



# BULLETIN

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## Ukraine: A DCFTA after All

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*The EU agreement with Ukraine on a free trade zone, or DCFTA, will come into force on 1 January 2016. The result, though, will not produce immediate economic benefits for Ukraine and will also carry the previously announced sanctions on Ukraine by Russia, including an embargo on food imports. In the long term, however, the DCFTA will allow Ukraine to accept the majority of the *acquis communautaire* and further its rapprochement with the EU, as well as to improve standards and the competitiveness of the economy. Ukrainian authorities need political and financial support from the EU during the first phase of the DCFTA's implementation, especially in countering the Russian sanctions.*

The creation of a free trade zone between Ukraine and the EU through a Deep and Comprehensive Free Trade Agreement, or DCFTA, is part of the Association Agreement between the two. The DCFTA's entry into force will mean not only the creation of a free trade zone, but when fully implemented, that Ukraine will adopt about 60% of the EU *acquis communautaire*, including energy law, technical regulations, sanitary and phytosanitary standards, customs regulations and principles of intellectual property protection.

As previously announced by Ukrainian and EU politicians, the DCFTA will come into force on 1 January 2016. There had been a danger that Russia would manage to block the agreement using a threat of the introduction from January 2016 of an embargo on Ukrainian food. However, Russia's threat did not affect Kyiv's decision.

**Consequences in the Coming Months.** In the short term, the main effect of the DCFTA will be a reduction in Ukrainian exports to Russia. It should be emphasised that in recent months there has been a decline in trade turnover between the two countries anyway. While in 2012 Ukrainian exports to Russia amounted to \$23 billion, in 2013 it was \$20.5 billion and in 2014 just \$13.3 billion. Exports to Russia as a percentage of Ukrainian exports decreased from 19.7% in January–August 2014 (\$4.9 billion) to 12.7% in January–August 2015 (\$3.1 billion). Furthermore, in Ukraine there is a boycott of Russian goods, and sales of such products in large supermarkets has fallen by as much as 50%. Therefore, the added Russian restrictions will not disrupt the Ukrainian economy. Prime Minister Arseniy Yatsenyuk estimated that the Russian embargo would cause a drop in exports to Russia of about \$900 million, but there are estimates stating that in case duties are imposed on other Ukrainian goods, it could drop even by up to \$2 billion. Total Ukrainian exports to all countries in the world in 2014 amounted to \$54 billion, but at the current pace of decline in 2015, that figure may fall to \$36 billion.

This severe a drop could be harmful, especially to Ukraine's heavy industry, particularly steelworks because Russia is the main market. Some industrial plants produce products specific to the needs of Russian industry (the firm Zoria in Nikolaev, which makes gas turbines, or Turboatom in Kharkiv, which makes steam turbines for nuclear power plants) and finding other manufacturers would be very difficult and time consuming. We can therefore expect that the Russian sanctions will vary, yet the Russian authorities will try to look for new suppliers or to build similar plants in the country.

**Future Benefits.** In the medium to long-term period, the DCFTA is expected to bring benefits for Ukraine. The positive effects of the agreement economically and politically most likely will outweigh the losses caused by the Russian actions. The main positive effect will be that Ukrainian companies will gain better access to a very large market, one with more than 500 million consumers, and as they improving production standards, other markets outside the EU). The European Union has already unilaterally practically abolished 97% of duties on Ukrainian goods (on average by lowering it from 7.6% to 0.5%), while Ukraine will lower its customs duties on EU products on average from 5% to 2.4%. It also will

be important that certificates of conformity from this country match those from the EU. Companies from Ukraine will also be able to apply for EU contracts and will have seven years to adapt to EU standards.

The key, however, is long-term benefits by improving the investment climate in Ukraine, primarily through alignment with the EU and ensuring greater transparency in the application of new laws. Today, investing in this country involves substantial risk, which has increased in recent years because of the war in Donbas, but which is essentially related to imprecise regulations, massive corruption, the lack of rule of law, and the poor performance of courts (in part because of corruption).

The DCFTA gives Ukraine long transition periods in many areas, which is fair and should enable such upgrades as modernisation of obsolete industrial plants and gradual changes in various regulations. On the one hand, association with the EU will incur real costs—in the long run amounting to tens of billions of euros (the Institute of Economics and Forecasting of the National Academy of Sciences of Ukraine estimated it could be up to €160 billion)—but on the other hand, such outlays are necessary to carry out needed reforms and modernisation, without which the prospects for the Ukrainian economy would be very poor.

**Countering Russia.** Moscow has not abandoned its objections to the agreement, emphasised since 2013 and especially from the first half of 2014, when, after the change of government in Kyiv, Ukraine and the EU signed the Association Agreement (the political part, in March, followed by the DCFTA in June). In 2014, Russia commented frequently on the document, attempting to show Ukraine that its entry into force would result in tangible losses. On 12 August 2014, at a meeting with the EU, Ukraine and Russia, it was decided that implementation of the DCFTA would be postponed until 1 January 2016. Both Kyiv and Brussels stressed that the majority of the Russian accusations were misplaced, but they delayed implementation in hopes of a compromise aimed at avoiding Russian retaliation.

The basic objection of Moscow concerned the possibility of duty-free re-export of EU goods through Ukraine to Russia. Meanwhile, the CISFTA agreement on free trade, a DCFTA-like agreement signed by countries of the Commonwealth of Independent States, forbid such practices. This indicates that Russian opposition to the DCFTA was politically motivated. Russia wants Ukraine back into its sphere of influence and sees deepening integration with the European Union as an obstacle.

In April, 2015, EU politicians and officials sought to find a compromise agreement between the EU, Russia and Ukraine. The EU has argued that Ukraine's economic and other integration with the Union or Russia need not be exclusive. However, it was not an attempt to find a real solution but intended to prevent escalation of the conflict between Russia and Ukraine, especially since for Kyiv the entry into force of the DCFTA is of great political importance; postponement would be tacit consent to Russia to decide the terms and pace of Ukraine's European integration. The tripartite talks have repeatedly failed to yield results.

At the beginning of November 2015, Russian Prime Minister Dmitry Medvedev announced that in response to the entry into force of the DCFTA that Russia would raise duties on goods imported from Ukraine. A few days later, the government of the Russian Federation decided to impose an embargo on Ukrainian food, motivating Kyiv to join the economic sanctions on Russia imposed as a result of the annexation of Crimea and aggression in Donbas. These activities represent another Russian-Ukrainian war but over trade. Russia has in the past restricted access to its markets to Ukrainian products: in 2012, it blocked dairy products for a while. Moscow enacted similar restrictions in the summer of 2013, which Kyiv considered undue pressure to curb its efforts at association with the EU. The restrictions also included heavy industry: in 2013, Russia halted purchases of Ukrainian rail cars, meaning factories such as Azovmash or those in Kryukov near Kremenchuk suddenly lost customers and faced the threat of bankruptcy. Similar troubles affected the producer of rockets in Dnipropetrovsk, the defence products firm Pivdenmash (known by the Russian name Yuzhmash). At the beginning of 2014, Moscow banned imports of Ukrainian yellow cheeses. So far, Russia's actions have not had the desired effect, and Ukraine has consistently aimed at full implementation of the Association Agreement.

**Conclusions and Recommendations.** The entry into force of the DCFTA will affect the political process, both inside Ukraine and in relations between Kiev and Moscow and between Brussels and Moscow, as well as the economy of Ukraine.

The Ukrainian authorities must carry out the needed reforms so as to tap the potential of the country's economy, investing in sectors that will have a chance to develop and to increase exports to new markets. In this regard, it is necessary to provide it with EU experts. Funds also will be needed from the EU and it is advisable to create a pool of money similar to pre-accession funds, which helped other EU Member States, including Poland, in their rapprochement efforts. Although at present Ukraine does not have the opportunity for membership in the EU, a DCFTA is a completely new type of agreement for it, far more demanding on the country as it integrates with the European Union than other such agreements. EU funds will also be necessary to counteract the effects of Russia's actions. EU Member States should also assist Ukraine in obtaining financing from other sources (such as the World Bank, Europe Bank for Reconstruction and Development, European Infrastructure Bank).

At the same time, Ukraine should remain present in the markets of the post-Soviet countries if it can. This can be pursued in tandem with strengthening the World Trade Organisation in the post-Soviet space because the effective application of its rules can reduce the negative impact of the Russian sanctions. Kazakhstan will become a full member of the WTO in December 2015. It is advisable for EU countries to speed up Belarus' entry to the WTO and to assist Ukraine within the organisation.