expected net benefits will be asymmetrical – much higher for Ukraine than for the EU. This is determined by the uneven size of the partners and their shares in bilateral trade. While in Ukraine the share of trade with the EU oscillates around 30% (depending on the year – see Section 3.1), for the EU, Ukraine accounts for only 1% of its total external trade (Eurostat data for 2010). Furthermore, as we explained in Section 4.5, Ukraine will have to undertake a more substantial trade and investment liberalization agenda (including far-reaching regulatory and institutional harmonization) than the EU, so the DCFTA impact on Ukraine will be more serious also for this reason. Second, most of the existing quantitative analyses focus on the benefits and costs of EU-Ukraine DCFTA for Ukraine.

The main benefits of the DCFTA for the Ukrainian economy can be characterized as follows (see IER, 2010 for more details):

- 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 IIT;
- 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 (see Section 6);
- 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.

5.2. Quantitative estimation of overall welfare effect

Quantitative analyses of the potential impact of DCFTA usually employ computable general equilibrium (CGE) modeling. Most of them have been based on pre-WTO-accession, pre-DCFTA-negotiation and pre-crisis data[8] so their results do not necessarily fully reflect the current outlook. The additional reason for caution comes from the fact that the exact content of the negotiated DCFTA is unknown yet. It may be that as a result of negotiation compromises (see Section 4.4), the actual agreement will fall short of the deep FTA concept as elaborated in the literature and assumed in most quantitative analyses. This would mean smaller actual net benefits than predicted by CGE modeling exercises.

Although individual studies differ in terms of assumptions, baseline scenarios, model details, timing of dataset used and analyzed variables, they come to a similar conclusion: a "deep" FTA will have a much more meaningful impact on economy of Ukraine than a "simple" FTA, i.e. when only tariffs are reduced/ removed.

[7] The ratification procedure on the EU side will involve both the European Parliament and 27 national parliaments.
[8] Some of them used also pre-EU-enlargement trade data.

Below we provide an overview of selected studies:

1. Emerson et al. (2006, pp. 5, 211-213), whose study was based on the 2001 GTAP dataset, offered an optimistic projection. According to the authors, a deep free trade agreement "*…could deliver welfare gains of the order of 4-7% according to comparative static simulations; taking into account dynamic effects, welfare gains over time could be twice or three times as large. In addition, a reduction in the cost of capital could lead to a further 4-5% welfare gain. Ukrainian exports to the EU could double, and EU exports to Ukraine could also grow very substantially.*" The welfare effects for the EU could also be positive but negligible, in the range of 0.03% for the EU15 and ca. 0.2% for those EU NMS which joined the EU in 2004 (both are long-term gains).

2. Ecorys (2007, p. 20) estimates short-term welfare gains coming from an "extended" FTA (including the effects of Ukraine's WTO accession) of 2.26% and the long-term cumulative gains – of 5.29%. The respective estimates for the EU27 amount to 0.030% in the short run and 0.071% in the long run.

3. Francois and Manchin (2009, p. 118) offer the most pessimistic outlook. According to their projection, a "full" FTA (i.e. equivalent to "deep" FTA in other studies) will bring Ukraine real income loses of 0.4% due to a deterioration of its terms of trade (as a result of scrapping import tariffs). However, a "partial" FTA (equivalent to a "simple" FTA in other studies) would bring even bigger real income loses which would mean that the net effect of removing the NTB will be positive. On the other hand, the real income of the EU will increase by 0.21% under a "full" FTA and by 0.13-0.14% under a "partial" FTA (depending on its exact variant).

4. Maliszewska, Orlova & Taran (2011, p. 55) estimate the effect of removing the NTB, which should give Ukraine a welfare gain of 5.8% in the long run.

5. In a recent study, Movchan & Shportyuk (2011) offer again an optimistic projection of the DCFTA effect for Ukraine. They estimate static (short run) welfare gains of 4.3% and steady state (long run) gain of 11.8%.

The studies by Maliszewska, Orlova & Taran (2011) and Movchan & Shportyuk (2011) do not contain estimates of welfare effects for the EU.

5.3. Quantitative estimation of sectoral effects

Most of the quantitative studies presented in Section 5.2 (all but Movchan & Shportyuk (2011)) also contain some projections of the sectoral effects of the DCFTA or similar arrangements. However, with one exception (Ecorys, 2007) they have been done for the Ukrainian economy only. All the reasons for methodological caution presented in Section 5.2 hold in this case. Furthermore, by their nature, estimations of sectoral effects are even more sensitive to potential data imperfections than estimations of aggregate welfare or income effect (where sectoral data mistakes with various signs can sometimes compensate each other).

Below we provide an overview of available estimates:

1. Emerson et al. (2006, p. 213) found the production of minerals and agriculture as the main Ukrainian losers in the case of a “deep” FTA in the long term. They identified metallurgy, food processing, light manufacturing, heavy manufacturing, and services as the main winners. There is no sectoral impact analysis for the EU apart from a narrative suggestion that some industries such as textiles may benefit from including Ukrainian producers into their value chains.

2. According to Ecorys (2007, p. 157-158), the projection of long-term output changes resulting from an “extended” FTA suggests that mineral production, meat products, processed rice, sugar, transport equipment and financial services would be the main losers on the Ukrainian side while dairy and other food products, textiles, wearing apparel, leather, wood, paper, petroleum, coal, chemical, rubber, plastic and metal products, motor vehicles and parts, electronic and machinery equipment, publishing, construction and trade services should record output gains on a varied scale. On the EU side, the only substantial (positive) change may relate to the sugar industry.

3. According to Francois and Manchin´s (2009, pp. 118-119) estimations of changes in sectoral outputs (limited to Ukrainian economy only), the textiles and apparel sector will be the only clear winner while food processing, light manufacturing, and “other services” will be moderate losers.

4. According to estimates by Maliszewska, Orlova & Taran (2011, p. 56) of the effects of removing NTB on Ukraine’s economy, ‘textiles and textiles products’, ‘leather’ and ‘wood products’ would gain from a DCFTA while the output of ‘manufactures NEC’

and 'transportation and storage' would contract. There is no estimation of sectoral effects for the EU.

6. Beyond the DCFTA: Improving the Business and Investment Climate in Ukraine

Since the collapse of the Soviet Union in 1991, Ukraine has gone through a painful and sometimes turbulent process of building its independent state and market economy. The results of this effort are mixed: Ukraine has never been considered a fast and effective reformer. Reform efforts undertaken by subsequent presidents and governments, even if well designed, did not bring the expected results due to slow and inconsistent implementation[9].

The unsatisfactory results of reforms are reflected in Ukraine's poor business reputation, as demonstrated by several global comparative rankings. Table 8 presents the recent results of three important rankings: World Bank (WB) Doing Business 2012, Transparency International Corruption Perception Index 2011 and World Bank (WB) Logistics Performance Index 2010. In all three rankings, Ukraine occupies very distant positions, even in comparison with other CIS countries. Even more importantly, the situation has not improved over the last decade in spite of the various reforms attempted by subsequent governments. In 2011, Ukraine's WB Doing Business and TI Corruption Perception indices further deteriorated.

[9] Analyzing the 20-year history of economic and institutional reforms in Ukraine and the reasons for their less than satisfactory results falls beyond the agenda of this paper. However, there is a large body of literature addressing these issues in more details – see e.g. Aslund (2009) or Dabrowski (2007).

Table 8: International indices of business and investment climate

Country	WB Doing Business 2012	TI Corruption Perception Index 2011	WB Logistic Performance Index 2010
Ukraine	152	152	102
Russia	120	143	94
Belarus	69	143	-
Kazakhstan	47	120	62
Armenia	55	129	111
Georgia	16	64	93
Azerbaijan	66	143	89
Moldova	81	112	104
Poland	62	41	30
Romania	72	75	59
Hungary	51	54	52
Croatia	80	66	74
Estonia	24	29	43
Latvia	21	61	37
Lithuania	27	50	45

Notes: WB Doing Business 2012 - economies are ranked based on their ease of doing business, from 1 - 183, with first place being the highest. Transparency International Corruption Perception Index 2011 - from 1 - 183, with first place being the highest. WB Logistic Index 2010 - from 1 - 155, with first place being the highest.

Sources: http://www.doingbusiness.org/, http://info.worldbank.org/etools/tradesurvey/mode1c.asp¸ http://cpi.transparency.org/cpi2011/results/#CountryResults

The third ranking is particularly important in the thematic context of this paper because it is directly related to the technical and institutional infrastructure of trade. Table 9, which provides a disaggregation of the WB Logistic Index, clearly demonstrates Ukraine's poor performance in several areas, in particular, customs bodies and procedures (135th rank), timeliness of shipments (114th rank), and ability to track and trace consignments (112th rank).

More generally, Ukraine's poor business and investment climate results from various institutional and systemic deficiencies such as barriers to market entry (for example, registration and licensing regimes), an excessive number of administrative permissions and administrative inspections, non-transparent tax and customs systems and their poor administration (especially in respect to VAT[10]), unstable and non-transparent legal system and its poor implementation, weak and corrupted public administration and judiciary, weak contract enforcement and insufficient property rights protection, excessive prerogatives of law enforcement agencies, underdevelopment and monopolization of infrastructure. Many of these problems have their roots in the unreformed post-Soviet state which continues to perform several functions typical for a command economy and non-democratic political regime. The Ukrainian state apparatus continues to interfere in the details of business activity and the day-to-day life of its citizens while it is unable to provide them basic public goods such as law and

[10] Numerous flaws of VAT refunding mechanism have persisted since at least the end of the 1990s despite several attempts to solve this problem.

order, security, judiciary, equal and fair treatment of all citizens and firms, basic technical and social infrastructure, etc.

Table 9: World Bank's Logistics Performance Index 2010

Countries	Overall LPI	Customs	Infrastructure	International shipments	Logistics competence	Tracking & tracing	Timeliness
		Efficiency of the clearance process by border control agencies, inc. customs	Quality of trade and transport related infrastructure	Ease of arranging of competitively priced shipments	Competence and quality of logistics services	Ability to track and trace consignments	Timeliness of shipments in reaching destination
Ukraine	102	135	79	84	77	112	114
Poland	30	34	43	35	36	33	2
Slovakia	38	47	42	57	41	31	34
Romania	59	85	99	34	66	66	73
Hungary	52	45	38	86	53	71	62
Turkey	39	46	39	44	37	56	31
Kazakhstan	62	79	57	29	73	85	86
Russia	94	115	83	96	88	97	88

Source: http://info.worldbank.org/etools/tradesurvey/mode1c.asp

The DCFTA can help to resolve some of these problems, for example, by reforming trade related technical regulations, customs procedures or 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 judiciary. By its very nature, even the most ambitious trade agreement focuses on the non-discrimination of imports vis a vis domestic production and foreign investors vis a vis domestic ones. The broader institutional issues can be addressed in some way in the AA but its potential is also limited, especially if it does not offer an EU membership perspective.

Thus, both the AA and DCFTA can, to a certain degree, be helpful instruments in improving business and investment climate and moving towards the “Europeization” of the Ukrainian state and economy but they cannot be substitutes for domestic reform efforts on various fronts. If such reforms are not conducted in a decisive way, the implementation of both agreements may prove disappointing.

Conclusions

The negotiations on AA and DCFTA between the EU and Ukraine have reached their end and both agreements are waiting to be signed and then ratified. The DCFTA is a relatively new concept in EU external trade policy based on the experience of building the Single European Market, the EEA and trade agreements between the EU and the prospective EU candidates. Although designed mostly for the purpose of the ENP and EaP it was also adopted, at least partly, in the EU's trade negotiations with other major external partners such as Chile, Korea, Canada or India. If signed and ratified, Ukraine will soon be the pioneer of such an arrangement among the Eastern neighbors of the EU.

As the detailed content of the DCFTA between the EU and Ukraine is not known publicly yet and the timetable of its signing and implementation remains under question, it is very difficult to assess its actual degree of "deepness" and "comprehensiveness". Nevertheless, the economic literature, CGE modeling exercises and the practical experience of "deep" trade integration suggest the substantial potential of such an agreement in promoting trade and investments, creating additional welfare and employment, regulatory and institutional harmonization with EU's acquis, and modernization of the economy of an EU trade partner (especially if the partner country is less developed as compared to the EU average). While beneficial for both sides, the potential gains (as well as the potential adjustment costs) are bigger for the EU partner.

However, even if the DCFTA is "deep" and "comprehensive," this does not guarantee 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. If the economic, political and institutional reforms are not accelerated and conducted in a more comprehensive and consistent manner, the prospect of implementing the DCFTA (and the potential gains coming from this agreement) will come under question.

The DCFTA between the EU and Ukraine will be the first ever FTA concluded between the EU and a CIS country. For this reason it is an important experience for the EU. Its lessons may be useful, to some extent, in the recently launched trade negotiations with Georgia, Moldova and perhaps in future negotiations with Russia and Armenia. All countries of the former USSR share the same historical and institutional background and have faced similar challenges in their political and economic transitions in the last two decades. However, they differ greatly among themselves in terms of size, income level, economic and trade structures, trade regimes, progress in economic reforms, political regimes, geographic location, foreign policy preferences and many other parameters.

Trade negotiations with smaller and less industrialized economies such as Georgia, Moldova and Armenia may be easier in respect to manufacturing trade (less protectionist pressure to defend domestic producers) but more complicated on other issues such as agriculture trade (which plays an important role in the exports of these countries, especially wines and vegetables) or short-term labor migration. Both issues may be considered sensitive from the EU perspective. On the contrary, in future trade negotiations with the EU, Russia may represent some similar structural and institutional issues to those of Ukraine. This concerns, for example, the substantial role of metal and chemical exports, the temptation to defend its car industry, and difficulties in improving its poor business climate.

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