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What's Next, after Ukraine Signs Association Agreement with the EU?

Ievgen Vorobiov

On the sidelines of the EU summit in Brussels on 27 June, Ukrainian and EU representatives signed the economic part of the Association Agreement. Following ratification of the agreement by parliament, Ukraine will start adopting EU regulations in exchange for obtaining access to EU markets. Ukraine is expected to increase its share of exports to EU markets and balance its trade deficit with the EU. The agreement with the EU is unlikely to compensate fully for exports halted by Russia, but will contribute to alleviating dependence on Russian markets in several sectors.

Legal Approximation Priorities. The signing of the Association Agreement between Ukraine and the EU starts a gradual process of approximating Ukraine's legislation to the bulk of the EU's regulations (known as *acquis communautaires*). This will require Ukraine's parliament to adopt certain laws, and should be carried out in accordance with the schedules outlined in the annexes of the agreement. However, given the likelihood of a parliamentary election in autumn, however, the process of ratifying and implementing the agreement may be unduly protracted.

On the other hand, the Association Agreement requires adoption of a limited number of laws in the short term. Only five EU regulations pertaining to trade in goods have to be transposed into Ukrainian law in the first year. These include laws on general product safety, requirements for accreditation and market surveillance, a common framework for the marketing of products, units of measurement, and liability for defective products. There are few obstacles to progress in this case as, for example, the Verkhovna Rada passed laws on standardisation and metrology last month.

In order to start the approximation to the EU's customs legislation, Ukraine needs to transpose the provisions of two 1987conventions, on the Simplification of Formalities in Trade in Goods, and on a Common Transit Procedure. The approximation of more complicated EU regulations (such as the EU Customs Code) may be delayed for up to three years, which will give Ukrainian authorities enough time to implement them properly. However, in respect to the formation of FTAs, non-tariff barriers regarding the trade of goods are more substantial. To that end, the Ukrainian government is expected to draw up a Strategy of Approximation to the EU's sanitary and phytosanitary standards within three months after the agreement comes into force. The lack of a centralised authority tasked with drafting such a document within this time is a reason for some concern, which is expected to be addressed by the establishment of an agency.

The schedules for approximating the services sector do not include any urgent regulations in the coming year, and most of the legal acts pertaining to financial services and telecommunications are only due to be transposed within four years of the agreement coming into force. In terms of public procurement, Ukraine is supposed to comply with the "basic standards" of EU regulations within the next six months. Upon successful implementation (to be assessed by the Trade Committee), procurement contracts will be established with EU governments, which would be a potentially hefty market for industrial goods. So far, the authorities in Kyiv have achieved partial progress in fixing Ukraine's non-transparent public purchasing procedures. For example, the amendments of 10 April introduced disclosure provisions for tenders organised by state-owned enterprises. Further reform of state purchasing in line with EU standards will have a positive effect on Ukraine's public finances as, according to estimates, corruption in this sphere has cost Ukraine's budget €2.5–4 billion annually (1.5–2.2% of GDP).

Impact on Ukraine's Economy. Ukraine's trade with the EU is likely to demonstrate continued growth on the back of further liberalisation under the provisions of the Association Agreement. The trends in bilateral trade have thus far been rather positive. For the past four months, Ukrainian exports to EU Member States have increased on average by 13% in comparison to the relevant period in 2013; only exports to France declined. The drastic depreciation of Ukraine's currency was the major factor behind this steady increase in dollar terms (the hryvnia has lost 40% against the dollar since January, spurring on export activity, but the unilateral application of trade preferences by the EU has also yielded modestly positive results. The increase in Ukrainian exports related not only to goods with low added value (such as grain and ferrous metals), but also to electrical machinery, on which higher import duties are levied in the EU.

Implementing the Association Agreement will sustain the positive "balancing" trend in EU–Ukraine trade. The initial signs this year are good, with the deficit for January to April at $240 million, the lowest in the past years (compared with over $1.3 billion in the same period of 2013). There are at least two factors underpinning this trend in the short term. First, the agreement will stipulate an asymmetric pattern in opening access to the market, as the decrease of import duties in the European markets will be faster than that on the Ukrainian side. Secondly, imports from the EU to Ukraine are unlikely to increase substantially in the near future. In the first four months of 2014, they have decreased by 17%, not least due to the depreciation of the hryvnia. Moreover, low demand from consumers in Ukraine in the following months is unlikely to favour increasing imports of EU products, while the precarious investment situation will limit the purchasing of machinery from the EU. The improvement of Ukraine's trade balance will, in turn, alleviate the pressures on its national currency.

As the agreement envisages no provisions for liberalisation of trade in services in the first year, it is not likely that it will support Ukrainian service providers. Paradoxically, the investment climate may be more favourable, as the government embarks on a number of deregulation steps. In the first quarter of 2014, investors from major EU countries have largely stayed in Ukraine, despite political and economic uncertainty. Investment stock from France, Germany and the Netherlands fell by only 1–4% in comparison to the average decrease of 10%. The investment protection provisions of the agreement will reinforce this resilience.

Impact on Trade with Russia. The signing of the Association Agreement is likely to trigger Russia's unilateral withdrawal of preferential trade terms for Ukraine (enshrined in the CIS Free Trade Agreement signed in 2011), which will be equivalent to 0.6–1% of Ukraine's GDP.[1] Having faced the lack of consensus from Belarus and Kazakhstan within the Eurasian Customs Union, Russia will resort to the loopholes created specifically for unilateral trade restrictions, such as Decision 63 of the Eurasian Supreme Council, which allows MFN duties on the goods imported from another CIS state to be applied unilaterally, "if one of the [Customs Union] Members is unwilling to enforce this measure." However, unlike in August 2013, such a move will not cause a severe shock to Ukraine's economy, as trade with Russia has already declined substantially since the Russian annexation of Crimea at the end of February (from 25 to 19%). This is an accelerating trend: in the first four months of 2014, exports to Russia decreased by 23%, compared to the same period in 2013. The most affected product groups were ferrous metals and machinery, for which it is rather hard to diversify markets. This decrease of trade interdependence will substantially limit Russia's ability to use market access for Ukraine's exporters as a political tool in the coming months.

A similar trend will be seen in imports, as Ukrainian consumers continue to boycott Russian products and producers account for risks of importing goods over the eastern borders. For the past four months, imports from Russia have decreased by 25%. They are expected to fall further, given the suspension of gas purchases from Gazprom by Ukraine (gas accounts for 60% of total imports from Russia). Unlike with the EU, the trade deficit with Russia is now becoming a macroeconomic burden for Ukraine, exceeding $1.6 billion (1% of GDP) for the first four months of 2014. To rectify this, Ukraine needs to cut down on imports from Russia, regardless of politics.

Conclusions and Recommendations. Implementation of the Association Agreement with the EU will not be an immediate panacea for Ukraine's economic problems and Russia's trade retaliation, but will help improve the country's trade balance and supply badly-needed foreign currency. Given the opposite trends in trade with the EU and Russia, Ukraine will further weaken its exposure to Russian markets, and the Kremlin's possible retaliation will only accelerate this process.

The EU should not wait until Ukraine nominates its members to Association Council and Trade Committee to start monitoring the approximation progress. An initial assessment of the proposed legislation is crucial for steering Ukraine's legislative change. In order to gauge the bottom-up drive for legal approximation stipulated by the agreement, the EU should use the newly established "Support Group for Ukraine" for institutionalising the dialogue with civil society initiatives (such as the Reanimation Package of Reforms).

In order to effectively counter the adverse effects of Russia's trade restrictions, the European Commission and Ukraine's government should set up an advisory body for consulting Ukrainian enterprises on redirecting their exports to European or global markets. The IFIs, primarily the European Investment Bank, should provide cheap loans for Ukrainian firms willing to invest in compliance with European standards, with possible co-financing from Ukraine's government.

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[1] For detailed estimates, see: I. Vorobiov, "The Embargo That Never Was: How Should the EU Respond to Russia's 'Message' to Ukraine?," *PISM Bulletin*, no. 97 (550), 19 September 2013.