

UDC 339.5.012.42(477+061.1ЄС)

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## UKRAINE IN FREE TRADE ZONE WITH THE EUROPEAN UNION

*The first year of the DCFTA is analyzed, identifying the prospects and drawbacks in the main socio-economic areas of its implementation. The state of international trade relations between Ukraine and the EU is examined, and the factors influencing it are determined. Problems in Ukraine's economy, which prevent the possible benefits of the DCFTA from manifesting, are identified; the possibilities of implementing the main benefits of integrating Ukraine and the EU in practice are determined. The necessity of developing a long-term strategy for Ukraine's economic development while taking into account the main stages and deadlines of implementing the DCFTA is proven.*

*Keywords:* economic integration, the association agreement, free trade zone, exports, imports, foreign investment, global production networks.

*Дугинец А. Украина в зоне свободной торговли с Европейским Союзом. Проведен анализ первого года реализации УВЗСТ, определены перспективы и недостатки в основных социально-экономических сферах ее реализации. Рассмотрено состояние внешнеторговых отношений с ЕС и определены факторы, влияющие на него. Выделены проблемы в экономике Украины, которые мешают получить преимущества от внедрения УВЗСТ, определены возможности реализации основных эффектов интеграции Украины с ЕС на практике. Обоснована необходимость разработки долгосрочной стратегии развития экономики страны с учетом основных этапов и сроков реализации УВЗСТ.*

*Ключевые слова:* экономическая интеграция, соглашение об ассоциации, зона свободной торговли, экспорт, импорт, иностранные инвестиции, глобальные производственные сети.

**Background.** Statement of the problem. It has been almost a year since the Agreement on the deep and comprehensive free trade area (DCFTA), which is part of the Association Agreement between the EU and Ukraine [1], came into action on January 1, 2016. Implementing the DCFTA has involved some adjustments in the export-import relations between states, but given the fact that the term of the Agreement's implementation is almost 10 years, it is difficult to expect a significant change in 2016. At this stage, the attitudes of civil society, government and business are of greater

importance, for the "unnoticeable" character of the changes threatens to promote a pessimistic view among a large group of Ukrainian citizens. In addition, there is a barrier from the EU, as shown by the referendum in the Netherlands. So, according to final data, 61 % of the population (about 2.5 million Pers.) voted against approving the agreement.

**Analysis of recent research and publications.** Analysis of recent research shows that this topic is the object of attention of a wide range of Ukrainian scientists. Moreover, the relevance of the issue is confirmed by numerous attempts at holding public discussions and meetings in order to determine further joint efforts of government and business towards implementing the requirements of the EU. Works of I. Burakovsky, A. Shnyrkov, A. Betliy, V. Movchan, V. Chuzhykov and others [2–6], as well as works of scientific and public research organizations (e.g. the International Institute of Advanced Studies and SI "Institute of Economics and Forecasting of the NAS of Ukraine") [7] are dedicated to determining the consequences of free trade and its impact on Ukrainian society.

Unsolved aspects of the problem that the article is devoted to. Appreciating the contribution of the aforementioned scientists and their research results obtained, it should be noted that these are more general in nature and determine the possible consequences of the agreement, but do not structure them in time, thus leaving aside the question as to what should be expected in the early years of the agreement's implementation. Therefore, in order to raise public awareness of European integration processes, it is relevant to analyze and explain the processes that occur exactly at the initial stage of the DCFTA implementation. Studying the influence of integration with the EU on Ukraine's economy plays an important role in developing a strategy for further development of the country. It also must not be neglected that crisis phenomena, which have considerably influenced the change in country's positions at the time of signing the association agreement with the EU, continue to develop in Ukraine's economy.

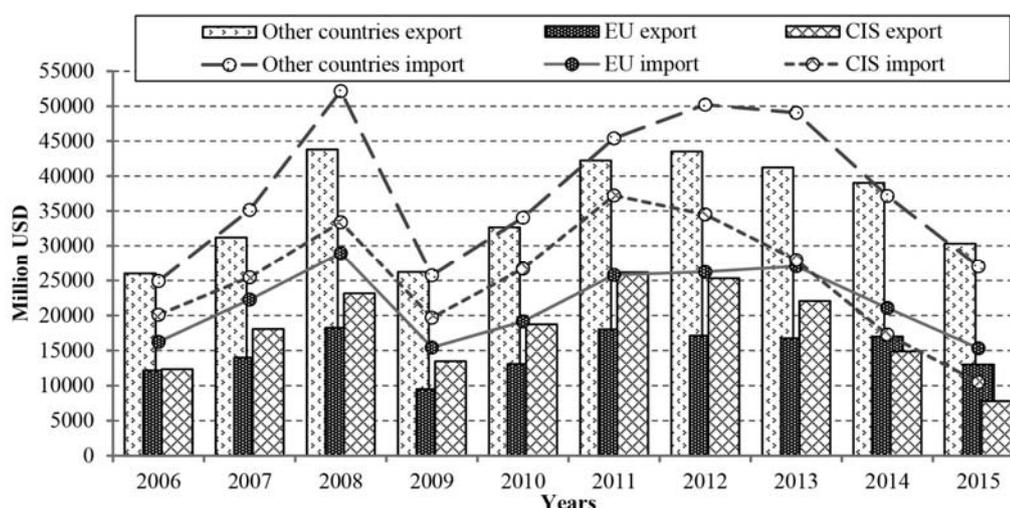
The **aim** of the study is to assess the preliminary results of the first year of implementation of the agreement on deep and comprehensive free trade area between the EU and Ukraine.

**Materials and methods.** The study subject is the possible consequences of deepening the integration relations between Ukraine and the EU over the course of DCFTA's implementation for Ukraine's economy.

The methodological base of the research is the combination of theoretical and quantitative analysis, comparison, and systematization aimed at identifying trends in the development of Ukraine's economy connected with the deepening of integration with the EU.

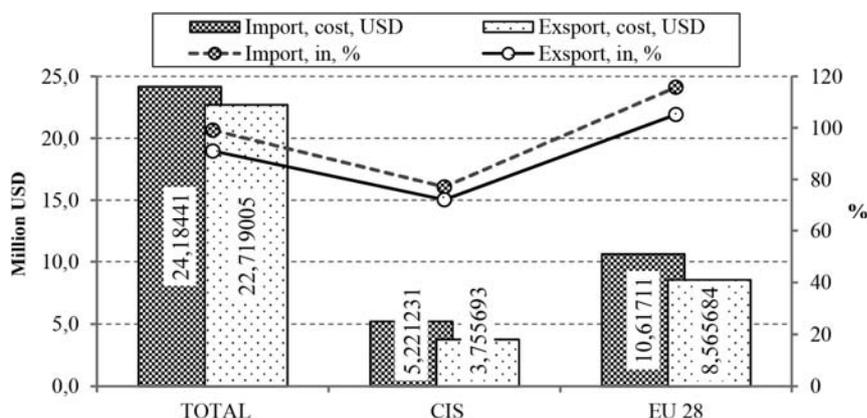
**Results.** Ukraine's path towards Europe has significant features, which are unlike those of most European countries. So, despite the constant declarative character of the European choice, Ukraine had been maneuvering between the EU and Russia for a long time. Therefore, Ukraine's strategy for international integration until 2014 had a bipolar character: participating in an FTA with the CIS countries and creating a DCFTA with the EU as key

partners. Only after the Revolution of Dignity did the European development vector become the only and final one. And this choice is happening in the conditions of Ukrainian nation's forming, on which the Soviet legacy still has a significant impact. Another feature is the fact that, unlike the Central European and Balkan states, Ukraine's European choice is being constantly challenged by the Government of Russian Federation (RF). This became especially noticeable in 2012, when Russia banned the import of certain Ukrainian products. And since 2014, along with military aggression in Crimea and Donbas, the pressure from Russia attained a systematic and all-round character. These events became an important factor in directing our state towards the west. As a result of the chosen direction, the share of trade with CIS countries can be seen to decline and the share of EU-28 countries in foreign trade to grow at the time of signing the Agreement (figure 1) and at the beginning of its implementation (figure 2).



**Fig. 1. Geographic structure of exports and imports of goods 2006–2015**

Source: Numbers for 2014 and 2015 excluding the temporarily occupied territory of the Autonomous Republic of Crimea, Sevastopol and the zone of the antiterrorist operation. Prepared according to [8–10].



**Fig. 2. Structure of Ukraine's foreign trade in January-August 2016**

Source: compiled from [8].

It should be noted that the creation of the DCFTA between Ukraine and the EU will happen gradually, over the course of 10 years. A tight economic integration and creating virtually the same conditions for trade between the EU and Ukraine as among states within the Union are the planned results of implementing the DCFTA [1]. A feature of this agreement is that it imposes obligations on Ukraine, which are characteristic for candidates for joining the EU, but does not contain any reference regarding the prospect of a full membership for our country in the future. Given this, implementing the DCFTA should better be viewed as an opportunity to achieve European standards of quality with a view to access not only the EU market, but also the markets of other countries.

The implementation of the Association Agreement with the EU is making significant adjustments to the export-import relations of our country. According to the State Statistics sales of Ukrainian goods to the EU increased by 3.3 % in the 9 months of 2016, amounting to 35.7 % in the structure of Ukrainian exports. On the other hand, exports to Ukraine make up only about 1 % of the EU export, and it must be also noted that in comparison with 2013, Ukraine's exports to the EU fell by 20 %, or by 3.4 billion dollars USA. As for imports, according to customs, Ukraine bought 10 % more goods from the EU than in 2015 [8]. Ukraine's foreign trade with EU countries was scarce, but now this deficit is growing. And as the Ukrainian market opens for European companies, this deficit may increase even further. In this situation it is important to build up Ukraine's exports to the EU fast enough or a situation may occur where Ukraine must spend more currency on European goods without getting significant revenue currency for Ukrainian goods from the EU.

Among the products that determine the dynamics of exports to the EU, products of agriculture and food industry play the foremost role, making up 31.5 % of total exports. Meanwhile, the existing potential capacity of Ukrainian enterprises is not fully used. The incomplete of tariff quotas for agricultural products is an example: Ukrainian exporters use opportunities within 26 existing quotas, out of a total of 40. Meanwhile, exports of butter to the EU increased by 130 times in 2016, Ukrainian exports of fruits and vegetables to the EU – by 7 to 15 times. But due to non-compliance with EU food safety regulations (products imported into the EU must meet the same high standards as products produced within the EU) the possibility of simplified access to the European market is almost unused.

It is thus of great importance to widely implement the HACCP system (system of food safety management, providing control at all stages of the food chain in any part of the production process) in the activity of domestic food industry enterprises. Meanwhile, despite the problems in selling domestic agricultural products on the European market, more than 270 Ukrainian enterprises export their agricultural products to the EU as of November 2016. In 2014, the total turnover of goods in this sector with the EU was only 10 percent of the total; to compare, in 2016 it is more than 40 percent of total turnover in the industry (the turnover with China and India being the greatest) [8].

As for industrial products and raw materials, it should be noted that the average level of tariff protection in the EU market oscillates for Ukraine within the range of 4.4–5 %. Therefore, the main barriers to trading manufactured goods with the EU are not import tariffs, but technical barriers. The EU's system of technical regulation is considered to be the most efficient and successful example of eliminating technical barriers to trade. The basic requirements are classified into the sectors of products' safety, technical standardization, and product packaging and labeling.

The liberalization of "substantially all" tariffs and duties planned by the Agreement on the DCFTA with the EU (taking WTO rules, scope and implementation schedule) will lead to the simplification and computerization of customs procedures, thus helping to fight corruption and reduce the time and costs of registration and, therefore, increase the efficiency of customs. In addition, the changes that have taken place recently in the customs legislation of Ukraine aimed at adapting to international and European standards are also targeted at simplifying trade interactions, in particular the process of granting the status of an authorized economic operator, introducing the institution of an approved exporter in Ukraine and the electronic data exchange system on the "single window" basis. This will reduce the administrative and actual costs for business in the future.

Another aspect is harmonizing the rules regarding origin of goods, also included in the Agreement: preventing re-export from the EU of goods produced in third countries; mutual recognition of certificates of origin, which involves close cooperation of relevant authorities of Ukraine and the EU; Ukraine's accession to the Pan Euro Mediterranean accumulation area, which will allow using raw materials of European origin in production processes in Ukraine and exporting to the EU at a zero rate of import duty. At the same time, there is a need to review Ukraine's system of rules of origin, which will cause Ukrainian producers to choose more meticulously the source of raw materials and to monitor the availability of all documents necessary to confirm the origin at every stage of production. Despite the fact that these changes require additional expenditures from the state budget, only this approach would allow Ukrainian producers to fully take advantage of preferential access to the European market.

It should be noted that domestic metallurgy requires special attention. Large energy intensity of the industry, high natural gas prices, low demand for metal products on the international market and minor consumption on the domestic market significantly worsen the financial conditions of the industry and cause increased demand for state aid. However, unlike most countries where restructuring the industry before signing the agreement took place with the active participation of the state, the Ukrainian government has not significantly concerned itself with radical modernization of domestic steel companies, leaving its implementation directly to the owners of enterprises alone. This means that Ukrainian metallurgists have not received targeted aid for the modernizing production facilities from the state for the almost 15 past years. At the same time, under the terms of the Agreement, such

possibility does not exist at all. The only way to get state aid that would not distort the conditions of competition is changing the structure of state aid in Ukraine in favor of so-called horizontal objectives – environmental protection, scientific research and development and regional aid. But, unfortunately, these changes require time and certain costs. As an example, adopted on July 1<sup>st</sup>, 2014, the Law of Ukraine "On state assistance to business entities" established the basic legal framework for monitoring and controlling state aid in Ukraine in accordance with EU principles. After a planned three-year transition period, the said Law will come into force on August 2, 2017, though agriculture, fisheries and defense industry are deliberately not covered in it, as required by the Agreement. An important feature of this law is that it is a framework law, which would require significant amendments to secondary legislation to set more detailed regulation of the actual rights and obligations of providers and recipients of state aid and restrictions on state aid in Ukraine, imposed by the Antimonopoly Committee as a regulative body in Ukraine. For the possibility of such development, the law provides a reasonable transition period before its entry into force. Meanwhile, the body (ACU) authorized to create secondary normative acts is already active, and it remains necessary to approve a detailed and comprehensive secondary legislation and guidance on implementation, as well as to create an appropriate institutional framework by August 2017. That means, until this time no significant changes in the area of state aid to Ukrainian enterprises are to be expected.

As for raw materials, exports of selected commodities, including ferrous, nonferrous metals and alloys, has not undergone significant changes since January 1<sup>st</sup>, 2016. Given the gradual elimination of export duties by Ukraine, this process will take a long time – 3 to 10 years, and in case of exceeding the set volumes – up to 15 years, meaning that the leading domestic steel producers will not be fundamentally affected. The above primarily concerns enterprises of Dnipropetrovsk, Zaporizhzhia and Donetsk regions in part. Regarding scrap metal, the remaining regions of Ukraine will have about the same conditions, and no significant changes are anticipated for the years 2016–2017.

One of the reasons for the remaining relatively high barriers to entry of domestic producers onto the European market is the fact that Ukraine is at a lower level of technological development than the EU. Proof of this can be found in, firstly, the share of exports of high technology products (% of total industrial exports) of Ukraine compared to some EU countries: Ukraine – 5; Hungary – 29; Finland – 21; Sweden – 17; France – 19 [5]; secondly – growing dependence of Ukrainian machine-building on imported high-tech products – both of final consumption and components used in the building of machines of well-known foreign brands. Creating innovation parks and clusters, with mandatory support from the state, would help overcome the technological backwardness. That in turn would allow to attain a new level for Ukrainian export – exporting goods with high added value, for now there exists the threat of the

county's exports' becoming imbalanced towards trading goods with a low degree of processing.

There are a number of reasons for this. Limitation of relations with Russia caused a decline in machine building production, it being traditionally exported to the Russian market, and the prospects for modernizing production and reorienting it to other markets is associated with many difficulties. The EU as a whole is more interested in preserving the raw material orientation of the Ukrainian export. To compare, the share of industry in the structure of Ukraine's economy amounted to 29 % in 2013, and had fallen to 24.4 % by 2015 [11]. On the one hand, there is a theoretical likelihood of some European industries' being transferred to Ukraine because of relatively low labor costs. On the other hand, there is a risk of no return on investment, given the current state of affairs in Ukraine's economy. An alternative to FDI can be the strategy of supporting domestic business by creating the conditions for the withdrawal of Ukrainian enterprises' own capital out of the "shadow". A good example is the experience of Israel, a country that, being in a constant state of emergency, does not cease to show a significant rate of socio-economic development.

The broad and deep character of the DCFTA envisages substantial spending from the national economy to adapt to the requirements of the common market of the EU. Opportunities for official EU assistance and national funding of consumer spending and domestic manufacturers are important in this process, but limited. As shown by the experience of Central European countries, it is essential to attract foreign investment, particularly to modernize the national economy. Creating an attractive domestic investment climate in Ukraine is an urgent need for economic association with the EU. On the other hand, guarantees to foreign investors about economic unity and indivisibility, and respect for borders of the investment fields in Ukraine should be seen as an important external factor in the implementation of the Association Agreement. This is especially true in conditions of the existing "hybrid war" in our country. Moreover, this lack of guarantees significantly reduces the investment attractiveness of Ukraine's economy for foreign investments, and thus the economic attractiveness of the association as a whole for Ukraine. Thus, an important role can be played by the development and securing of new political and safety and security guarantees of preserving the territorial unity and socio-economic stability of Ukraine.

Despite the difficult socio-political conditions in the country, Ukrainian enterprises have significant potential to enter the European market, but also there exist a number of obstacles to further development of trade relations in the European direction [12]. The most influential is the need to address the issues in the public consciousness, namely the advantage of family and other like relations over open (and hence competitive), public relationship networks and the tendency to put formal status features of relationships ahead of the actual content (and hence, essence) of the relationships. Another important issue is the need to change the socio-cultural direction of business activity,

namely to form and nourish the ability to think and behave strategically, with a focus on long-term development goals. The sole fact that the Association Agreement has a term of 10 years should direct the society and state to develop and implement long-term development strategies. For a long time, the country's economic development was sporadic and in accordance with the goals of pro-government structures in a given period of time. In the case of the Agreement, regardless of who would be the president, the conditions laid down in it must be followed. Perhaps for the first time in the history of our country there is an urgent need to develop effective strategies for development at all levels – national, regional, sectoral (business associations), and socio-humanitarian (non-governmental organizations of different profiles). At the moment, there is no common understanding in the Ukrainian society that the Association Agreement applies to each and everyone. Indeed, the creation of a FTA will affect primarily those exporting Ukrainian products, but large-scale harmonization of legislation, technical regulations, sanitary and phytosanitary standards will apply even to those selling products exclusively on the domestic market.

In general, the expected effects of implementing the provisions of the Agreement and the author's evaluation of the feasibility of their implementation in the current crisis conditions are presented in *table*.

*Table*

**Possibilities of achieving some effects of integration through implementing the DCFTA between the EU and Ukraine**

Theoretical effect	Expected manifestation of the theoretical effect in practice, as viewed at the moment of signing the Association Agreement [13]	Critical assessment of the possibility of implementing the desired effect in practice
The effect of "trade expansion"	Increase in exports of goods and services to the EU	Difficulties in reorienting the exports of engineering products, which used to be exported to the CIS, towards the EU market due to the inconsistency of their technical characteristics
Expansion of specialization	Inclusion of Ukrainian producers into international production networks	Inclusion of only extractive industries of Ukraine into European production networks is most probable
The effect of "investments deviations"	Relocation of certain European industries to Ukraine in accordance with the advantages of specialization	Potentially, European resource-demanding industries could, in the long term, relocate geographically closer to Ukrainian extractive industry enterprises; however, it is difficult to assess the rationality of such a relocation
The effect of "increasing productivity"	Re-equipment and modernization of national industry	Given the current crisis conditions, Ukrainian enterprises have almost no financial capabilities for modernizing production
Increased competitiveness	Introduction of European technical standards into Ukrainian production	Adopting European technological and other standards as national standards involves significant financial costs and will require a certain period of time

*Source: Compiled by the author.*

In the years to come, the efficiency of the DCFTA with the EU will, given the current conditions, to an equal extent depend on political and economic stability and security in Ukraine.

**Conclusion.** The research on the status of implementation of the DCFTA between the EU and Ukraine allows to draw following conclusions: first, during the period of preparation and early implementation of the Agreement, the necessary conditions for growth of the Ukrainian economy and improving the living standards of its population have not been created. Second, stabilizing and settling internal and external political and military conflicts is highly favorable for economic development. Thirdly, Ukrainian producers will have to switch to European standards of product quality, and this will require considerable financial expenses. Most businesses need to undergo an almost complete modernization of production and train staff to work with new technologies. Fourth, the Agreement creates opportunities for enterprises to access European credits, but those domestic producers, who are in a difficult economic situation, pose a high risk and are thus unlikely to qualify for European loans.

Considering all of the above, the implementation of the DCFTA at this stage is better viewed as a mechanism of comprehensive, all-encompassing modernization, strengthening the competitiveness of national products and further integration into the world economy, including the deepening of cooperation with the Asia-Pacific region.

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*Articles submitted to editor office of 17.01.2017.*

***Дугінець Г. Україна в зоні вільної торгівлі з Європейським Союзом.***

**Постановка проблеми.** Імплементція ПВЗВТ вносить певні корективи в систему експортно-імпортних відносин між державами, але, зважаючи на термін запровадження Угоди, який становить майже 10 років, важко очікувати появу значних змін протягом 2016 р. На даному етапі більш важливим є психологічний настрій громадянського суспільства, влади та бізнесу, оскільки «невідчутність» змін – загроза для поширення песимістичних налаштувань значної групи громадян України. До того ж, існує певна перешкода з боку ЄС щодо реалізації Угоди про асоціацію відповідно до результатів референдуму в Нідерландах.

**Аналіз останніх досліджень і публікацій.** Аналіз останніх досліджень свідчить, що обрана тема є предметом уваги широкого кола українських науковців. Актуальність досліджуваної проблематики підтверджують численні спроби проведення громадських обговорень та зустрічей з метою визначення подальших спільних дій влади та бізнесу у напрямі реалізації вимог ЄС. Проте, неможливо не враховувати те, що в українській економіці продовжують розвиватися кризові явища, що вже вплинули на зміну стартових позицій країни під час підписання Асоціації з ЄС.

**Метою** роботи є попередні підсумки першого року реалізації Поглибленої та Всеосяжної Зони Вільної Торгівлі між ЄС та Україною.

**Матеріали та методи.** Методологічною базою дослідження є поєднання теоретичного та кількісного аналізу, порівняння, систематизації для виявлення тенденцій розвитку економіки України в зв'язку з поглибленням інтеграції з ЄС.

**Результати дослідження.** У статті проведено аналіз першого року реалізації ПВЗВТ і визначено перспективи та недоліки в основних соціально-економічних сферах її реалізації. Розглянуто стан зовнішньоторговельних відносин з ЄС та визначено чинники, що впливають на нього. Виділено проблеми в економіці України, які заважають максимально отримати переваги від впровадження ПВЗВТ, визначено можливості реалізації основних ефектів інтеграції України з ЄС на практиці. Обґрунтовано необхідність розробки довгострокової стратегії розвитку економіки країни з урахуванням основних етапів та терміну реалізації ПВЗВТ.

**Висновки.** Проведене дослідження стану реалізації ПВЗВТ між ЄС та України надає можливість отримати висновок що при існуючих потенційних можливостях доступу національних підприємств до європейського ринку наявні кризові явища в українській економіці гальмують отримання позитивних наслідків від імплементції ПВЗВТ. Враховуючи це, на сучасному етапі реалізацію Угоди краще сприймати як механізм всебічної модернізації, зміцнення конкурентоспроможності національного продукту та подальшої інтеграції у світову економіку, зокрема – поглиблення співробітництва з країнами Азіатсько-Тихоокеанського регіону.

*Ключові слова:* економічна інтеграція, угода про асоціацію, зона вільної торгівлі, експорт, імпорт, іноземні інвестиції, глобальні виробничі мережі.