THE IMPACT OF TRADE LIBERALIZATION BETWEEN UKRAINE AND EU ON TRADE AND INVESTMENT

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Abstract: *The benefits and costs of the implementation of the Deep and Comprehensive Free Trade Area (DCFTA) between Ukraine and the EU have been studied. The study aimed to find out to what extent the implementation of DCFTA has helped increase exports and attract foreign direct investment into Ukraine's economy. A comparison method was used to conduct the study. The period of implementation of the DCFTA (2016-2020) was compared with the period before the implementation of the DCFTA (2010-2014). Due to trade liberalization, exports of Ukrainian goods to the EU and imports of goods from the EU to Ukraine have increased. Trade liberalization has not contributed to further attracting foreign direct investment from the EU to Ukraine's economy. The urgent task of the Government of Ukraine is to create a business regulatory environment according to European standards and protect foreign investment.*

Keywords: *Deep and Comprehensive Free Trade Area, Exports of goods, Imports of goods, Foreign direct investment, Ukraine, European Union.*

1. INTRODUCTION

In January 2021, five years have passed since the beginning of the creation of a Deep and Comprehensive Free Trade Area between Ukraine and the EU (DCFTA). According to Article 25 of the Association Agreement between Ukraine and the EU, the DCFTA is established within 10 years (Association Agreement, 2014). Also, according to Article 481 of the Association Agreement between Ukraine and the EU, five years is a sufficient period to review the positive effects and negative consequences of the DCFTA. Five years is also sufficient to review the terms of trade liberalization for goods (Article 29 of the Association Agreement). One of the main goals of the DCFTA is to intensify bilateral trade and attract foreign direct investment. Ukraine's economy today is small and open. Its growth rate largely depends on export activities. After the closure of traditional markets in the CIS countries, the need to open new markets has become particularly urgent.

Ukraine needs to increase exports faster than to increase imports. During 2010-2019, the trade balance was negative for Ukraine. In commodity trade, the negative balance averaged $8 billion per year, and in trade in goods and services - $2 billion. In addition, Ukraine's economy has a high level of import dependence. During 2010-2019, the ratio between imports of goods and services and GDP averaged 0.53.

Attracting foreign direct investment is important for Ukraine's economy. Today their volumes are insignificant. In terms of the number of foreign direct investments per capita, Ukraine ranks one of the last in the region. In 2019, this figure was $1117 for Ukraine (United Nations Conference on Trade and Development, 2020). For comparison, for Moldova it was $1198, for Belarus - $1544, for Romania - $4979. For the countries of Eastern Europe this indicator increased during 2010-2019, but for Ukraine it decreased.

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The study aimed to find out to what extent the formation of Ukraine's DCFTA with the EU has helped increase exports and attract foreign direct investment to Ukraine's economy.

2. METHODOLOGY AND DATA

A comparison method was used to conduct the study. The period before the beginning of the formation of the DCFTA (2010-2014) was compared with the period of formation of the DCFTA (2016-2020). During the first period, the factor of liberalization of trade relations between Ukraine and the EU was absent. During the second period, factor of liberalization acted. A set of comparative indicators was used for comparison. In addition to comparative analysis, the method of averages, the method of seasonal smoothing of time series, and factor analysis were used.

The information bases of the study were: 1) statistical data of the State Statistics Service of Ukraine; 2) the United Nations Population Fund; 3) the United Nations Commodity Trade Statistics Database (UN COMTRADE); 4) Association Agreement between the European Union and its Member States, of the one part, and Ukraine, of the other part.

3. RESULTS

Due to trade liberalization, exports of Ukrainian goods to the EU have increased. If during 2010-2014 exports averaged $16.3 billion per year, during 2016-2020 it increased to $18.1 billion. This happened in the conditions of Ukraine's loss of a part of the territory with great export potential (Donbass region, Crimea).

Exports increased for most large product groups (HS 2-digit code). Exceptions were only goods produced in Donbass region (iron, steel, chemical products, coal and coke). During 2010-2014 Donbass region was the largest exporter of goods among the regions of Ukraine. The share of exports of this region averaged 29% (State Statistics Service of Ukraine, 2020). After the loss of part of Donbass, the share of exports decreased to 11%. Also due to the lack of raw materials and investments, exports of oil products and fertilizers to the EU decreased. If during 2010-2012 the exports of oil products to the EU averaged $445 million per year, in 2016-2018 - $129 million. Similarly, the exports of fertilizers during 2010-2014 averaged $170 million per year, and during 2016-2020 - $60 million.

Exports of the most competitive Ukrainian goods to the EU have increased. In the EU market, such goods are: corn (HS 4-digit code - 1005), sunflower oil (1512), iron ore (2601), carbon steel semi-finished products (7207), insulated wires (8544). Exports of corn, sunflower oil and insulated wires increased after liberalization. Exports of carbon steel semi-finished products and iron ore decreased due to the loss of production capacity in Donbass.

The diversification of supplies of the most competitive goods within the EU has improved. If in 2011 large supplies of corn (more than $10 million per year) came to 7 countries, in 2019 - to 12 countries. Similarly, sunflower oil in 2011 was exported to 9 countries, and in 2019 - to 11 countries. Insulated wires in 2011 - up to 7 countries, and in 2019 - up to 9 countries.

Due to liberalization the geographical diversification of Ukrainian exports has improved. During 2010-2014, the largest importers of Ukrainian goods were Italy, Poland, Germany, Hungary and Spain. Exports to each of these countries exceeded $1 billion. The total share of these 5 countries in Ukrainian exports was 55%. After liberalization, the share of these countries in exports decreased to 54%. The share of other EU member states increased by 1%.

The share of EU-15 countries in exports to the EU has increased. During 2010-2014, the share of these countries averaged 54%. After liberalization during 2016-2020, it increased to 56%. Exports to the Netherlands (by 81%), Luxembourg (by 58%), Ireland (by 49%) and Denmark (by 46%) increased the most.

The commodity structure of exports to the EU has become more diversified. The number of commodity groups with large volumes of exports (more than $10 million per year) has increased in exports. During 2016-2020, the volumes of exports of the following product groups (HS 2-digit code) became large: “03 - Fish and crustaceans”, “11 - Products of the milling industry”, “49 - Printed books”, “ 56 - Wadding”,” 96 – Miscellaneous manufactured product”. Exports of product group “88 – Aircraft and spacecraft” became small. Exports of 30 product groups doubled or raised even more. Thus, the European market has opened up to a wider range of Ukrainian producers.

Tariff rate quotas have helped increase exports to the EU. The Association Agreement established tariff quotas for 36 product groups. For 29 product groups the quotas were larger than the actual volumes of imports before liberalization, and for 7 product groups - smaller. After the introduction of tariff quotas, exports of the vast majority of product groups increased. And the increase was significant. For 28 product groups, exports increased 2 or more times. The decrease in exports to the EU was recorded only for two product groups that were subject to tariff quotas.

During the first 5 years of formation of the DCFTA, not all product groups managed to use the opportunities of duty-free trade in the amount of tariff quotas. In addition to the two product groups for which exports decreased, quotas for another 22 product groups were not fully used during the year. This was due to three main factors: non-tariff barriers from the EU, low demand from the EU, and insufficient supply from Ukrainian producers. For each product group, the impact on exports of these three factors had its own features.

After the beginning of the formation of the DCFTA, the exports of furniture to the EU increased 3 times. It is important for Ukraine to increase the share of consumer goods in exports. Consumer goods have a wider market. It was possible to increase furniture exports due to EU demand and high-quality supply from Ukrainian manufacturers. The rate of import duty on furniture is free, and non-tariff barriers do not hinder exports. A wide range of furniture is exported to the EU. The furniture is exported to both Eastern and Western Europe. The share of finished products predominates in exports. If during 2011-2013 the share of finished furniture was 42% (other products were parts of furniture), in 2016-2018 the share of finished furniture increased to 52%.

Liberalization has helped increase imports of goods from the EU to Ukraine. If before liberalization during 2010-2013, imports increased by 40%, then with the beginning of the formation of the DCFTA during 2016-2019 it increased by 46%. If during 2010-2013 a decrease in imports to Ukraine was recorded for 19 commodity groups according to HS 2-digit code, during 2016-2019 there were only 8 such groups.

During 2016-2020, the average annual imports of goods from the EU were lower than during 2010-2014 by 8%. This was due to the loss of part of Ukraine’s territory, as well as the general decline in industrial production. However, for 37 product groups out of 95, the average volumes of imports during 2016-2020 were higher than during 2010-2014.

The European Union has not fully used the opportunity to export products to Ukraine under tariff quotas. The tariff quota “Pork” was used by European producers in 2016 by 14%, and in 2017 - by 26%. The difficult epizootic situation in the European region, namely outbreaks of infectious animal diseases (swine flu, African swine fever, etc.), has become an obstacle. Similarly, the quota “Sugar” in 2016 was used by 70%, in 2017 - by 3%, in 2018 - by 3%. Ukraine’s domestic market of sugar remains closed to imports. This situation is unfavorable for consumers. Lack of competition does not allow to reduce the price in the domestic market. Local producers have no additional incentives to increase production efficiency.

The liberalization of trade with the EU has not led to a large expansion of imports in the domestic market of Ukraine. Seven most vulnerable product groups were selectively examined - confectionery (1905), carpets (5703), clothing (6110, 6115, 6204, 6212), footwear (6403). These sectors had the highest tariff protection (10-12%) before liberalization. Protection was abolished immediately after the formation of the free trade zone.

No excessive expansion of imports was recorded by product groups (1905, 5703, 6110, 6115, 6204, 6212 and 6403). In one commodity group (6110) the volumes of imports during 2016-2018 decreased. In three product groups (6115, 6212, 6403) the growth rate of imports during 2016-2018 was not higher than during 2011-2014. And only in three product groups (1905, 5703, 6204) the growth rate of imports accelerated somewhat. This acceleration did not significantly worsen the dynamics of domestic production.

The most noticeable was the expansion of imports in two product groups: motor cars (8703) and wine of fresh grape (2204). These product groups were protected by the transition period of 10 and 5 years, respectively. If during 2011-2013 imports of cars have increased by 15%, then after liberalization during 2016-2018 imports have increased 2.7 times. Large volumes of cars from the EU were smuggled into Ukraine. These were cars with foreign registration in the transit mode or the temporary importation mode. According to the State Fiscal Service of Ukraine at the end of 2018 in Ukraine there were 640 thousand cars with foreign registration. That is, during 2016-2018, averages of 213 thousand cars were imported to Ukraine in the transit mode or the temporary import mode per year. For comparison, in the normal mode of imports in 2016 - 52 thousand units were imported, in 2017 - 98 thousand units, in 2018 - 142 thousand units.

Imports of wine of fresh grape from the EU have also increased significantly. If during 2011-2013 these imports were at the same level, during 2016-2018 imports of wine of fresh grape increased by 36%. At the beginning of 2021, the prices for European wines in supermarkets of Ukraine were practically equal to the prices for wines of Ukrainian production. This is especially true for wines produced in Spain.

The imports of European made cars on the Ukrainian market have significantly affected domestic production. During 2010-2013, Ukraine produced an average of 72,000 cars a year. During 2016-2019, only 6,000 cars were produced per year. This was mainly a large-scale assembly of Skoda cars with a minimum level of localization.

After liberalization, the negative balance of trade in goods with the EU for Ukraine became smaller. Before liberalization in 2010-2013, the negative balance averaged $8.3 billion per year. After the start of liberalization during 2016-2019 the negative balance averaged $3.6 billion. This can be explained by the action of two main factors: 1) the relatively slow growth of the Ukrainian economy, and consequently the weak demand for investment and consumer goods; 2) competition from Chinese goods.

Imports of Chinese goods to Ukraine increase absolutely and relatively. This is especially true for consumer goods. The growth rate of imports from China is higher than the growth rate of imports from the EU. During 2010-2013 imports from the EU increased by 40%, from China - by 68%. After the start of liberalization, during 2016-2019, imports from the EU increased by 46%, from China - by 96%. During 2016-2019, China increased its imports to Ukraine in the vast majority of product groups. During 2016-2019, the share of the EU in imports of goods decreased from 44% to 41%, while the share of imports from China increased from 12% to 15%. In 2019, China was the largest importer of goods to Ukraine; Germany - the largest importer from the EU - was in third place. In 2019, for 19 product groups (HS 2-digit code) out of 95 Chinese imports were higher than imports from the EU.

The increase in trade between Ukraine and the EU has been hampered by certain artificial barriers. In particular, this applies to the introduction of a moratorium (by Ukraine, in 2015) on the exports of timber and lumber in raw form (rough logs). The vast majority of these exports came to the EU. The moratorium was introduced for 10 years. It was a forced measure aimed at protecting forests from predatory, unrestricted logging. Local woodworking companies benefited from the moratorium. Well-known international companies such as Kronospan have invested in the Ukrainian woodworking industry. However, the moratorium did not radically solve the problem of predatory logging. This is evidenced by reports from the British non-governmental company Earthsight (*Flatpacked Forests*, 2020). Radical reform of the State Agency of Forest Resources of Ukraine and the introduction of a civilized timber market are needed.

Trade liberalization has not helped to attract additional foreign direct investment from the EU into Ukraine's economy. If during 2010-2013 investments increased by 30%, during 2016-2019 they increased by only 18%. The absolute amount of investment also decreased. If during 2010-2014 foreign direct investment averaged $38.0 billion, and then during 2016-2020 - averaged $35.1 billion. This can be explained in part by the slower growth of the economy after liberalization, as well as the loss of control over part of the territory.

EU investment in Ukraine has become more diversified. The Netherlands, Germany, Austria and France were the largest investors in Ukraine before liberalization and remained so after the formation of the DCFTA. However, before liberalization, the total share of these countries in investment was 47%, and after the formation of the DCFTA it decreased to 41%. During 2016-2020, foreign direct investment increased from Luxembourg (3.0 times), Slovakia (2.8 times), Slovenia (2.2 times), and Croatia (2.1 times). The Netherlands, as the largest investor in the Ukrainian economy, also increased direct investment by 25%.

The DCFTA did not help reduce the share of offshore companies in foreign direct investment. During 2016-2020, the share of offshore companies registered in Cyprus in EU FDI in Ukraine was 41%. For comparison, during 2010-2014 their share was 34%. These are mainly investments of Ukrainian entrepreneurs who avoid taxation. These FDI do not contribute to the modernization of the economy and the transition to European standards (Adarov & Havlik, 2016). In Eastern Europe, the share of offshore companies in investment is small, and the share of companies from Western Europe is large. In particular, in Poland the share of EU-15 countries in FDI in 2016 was 86%, in Romania - 80%, Slovakia - 70%, in Serbia - 64% (Adarov & Havlik, 2016).

According to the Association Agreement, Ukraine has undertaken to create a regulatory environment according to European standards. This is the main prerequisite for increasing European investment in the Ukrainian economy. Tax levels, political stability, a favorable macroeconomic environment, prospects for economic growth and increased household incomes are also important. In order to facilitate the attraction of foreign direct investment in 2016, the Ukraine Investment Promotion Office (UkraineInvest) was established under the Cabinet of Ministers of Ukraine. It was a permanent advisory body. In 2018 this advisory body received the status of a state institution.

Even before the establishment of the DCFTA, well-known European companies launched production activities in Ukraine: Carlsberg, Anheuser-Busch InBev, Bell Group, Electrolux, Fisher Sports, Nexans, Danone Groupe, Groupe Lactalis, Unilever, Pfeifer&Langen, and Pulp Mill Holding. These companies have mastered European production standards. There are no technical barriers to exporting their products to the EU market. Using Ukraine's cheap resources and the preferential treatment created by the DCFTA, they have the potential to increase exports to the EU. Moreover, after 2016 the CIS market for their products is closed.

The potential of European companies to increase exports to the EU was only partially used. Nexans increased its exports by 34%, while Fisher Sports exports decreased by 6%. Exports of beer after liberalization increased by 77%. However, the share of Ukrainian beer in exports to the EU is insignificant. In particular, in 2019 Ukraine exported $0.27 million worth of beer to Germany (United Nations, 2020). Mexico has also a free trade area with the EU. In 2019 Mexico exported $6 million worth of beer to Germany. Ukraine exported $0.04 million worth of beer to Italy. Mexico exported $34 million worth of beer to Italy in 2019.

Export of dairy products to the EU also remained minimal after liberalization. The French company Bel has production facilities in the city of Shostka. These are the only production facilities of this company in the CIS countries. During 2011-2013, the export of Ukrainian cheeses to the CIS countries averaged $387 million per year. In 2016-2018, exports decreased to $23 million on average per year. Proportionately, the exports of products of the Bel plant in Shostka to the CIS countries have decreased. However, exports to the EU were reoriented to a minimum. In particular, in 2019, Ukrainian cheese (0406) was not exported to Germany, France or Italy at all. At the same time, cheese exports from New Zealand amounted to $2 million. New Zealand has no preferences in trade with the EU.

The French companies Danone Groupe and Groupe Lactalis only partially took advantage of the preferential treatment. In particular, in 2018, the duty-free quota "Milk, cream, condensed milk and yogurt" was used by 6%, and the quota "Powdered milk" - by 35%. Thus, EU companies that are focused on the CIS market have made minimal use of the benefits of preferential trade with the EU. The same applies to multinational corporations from other countries that carry out production activities in Ukraine. The American company PepsiCo is engaged in the production of dairy products in Ukraine. Transnational corporations, which are mainly focused on the EU market (Nexans, Fisher Sports, Electrolux, etc.), have taken advantage of the preferential regime of the DCFTA.

After the introduction of the DCFTA of Ukraine with the EU, production from customer's materials was intensified. These activities were launched by EU companies long before the formation of the DCFTA. It mainly concerned the production of textiles and footwear of European brands at Ukrainian enterprises. All raw materials and equipment were imported from the EU. The vast majority of manufactured products were exported to the EU. During 2010-2013, exports to the EU of textiles, knitwear and footwear (HS 2-digit code - 61-64) decreased by 2%. After liberalization, during 2016-2019, exports increased by 19%. The increase occurred in all product groups.

Pursuant to Article 29 of the Association Agreement, after 5 years of the establishment of the DCFTA, the preferential terms of trade may be revised. The EU has opened 36 tariff quotas for Ukraine. Some of these tariff quotas were used for less than 1% over five years (mushrooms, processed butter products, lamb, etc.). It is advisable to reduce the volume of these quotas and increase the volume of quotas for products that are in high demand in the EU market (honey, corn, processed sugar products, processed milk cream products, etc.). The process of amending trade preferences began in July 2019 with the conclusion of the Agreement in the form of an exchange of letters between Ukraine and the EU on poultry meat and processed poultry meat (Council Decision, 2019).

4. CONCLUSION

The formation of the DCFTA between Ukraine and the EU has contributed to the development of Ukrainian exports. Exports to the EU have increased and become more diversified. The number of Ukrainian companies exporting products to the EU has increased. Further increases in exports were hampered by relatively small values of tariff quotas. Exports of 11 product groups were 2 or more times higher than the tariff quota. Technical barriers to trade and sanitary and phytosanitary measures also remain significant obstacles to increasing exports.

Trade liberalization has not helped attract foreign direct investment from the EU to Ukraine. The share of FDI of offshore companies remained large. The creation of a favorable investment climate and the introduction of European standards of business regulation remains an urgent task.

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