

How Important is the DCFTA for Ukraine? An Appraisal

In the very near future a decision is going to be made on whether the deep and comprehensive free trade agreement (DCFTA) can be signed in the autumn as part of an Association Agreement between the EU and Ukraine. Against this backdrop the question arises as to whether or not the DCFTA is of strategic significance for Ukraine or merely of minor importance.

Although customs duties are already low on both sides, EU-Ukraine trade still has to deal with significant trade barriers in the shape of product standards, certification and regulatory approval. A major feature of the DCFTA is that it noticeably reduces these non-tariff barriers to trade. This leads to more external trade, and makes an important contribution to combating corruption, to improving the business climate, and to attracting more foreign investment.

Furthermore, the DCFTA excludes Ukrainian membership of the Customs Union that links Russia, Belarus and Kazakhstan, and thus in our opinion will prevent Ukraine from making an incorrect strategic decision. Finally, the DCFTA will have a positive distributional impact that will be of benefit to the wider population.

The implementation of the DCFTA will certainly not proceed in a straight line and will have to overcome numerous difficulties. However, we believe that there will be a noticeable improvement in the overall situation. And for this reason the DCFTA is strategically significant for Ukraine.

The Initial Question. Is the DCFTA Strategically Significant?

On 19 July 2012, after several years of negotiations, the "deep and comprehensive free trade agreement" or DCFTA was initialled by the EU and Ukraine. This means that the text of the treaty has now been finalized. However, it is still unclear whether the Association Agreement, of which the DCFTA forms an integral part, will be signed in 2013. A decision about whether or not the agreement will be signed at the EU summit meeting on the Eastern Partnership in Vilnius in the autumn will be made in the very near future.

Such a decision is influenced by a number of different factors. However, one crucial issue seems to be the question of whether or not the DCFTA is of strategic significance, or merely of minor importance.

There are two methodological reasons why it is not easy to answer this question. First, there are virtually no data relating to the impact of such free trade

agreements, since this is a relatively new tool. Second, in Ukraine there is often a great discrepancy between the law and what happens in the real world. That is why it is not easy to assess the extent to which new laws and regulations will lead to a noticeable improvement in the situation in the wake of the DCFTA. However, despite such methodological reservations it certainly seems possible to assess what will happen.

Three Ways in which the DCFTA Will Have a Direct Impact

Abolition of Customs Duties. In the framework of the free trade agreement customs duties on both sides will be reduced to zero. However, for the industrial sector this is probably not especially significant, since the duties are already very low, amounting on average to 2.45% in Ukraine and to 1.19% in the EU. The situation is rather different in the agricultural sector. The average import tariffs in Ukraine amount to 6.41% and in the EU to 7.42%. Thus the abolition of tariffs is important for the agricultural sector, but on the whole not of critical significance.

Harmonization of product regulation. The product standards in Ukraine are out of date and internationally invalid. On top of this the regulatory approval and certification of products is based on inadequate and contradictory provisions. This nurtures corruption, and, moreover, constitutes an obstacle to exports and makes them considerably more expensive. Ukrainian companies have to be in compliance with both national and internationally accepted standards in order to export their goods. And when it comes to imports, products certified in Germany have to be examined a second time. This is quite expensive in terms of both time and money.

These non-tariff barriers to trade will no doubt be significantly reduced as a result of the "DC" part of the DCFTA, and this will probably boost exports. And this in turn will have a positive impact on economic growth. But greater competition will also change the way in which many companies do business. The most important thing will no longer be maintaining "friendly relations" with policymakers and the government agencies. It will be production efficiency and the implementation of innovative ideas. With this the skills needed by leading managers will also change. Henceforth the requisite training and what they have achieved will be of decisive importance.

However, one could also say that in practice the abolition of non-tariff barriers to trade will not make a great deal of difference, and that for this reason

the advantages described above may not actually materialize. In point of fact it would be unrealistic to expect that the abolition of non-tariff barriers to trade will be implemented in a faultless manner. But as far as we are concerned it is just as unrealistic to assume that the new regulations will have practically no impact on the status quo. Ukraine's accession to the WTO in 2008 showed quite clearly that many new regulations, however imperfect their implementation may be, are actually of great importance. Thus it should be noted that, despite the implementation problems that are bound to occur, the harmonization of product regulation will have a very powerful and positive impact on Ukraine.

Regulatory Harmonization in Other Areas. The DCFTA also envisages regulatory harmonization in other areas such public tenders, competition policy, public finances, state subsidies, protection of intellectual property, and energy policy. It is certainly legitimate to assume that this will have a positive impact on Ukraine. However, it is very difficult to assess all this in quantitative terms in advance. For this reason it is still unclear whether we are dealing with a very considerable or merely a medium-sized impact.

Other Important Aspects of the DCFTA

In addition to the direct impact described above, the DCFTA will have a number of other positive effects.

Business Climate and FDI. We believe that the DCFTA will make a positive contribution to improving the difficult business climate. This is something which is continually being emphasized by German and Western investors in Ukraine. In conjunction with better access to the EU market it may well lead to higher levels of foreign direct investment (FDI).

Relationship to Russia. Furthermore, the DCFTA would make it impossible for Ukraine to join the Customs Union that links Russia, Belarus and Kazakhstan. This should be seen as an important feature, since accession would have a very negative economic impact. It is also important because, contrary to the views expressed by many Western observers, we believe that at this point in time accession to the Customs Union cannot be entirely ruled out.

Distributional Aspects. Finally, the DCFTA would have a positive distributional impact in Ukraine. Many companies protect themselves against competition with the help of dubious tricks and can thus charge inflated prices for their goods. Greater competitive pressure would reduce these monopoly profits and lead to price reductions, which would quite clearly be to the benefit of the man in the street. The net result will be a redistribution from (monopoly) companies to the general population.

But why are the "oligarchs" so much in favour of the DCFTA? Large Ukrainian companies are not interested

in the Ukrainian market, but in the much larger EU market. Thus there is no contradiction between the attitude adopted by the oligarchs and the distributional impact described above.

Conclusions

The multifaceted impact that the DCFTA will have on Ukraine is not altogether easy to assess. However, many aspects of the agreement are fairly straightforward and enable us to arrive at incontrovertible conclusions. The DCFTA would considerably reduce the very large non-tariff barriers to trade and in so doing would promote foreign trade and ensure that there is less corruption and more competition in the country. This would certainly help to improve the business climate, which in turn would lead to higher inflows of FDI. Apart from this the DCFTA would put an end to talk of a customs union with Russia, and would prevent Ukraine from setting off in a very negative (but nonetheless possible) direction. Finally, the DCFTA will probably make a positive distributional impact. This would be welcome news in view of the extremely unequal income distribution in the country.

For this reason the answer to the initial question, which was whether the DCFTA is strategically significant as far as Ukraine is concerned, must be an unequivocal "Yes." Thus from a purely economic point of view one hopes that a decision will be made to sign the DCFTA in the context of an Association Agreement.

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German Advisory Group

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